

THE ROLE OF THE SECONDARY MARKET IN SUBPRIME MORTGAGE LENDING

HEARING

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
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CONTENTS

| | Page |
|----------------------|------|
| Hearing held on: | |
| March 27, 2007 | 1 |
| Appendix: | |
| March 27, 2007 | 61 |

WITNESSES

WEDNESDAY, MAY 8, 2007

| | |
|--|----|
| Calhoun, Michael D., President and Chief Operating Officer, Center for Responsible Lending | 17 |
| Heiden, Cara, Division President, Wells Fargo Home Mortgage | 8 |
| Kennedy, Judith A., President and CEO, National Association of Affordable Housing Lenders | 19 |
| Kornfeld, Warren, Managing Director, Moody's Investors Service | 10 |
| Lampe, Donald C., partner, Womble Carlyle Sandridge & Rice, PLLC | 14 |
| Litton, Larry B., Jr., President and CEO, Litton Loan Servicing LP | 15 |
| Mulligan, Howard F., partner, McDermott Will & Emery | 12 |

APPENDIX

| | |
|-------------------------------|-----|
| Prepared statements: | |
| Maloney, Hon. Carolyn B. | 62 |
| Gillmor, Hon. Paul E. | 65 |
| Calhoun, Michael D. | 66 |
| Heiden, Cara | 83 |
| Kennedy, Judith A. | 87 |
| Kornfeld, Warren | 99 |
| Lampe, Donald C. | 119 |
| Litton, Larry B., Jr. | 129 |
| Mulligan, Howard F. | 137 |

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

| | |
|--|-----|
| Maloney, Hon. Carolyn B.: | |
| Newspaper article entitled, "Predatory Lending in NY Compared to S&L Crisis, As Subcrime Disparities Worsen" | 145 |
| Statement of the National Association of Realtors | 149 |

THE ROLE OF THE SECONDARY MARKET IN SUBPRIME MORTGAGE LENDING

Wednesday, May 8, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn B. Maloney [chairwoman of the subcommittee] presiding.

Present: Representatives Maloney, Watt, Waters, McCarthy, Green, Miller of North Carolina, Scott, Cleaver, Bean, Ellison, Klein, Perlmutter; Gillmor, Price, Baker, Pryce, Castle, Biggert, Capito, Feeney, Hensarling, Neugebauer, and Campbell.

Ex officio: Representative Bachus.

Chairwoman MALONEY. This hearing will come to order. This is the third in a series of hearings that the full committee and this subcommittee are holding on the topic of subprime lending, and what legislative action, if any, might be appropriate to address the rapidly growing subprime mortgage crisis.

We started with a hearing on March 27th, where we heard from the Federal regulators on their proposed guidance to strengthen underwriting and correct abuses in subprime lending, and from industry and consumer representatives on what the likely effect of that guidance might be.

We then had a hearing on April 17th on how subprime borrowers presently facing default or foreclosure could be assisted by the housing GSEs, the FHA, or the private sector.

Our topic today is the role of the secondary market in subprime mortgage lending. We will specifically examine how that market has contributed to the expansion of the subprime mortgage sector and what characteristics of the secondary market should be considered when proposing remedies for borrowers or reform of the subprime lending system.

The crisis in subprime lending is wide ranging and complex, requiring the expertise of several of our subcommittees. I want to especially acknowledge the prior work of Congressman Kanjorski, chairman of the Capital Markets Subcommittee, and his staff, in this particular area, and to thank them for their contribution to this hearing.

I also want to welcome all of the witnesses, and to thank them for making time to appear before us today, to help us understand

and grapple with the highly complicated and powerful dynamic of securitization.

There is no question that the huge growth of the secondary market from 1986 on has greatly supported the expansion of credit, and the availability of mortgage financing on a much wider basis than ever before.

With the legal structure put in place by the Tax Reform Act of 1986, and its predecessor, the Secondary Market Mortgage Enhancement Act of 1984, mortgage-backed securities burst out of the GSEs and became private sector business.

Private label issuers moved quickly to utilize the full range of the market opportunities available through the creation of REMICs, real estate mortgage investment companies. REMICs not only offered tax advantages, but also made mortgages an investment in which large investors could participate, since they could structure the risk to meet their needs.

Since the tax laws and accounting rules made it very difficult to alter the securities in the static pool of a REMIC, investors could take a fixed part of the payment stream and know what risks they were exposed to.

In the popular press, the irresponsible growth of the subprime market is often blamed on the securitization process. We read every day that borrowers were put in mortgages they could not repay, because of the pressure on Wall Street to satisfy the appetite of investors, both foreign and domestic, and the vast fortunes to be made doing so.

I hope the witnesses today will put some facts and structure to these generalities, and explain how we can make sure the incentives in this market are aligned with sound policy and not against it. I also hope they can explain the difficulties and issues that are presented by current proposals to restructure loans that have been securitized.

To some extent, we began this discussion in our last hearing, when the housing GSEs and the FHA came in to tell us what they were doing to help borrowers move out of loans that are resetting to unaffordably high rates. By some estimates, the GSEs and the FHA can help 50 percent of the borrowers in this predicament, because by having made 12 months of regular payments on their loans, these borrowers qualify for a better fixed rate loan from these entities. That still leaves a great deal of borrowers in need of help.

Also, while in our last hearing we discussed how to help the borrowers in this crisis, in this hearing I also want to explore what we can and should do to avoid a repeat of this vicious cycle in the next housing bubble.

One point that all players in the industry have been quick to point out is that no one makes money when a borrower loses his house and gets put out on the street. If true, that should provide a strong motivation for all participants to help borrowers stay in their homes, through a market-based solution. That is the guiding principal behind recent efforts, such as the FDIC's conference 3 weeks ago, or Senator Dodd's summit last month.

I am generally a supporter of market-based solutions, and I am hopeful that these efforts at dialogue will provide a way for the pri-

vate sector to find a solution. But as these hearings should make clear, this committee is by no means waiting for the private sector to do what it thinks is right to solve this rapidly growing crisis. Market-based solutions sometimes don't provide sufficient protections to those with little market power, in this case our constituents, who face the loss of their homes.

To help shift the balance, States have pioneered assignee liability protections that have had some good results, although the Georgia problems demonstrate what happens when one State goes too far, and the power of the rating agencies and the market to shut down a remedy that does not meet market needs.

My intent in this hearing today is to discuss what Congress or regulators can do to encourage support, or, if necessary, mandate changes to the incentives that created the problem we face today, without creating unanticipated problems in the market. It is a difficult assignment, but one we must make.

I look forward to the dialogue we will have today with our witnesses, and I thank you again for coming. I recognize Mr. Gillmor for 5 minutes.

Mr. GILLMOR. I thank the chairwoman for yielding, and also for calling this important hearing today. Turmoil in the subprime lending market continues to cause all of us great concern.

Ohio, regrettably, remains one of the leaders in subprime mortgage foreclosure at a time when we prefer to be number one in something else. This is the third committee hearing this year on the causes and potential solutions to the increase in subprime defaults, and it's my hope that this committee will take a deliberative approach when considering the ways to respond.

An overreach by Congress during this cyclical downturn in the housing market could put significant road blocks to the perspective home buyers looking to join the American dream, and that is the exact opposite of the impact we want.

The evolution of the secondary mortgage market has been critical to the levels of home ownership we experienced over the last few years. The securitization of subprime loans alone is now close to half a trillion dollars. Today we have both increased liquidity and a marked downturn in home price appreciation. Unfortunately, lenders in recent years have loosened underwriting standards, and all of those factors have led to the wave of defaults we are currently experiencing.

There is no silver bullet to solve the problem, but I do look forward to considering all of the various legislative proposals that will come before us. We have a great panel of experts assembled today, and I look forward to receiving their testimony. I yield back the balance of my time.

Chairwoman MALONEY. I thank the gentleman, and I yield 3 minutes to Mr. Watt, who has a long history of working hard on this issue, and working with the North Carolina State law. Mr. Watt?

Mr. WATT. Thank you, Madam Chairwoman, and I won't take 3 minutes, I don't think. I just want to take the opportunity to applaud the chairwoman for the continuing series of hearings that she has conducted, and continues to conduct on this issue, because at some point, we need to get to the point that we understand the

various elements that play into the rising rate of foreclosures, and whether there is a government role, a legislative role, that we have to implement to address that concern, and, if so, what that legislative role is.

What we have found up to this point is that there is a very complicated web of contributors to this issue that makes it very difficult and unwieldy to unwind. You have the borrower, on one hand, and then you have a series of people on the other hand that, if you look at this very superficially, you miss part of.

You have a lender over there, you have a servicer over there, you have a broker over there, you have a pooling and servicing agreement over there, you have a REMIC over there, you have a whole group of entities that play into this mess that we are trying to deal with. And it's kind of like the Pillsbury Dough Boy; if you push in one place, it juts out somewhere else.

We need to know, not only where we need to push in, but if we're going to push in at a certain point in the process, we need to know where it's going to jut out, and what consequences it's going to have on the other end of our push. And the only way we can get to that, really, Madam Chairwoman, is to do exactly what you are doing.

The reason I applaud you for doing it is that we need to understand, this committee, if we are going to legislate, or if the Financial Services Committee, or the whole House or Senate is going to legislate, we all need to know how these various components fit together. And that's the benefit, I think, of having these hearings, because it's very complicated and intricate.

And I said I wouldn't take 3 minutes, but I did, anyway. But since I was applauding the chairwoman, she didn't gavel me.

[Laughter]

Mr. WATT. So I will yield back, Madam Chairwoman.

Chairwoman MALONEY. Thank you, Mr. Watt. The Chair recognizes Congressman Bachus for 5 minutes.

Mr. BACHUS. I thank the chairwoman for holding this hearing. As I think we all know, the growth in the subprime market over the past decade has been dramatic. And, really, what has fueled this growth has been the development of a robust secondary market for subprime loans.

By selling loans that originate into the secondary market, rather than retaining them in their own portfolios, subprime lenders have been able to obtain fresh capital that can be recycled into new mortgage loans.

Now, while it does diffuse risk across a broad spectrum of a market among all the participants, it also enhances liquidity in the subprime market. And, most importantly, it expands the availability of credit to low- and moderate-income borrowers. We should never forget that a lot of people are home owners today because of the secondary market, and because of the credit they received as a result of the assignment of these mortgages.

Some have questioned the fairness of imposing liability on these secondary market participants for violations that cannot possibly be detected through review of the loan documentation on which their underwriting judgements are based.

In fact, credit rating agencies, such as Standard and Poors, have simply refused to rate mortgage-backed securities containing subprime loans originating in jurisdictions with particularly vague or open-ended assignee liability standards, and that has left legitimate lenders with no way to securitize subprime loans, which significantly curtails the availability of mortgage credit to low- and moderate-income borrowers.

A very active member of this committee, Mr. Price from Georgia, has reminded us of the Georgia example, where overly burdensome restrictions have caused a credit crisis to occur. The Georgia legislature passed an onerous law with strict assignee liability and the result was that low- and moderate-income Georgians with less than perfect credit weren't able to get a loan until the Georgia legislature fixed the problem by amending that flawed statute. I know Mr. Price will probably have some more to say about that.

It is important for all participants in the mortgage process to share responsibility—from the consumer to the lender to the secondary market.

I am not advocating that the secondary market escape liability. However, assignee liability should not be about going after those with deep pockets. The secondary market's role in the mortgage process, while important, does not compare to the primary role of the mortgage originator. Secondary market participants have no way of knowing what transpires between the consumer and loan originators during the transaction.

For this reason, those involved in the origination process should shoulder more of the responsibility. The assignee liability standard in current law, under the Home Ownership Equity Protection Act (HOEPA), does not work. HOEPA loans are not being made, mainly because of the lack of legal certainty for secondary market participants.

As we look for ways to address predatory lending practices, any assignee liability standard must include safe harbor provisions similar to those contained in the New Jersey predatory lending law: a limitation on damages; a prohibition on class action lawsuits; and a clear due diligence standard.

This is an important issue. We need to get it right. If Congress doesn't proceed with caution, the end result could be a credit crunch that continues to harm, and really worsen, what we already are seeing in the market. And what it will do is it will harm low- and middle-income Americans and their ability to finance the purchase of a home, and damage the mortgage lending industry on who they depend for home ownership.

Let me conclude by thanking our witnesses for taking the time to be here today. I have worked with several of you when, last year, we tried to put together a subprime lending bill. I am sorry, looking back on that, that we weren't able to come to an agreement. I think it would have saved some people from losing their homes.

But speaking for the Republican members of this committee, we are genuinely interested, the members of the subcommittee, in hearing what each of you has to say, and I thank you for being here.

Chairwoman MALONEY. Thank you. The Chair recognizes Congressman Scott from Georgia, who has been deeply involved in this issue.

Mr. SCOTT. Thank you, Madam Chairwoman, and I just want to, again, commend you for holding these hearings. They are very, very important, and very, very timely.

Just briefly, it seems that most banks depend greatly on the secondary market, and in view of the recent subprime meltdown, it would be very helpful for us to get your feelings on what effect this meltdown has on other mortgage markets, and the ability for banks to be able to sell their more prime loans on the secondary market. I think that would be very helpful and sort of a key question here today.

The other one is, as the follow-up on Mr. Bachus, who mentioned about our rather interesting misadventure in the Georgia legislature—of course, I am a former member of the Georgia legislature, and we have grappled with this issue in Georgia, because we are one of the leading States in foreclosures. And, certainly, in so many unfortunate incidences, we have become the poster child for predatory lending practices.

So, it would be very interesting to get your take on just what the standard for assignee liability should be. I think it would be very helpful for us to really examine that today. We can leave this hearing much smarter, much wiser, if we could come up with that, and one that works, and as we grapple with this very, very important subprime lending issue.

Madam Chairwoman, I yield back the balance of my time, and I thank you very much.

Chairwoman MALONEY. Thank you. The Chair recognizes Congressman Price from Georgia for 3 minutes.

Mr. PRICE. I thank the chairwoman, and I will be very, very brief.

I want to join my colleague, Congressman Scott. He and I both served in the Georgia State senate when the action on this issue was occurring. And I want to thank the Chair for this hearing and the others on this important area.

Georgia, as everyone well knows, has a significant history, I think from which we all may learn more about the appropriate—and maybe the inappropriate—role of government.

And so, I look forward to the comments of the members—the witnesses who are here, and I want to thank you for taking the time to be with us. And, hopefully, you will be able to educate us on how far government ought to go and not go. I yield back.

Chairwoman MALONEY. The Chair recognizes Congressman Hensarling from Texas for 2 minutes.

Mr. HENSARLING. Thank you, Madam Chairwoman. As I often say at these hearings and mark-ups, I am reminded of the charge, “First, do no harm.”

And as we approach this challenge in our Nation’s history some have described as a crisis—I don’t know if it’s a crisis or not, but a crisis does suggest a Draconian remedy. And, clearly, assignee liability is one of the remedies that is being discussed. It is one that potentially troubles me greatly.

I see many people in the secondary market, frankly, following, really, Federal policy in trying to make credit more available to low-income people, people who may have a checkered credit past.

I, for one, believe that great things have been done in the subprime lending area, making credit available to people who have never had it before, and giving them the ability to recognize their American dream. And if I am reading the data correctly, delinquency rates on subprimes are still below where they were in 2002, as are foreclosure rates. Not that the recent upward trend has not been disconcerting, but they are still lower than what we have seen in the past.

I just want to make sure that the roughly 85 to 87 percent of the loans that are still compliant are not harmed by any remedy that we may come up with, so I think we ought to study very carefully what has happened in the HOEPA market, what has happened in Georgia, and what has happened in North Carolina, and be reminded of all the people who have realized the American dream of home ownership through subprime lending.

And, with that, I yield back my time. Thank you.

Chairwoman MALONEY. Thank you. Our first witness is Ms. Cara Heiden, division president of Wells Fargo Home Mortgage. Ms. Heiden has been with Wells Fargo since 1981, and has served as division president of Wells Fargo Home Mortgage since 2004.

She will be followed by Mr. Warren Kornfeld of Moody's Investors Service. Mr. Kornfeld is the managing director for the residential mortgage-backed securities rating team at Moody's Investors Service.

Following Mr. Kornfeld, we have Mr. Howard Mulligan, attorney at law, at the firm of McDermott, Will and Emery. Mr. Mulligan is a constituent of mine, so I want to give him a very warm welcome. And he is here at the request of the chair of the capital markets subcommittee, Mr. Kanjorski. Mr. Mulligan is a partner at McDermott, Will and Emery, and has practiced and has focused on a wide range of securitizations and structural finance transactions involving commercial mortgages, and residential mortgages, among other things.

I am going to yield to Congressman Price to introduce Mr. Lampe.

Mr. PRICE. Yes, thank you so much. I appreciate that. And although Mr. Lampe isn't from Georgia, he was instrumental in the Georgia fix.

Mr. Lampe is a partner with the firm Womble Carlyle Sandridge & Rice, and a recognized national expert on fair lending standards, especially the issue of predatory lending.

He was initially asked to help clean up the mess from the original Georgia Fair Lending Act, enacted by our general assembly in 2002. That original bill was effective on October 1, 2002, and there were reports of many problems in the secondary market almost immediately. GSEs declined to purchase Georgia home loans, and the rating agencies decided they were unable to rate loans that contained post-Georgia Fair Lending Act home loans.

Three trade associations testified jointly on the need to correct the original version, and Mr. Lampe was the expert who spoke on the technical aspects, mostly on the secondary market. And at the

request of the legislative leadership, he worked tirelessly with all groups on all sides. And immediately upon the bill that we passed, and the signature by the Governor, the secondary market opened up with the acute problem being solved.

Georgia still has one of the toughest anti-predatory lending laws in the country, but without assignee liability for the secondary market purchasers of the loan. And since the enactment of the Georgia law in 2003, Mr. Lampe has worked on legislation in many other States, and his reputation as a recognized expert continues to grow in this area. We welcome him, and all of the other witnesses. Thank you, Madam Chairwoman.

Chairwoman MALONEY. Thank you. And we also welcome Mr. Larry B. Litton, Jr., president and CEO of Litton Loan Servicing. Mr. Litton founded Litton Loan Servicing in 1988, to be a subservicer of problem loans from various mortgage servicers and private investors. He brings with him an extensive knowledge of the loan servicing business.

And we welcome Mr. Michael Calhoun, president and chief operating officer for the Center for Responsible Lending. Mr. Calhoun has extensive knowledge and experience in all aspects of consumer lending, especially lending within the subprime mortgage market.

And, finally, we have Ms. Joan Kennedy, president and CEO of the National Association of Affordable Housing Lenders, NAAHL. Under Ms. Kennedy's leadership, NAAHL has become recognized as the premier authority in the Nation's capital on private lending and investing in low- and moderate-income communities. She is a former staff member of this committee, as well as the Senate Banking Committee and HUD.

And, without objection, all of your statements will be made part of the record. You will each be recognized for a 5-minute summary of your testimony, and I recognize Ms. Heiden for 5 minutes. Thank you.

STATEMENT OF CARA HEIDEN, DIVISION PRESIDENT, WELLS FARGO HOME MORTGAGE

Ms. HEIDEN. Chairwoman Maloney, Ranking Member Gillmor, and members of the subcommittee, thank you for the invitation to testify today.

Understanding your focus is on the secondary market, I have been asked to provide context for the role of the lender and servicer in the mortgage lending cycle. This includes the efforts we undertake every day to make the dream of home ownership achievable and sustainable for a wide spectrum of consumers, under terms that are appropriate for all transaction stakeholders, including the secondary market.

I am Cara Heiden, and together with co-president Mike Heid, I lead Wells Fargo Home Mortgage, the Nation's leading mortgage lender, and the largest servicer, with more than 7.7 million customers, and loan balances, totaling \$1.4 trillion.

Ninety-four percent of the loans we service are for other investors, and the vast majority are packaged into mortgage-backed securities. We have consistently achieved the highest rankings for servicing practices by Fannie Mae, Freddie Mac, HUD, private investors, and our rating agencies.

Having spent the past 25 years at Wells Fargo, I can honestly tell you that our fair and responsible lending and servicing principles are not viewed as policies by which we all must abide, but rather, the moral fabric upon which our business operates.

Culturally, we have always been, and we remain, committed to the lifetime customer relationship. Our vision is all about helping our consumers achieve financial success. And this includes, importantly, treating non-prime borrowers fairly and responsibly.

Along with our prudent credit underwriting, here are the examples of practices we follow. First, and foremost, we only approve applications for loans if we believe the borrower does have the ability to repay. We provide consumers with the information needed, helping them to make fully informed decisions about the terms of our loans. We do not make pay option ARM, or loans with negative amortization.

We have controls to ensure that first mortgage customers are offered prime pricing options when they qualify, based on their credit characteristics and the terms of their loan transaction.

We advise customers who apply for loans with pre-payment fees of the availability of loans without them, and we help them understand the associated cost impacts. We also limit our pre-payment fees to the lesser of 3 years, or the fixed term of an adjustable rate loan.

And, finally, we only make a loan if it offers a demonstrable benefit to the consumer, such as reducing the monthly payment on debt, obtaining significant new money, or purchasing a new home.

Our responsible lending principles have been publicly posted for years on our wellsfargo.com Web site, for all consumers to read.

In addition, we have a series of longstanding responsible servicing practices that serve the needs of our customers and our investors. We proactively contact customers in default, and work with them, on a case-by-case basis, to find solutions that help them remain in their home, and to protect their credit. Most customers never miss a payment. But for those who do, we have experts dedicated to working with them early, often, and typically, up to the actual point of foreclosure.

In addition, we work extensively with local organizations and credit counselors that provide assistance to borrowers. Importantly, the lending and servicing principles I have just described are ever-green, meaning they are designed to survive every economic cycle. Occasionally, such as in the current unique economic environment, it is even more important to live by these principles.

For instance, we are collaborating with the investor community. We must develop more options to assist customers facing difficult adjustable rate mortgage resets. This work involves introducing greater levels of flexibility and loan modifications and customer loan work-outs. We do this, understanding that the solutions must align with investor, trustee, and master servicer contractual and credit obligations.

Also, in outreach to new borrowers or those refinancing, we launched our Steps to Success program in mid-2006. This free program provides financial education, the means to be more familiar with credit reports, and information about banking products that can help make money management routine and effective for them.

This program is proving to be beneficial to those who do need assistance.

In closing, let me reiterate that Wells Fargo is firmly committed to continuing to lead the industry in advocating and conducting fair and responsible lending and servicing. It is critical that mortgage lenders and servicers live by principles that eliminate troublesome practices, and help consumers through their challenging times.

We look forward to continually working with all the participants in the housing finance industry to find more solutions that benefit consumers, expanding home ownership, and preserving it.

Thank you again, Chairwoman Maloney, Ranking Member Gillmor, and members of the subcommittee, for your time today, and for this opportunity to share Wells Fargo's day-to-day responsible lending and servicing practices. I will be happy to answer any questions this subcommittee may have.

[The prepared statement of Ms. Heiden can be found on page 83 of the appendix.]

Chairwoman MALONEY. Thank you.

**STATEMENT OF WARREN KORNFELD, MANAGING DIRECTOR,
MOODY'S INVESTORS SERVICE**

Mr. KORNFELD. Good morning Congresswoman Maloney, Ranking Member Gillmor, and members of the subcommittee. I appreciate the opportunity to be here on behalf of my colleagues at Moody's Investors Service.

By way of background, Moody's role is limited to publishing rating opinions that speak only to one aspect of the subprime securitization market, which is the credit risk associated with the bonds we are asked to rate that are issued by securitization structures.

The use of securitization has grown rapidly, both in the United States and abroad, since its inception approximately 30 years ago. Today, it is an important source of funding for financial institutions and corporations. Securitization is, essentially, the packaging of a collection of assets, which could include loans, into a security that can be sold to bond investors. Securitization transactions vary in complexity, depending on specific structural and legal considerations, as well as on the type of asset that is being securitized.

Through securitization, mortgages of many different kinds can be packaged into bonds commonly referred to as mortgage-backed securities, which are then sold into the market like any other bond. The total mortgage loan origination volume in 2006 was approximately \$2.5 trillion, and of this, approximately \$1.9 trillion was securitized.

Furthermore, we estimate that roughly 25 percent of the total mortgage securitizations were backed by subprime mortgages. Securitizations use various features to protect bond holders from losses. These include over-collateralization, subordination, and excess spread. The more loss protection or credit enhancement a bond has, the higher the likelihood that the investors holding that bond will receive the interest and principal promised to them.

When Moody's is asked to rate a subprime mortgage-backed securitization, we first estimate the amount of cumulative losses the underlying pool of subprime mortgage loans will experience

over the lifetime of the loans. We do not see actual loan files, or data identifying the borrowers, or specific properties; we rely on information provided by the originators or the intermediaries. The underlying deal documents provide representations and warranties on numerous items, including various aspects of the loans, the fact that they were originated in compliance with applicable law and regulations, and the accuracy of certain information about those loans.

Moody's considers both quantitative and qualitative factors of loans to arrive at the cumulative loss estimate. We then analyze the transaction structure and the level of loss protection allocated to each class, or tranche, of bonds.

Finally, based on all this information, a Moody's rating committee determines the rating of each tranche. Moody's regularly monitors its ratings on securitization tranches through a number of different steps. We receive updated loan performance statistics, generally, monthly. A Moody's surveillance analyst will further investigate the status of any outlier transactions, and consider whether a rating committee should be convened to consider a ratings change.

A majority of the subprime mortgages contained in the bonds that Moody's has rated or originated between 2002 and 2005 have been performing better than historical experience might have suggested. In contrast, the mortgages that were originated in 2006 are not performing as well. However, they are performing, at this early stage, in line with mortgages originated in 2000 and 2001.

While the employment outlook today is stronger than the post-2000 period, the outlook for the other major drivers of mortgage losses—home price appreciation, interest rates, and refinancing opportunities for subprime borrowers facing rate payment resets—is less favorable.

From 2003 to 2006, Moody's cumulative loss expectations for subprime securitization steadily increased by approximately 30 percent in response to the increasing risk characteristics of subprime mortgage loans, and changes to our market outlook.

As Moody's loss expectations have steadily increased over the past few years, the amount of loss protection on bonds we have rated has also increased. We believe that performance of these mortgages will need to deteriorate significantly for the vast majority of the bonds we have rated single A or higher, to be at risk of loss.

Finally, I want to give Moody's view on loan modifications by servicers in the event of a borrower's delinquency. Loan modifications are typically aimed at providing borrowers an opportunity to make good on their loan obligations. Some MBS transactions, however, have limits on the percentage of loans in any one securitization pool that the servicer may modify.

Chairwoman MALONEY. I grant the gentleman 60 additional seconds.

Mr. KORNFELD. Okay. Moody's believes that restrictions on securitizations which limit servicers' flexibility to modify distressed loans are generally not beneficial to holders of the bonds. We believe loan modifications can typically have positive credit implications for securities backed by subprime mortgage loans.

With that, I thank you, and I would be pleased to answer any of your questions.

[The prepared statement of Mr. Kornfeld can be found on page 99 of the appendix.]

Chairwoman MALONEY. Mr. Mulligan?

**STATEMENT OF HOWARD MULLIGAN, PARTNER, McDERMOTT
WILL & EMERY**

Mr. MULLIGAN. Thank you, and good morning. My name is Howard Mulligan, and I am a partner in the New York office of the international law firm of McDermott Will and Emery.

For the past 14 years, I have been engaged in representing issuers, underwriters, servicers, bond insurers, and rating agencies in securitization and other structured finance transactions, including the securitization of home mortgages. I am pleased to be here today to testify, based on my experience with regard to securitization, generally, and also with regard to issues related to the rural and the secondary market in subprime lending.

I commend the committee, the chairwoman, the ranking member, and the others on the Financial Services Committee for calling these hearings.

Home ownership is widely viewed as a salient feature of the American cultural landscape. Federal law reflects the importance of home ownership in the United States, by encouraging and assisting deserving families in endeavoring to purchase a home. The capital markets have also contributed substantially to expanding the availability, and reducing the cost of mortgage credit, by coupling investors and home-buying families through the process of mortgage securitization.

Home mortgage credit is more widely available today, and at a relatively lower cost, than ever before. This is due, in no small part, to securitization and secondary mortgage market activity.

Mortgage securitization is the process of packaging and bundling a mortgagee's monthly principal and interest payments of home mortgage loans, and then using these payments to back mortgage-backed securities, which are sold to institutional investors, such as pension funds, insurance companies, and mutual funds, in either private placements or public transactions. Mortgage securitizations are structured and implemented in accordance with the requirements and expectations of the national rating agencies.

In a myriad of ways, securitization transactions have made mortgage loans more available and affordable to American consumers. First, securitization taps on a wide and deep reservoir of capital sources to fund the mortgage lending market. Institutional investors, both inside and outside the United States, generally do not want to hold individual mortgage loans in their investment portfolios, because of the risk attributable to an unrated, ordinary consumer.

However, because of the risk mitigants and rating enhancers inherent in the technology and scaffolding of structured finance transactions, these institutional investors are active buyers of mortgage-backed securities, making funds available to American families that they can use in the process of buying homes.

The ability of mortgage lenders to sell mortgages in the secondary market promptly, efficiently, and with substantial certainty, increases funds available to lend, and significantly reduces consumer borrowing costs.

Second, mortgage-backed issuances provide a way for mortgage originators to sell the loans that they originate, which, in turn, creates and generates new capital for the extension of new loans to consumers.

Before securitization became widely prevalent, banks funded mortgage loans through their customers' deposits, and mortgaged credit was largely dictated, in most cases, by the volume of bank deposits. Today, because of the outlet of securitization, and the flexibility that such securitization transactions provide, banks, mortgage companies, financial service companies, and other lenders, have the option of selling loans into the secondary market, rather than merely retaining the loans on their books for the entire term of the loans.

Third, securitization not only mitigates, but specifically tailors, the risk of investing in mortgages. The professionals—the lawyers, the accountants, the investment bankers—that structure mortgage-backed transactions have formulated innovative methods, including derivative enhancements, and other synthetic techniques, of segmenting the risks associated with investing in mortgages, and creating securities that allow investors to assume the precise level of risk to which that individual investor is comfortable.

Fourth, and finally, in disbursing mortgage-related securities across a wide array of purchasers, including purchasers outside the United States, the widespread securitization of residential mortgage loans has decreased the systemic risk of regional mortgage holdings in local banks.

Because mortgage-backed issuances are less concentrated, the risk of borrower default has been allocated more efficiently. And, as a result, it is less dependent on individual localized real estate markets.

The mortgage market is largely predicated on certainty. The fundamental goal of a securitization issuance is—

Chairwoman MALONEY. The Chair grants an additional 60 seconds.

Mr. MULLIGAN. Yes, I appreciate that. Again, I would like to urge members today that in implementing legislation, to take a cautionary role to remember that the mortgage market is predicated on legal certainty, that the imposition of assignee liability, if over-extended, could impair the secondary mortgage market, and that mandated forbearance could be punitive and inflexible.

Again, in closing, I would ask that in legislating a national framework for anti-predatory lending, that Congress consider the assiduous enforcement of existing law, consumer education and disclosure, and robust education and disclosure, a preference for uniform and objective standards, and, in many cases, allow the market response, which has been effective, to take hold.

Thank you. I am happy to answer any questions that the subcommittee may have.

[The prepared statement of Mr. Mulligan can be found on page 137 of the appendix.]

Chairwoman MALONEY. Mr. Lampe?

**STATEMENT OF DONALD C. LAMPE, PARTNER, WOMBLE
CARLYLE SANDRIDGE & RICE, PLLC**

Mr. LAMPE. Madam Chairwoman, Ranking Member Gillmor, and members of the subcommittee, thank you for providing me the opportunity to be here today. I am Don Lampe, and I am a partner in the Charlotte office of Womble Carlyle Sandridge & Rice. I have been involved extensively in State legislative activity to regulate predatory lending and high-cost home loans, including the effort in Georgia.

I have been requested to testify today on the following topics related to the secondary market and subprime mortgage lending. One, is there a need for additional legislation? Two, specifically, how would the imposition of assignee liability affect the secondary market, and are there State experiences that we can look to as examples?

The Georgia Fair Lending Act is cited most frequently, if not most notoriously, as an example of how well-intended legislators may go too far, and our experiences in Georgia are instructive, as this body considers similar legislation. After the Georgia law became effective in 2002, the secondary market began to close down in Georgia. Not just the secondary market for subprime loans, or high-cost loans, but the secondary market, generally, for all mortgage loans for all of the citizens.

Why did this happen in Georgia? Well, the Georgia Fair Lending Act imposed unlimited, unconditional assignee liability on anyone who became an assignee or a holder of a mortgage loan. It was strict liability to anyone who touched a home mortgage loan. There were no policies and procedures built into the statute whereby compliance, good faith compliance, or due diligence would mitigate that liability.

There also, notably, was in that law a blurring of definitions. Because, after all, it was intended to be a high-cost home mortgage law. But the blurring of definitions resulted in the assignee liability provisions, arguably applying to all mortgages.

And so, the secondary market reacted in a way that was hard to predict when the well-intentioned legislature in Georgia originally enacted the law, and the unintended consequences in Georgia are well known. The secondary market began to shut down, the GSEs would not purchase Georgia home loans. The rating agencies couldn't rate them for private securitizations.

Ironically, we observed in Georgia, because the assignee liability provisions were thought to cover all home loans, even nonprofit and government agency-sponsored lending activities began to be impaired in Georgia. Of course, the Georgia general assembly went back in 2003 and clarified the aspects of the law, including assignee liability.

The legislature clarified that assignee liability would only apply to high-cost home loans. It permitted assignees and secondary market participants to conduct reasonable due diligence, in order to mitigate their liability in the secondary market transactions. This is known—and as it has been replicated in many other States—as a predatory lending diligence-based safe harbor.

Also, there were limitations on class actions, and limitations on damages. But rights that borrowers may have in foreclosure were preserved. And, as we know, the Georgia lending market—generally, the secondary market—returned to vitality in the spring of 2003, but it is notable that lenders in Georgia and elsewhere do not make high-cost home loans. And Georgia high-cost home loans are not being made today, as is the case with HOEPA loans, as we know.

States have taken different approaches since our experiences in Georgia, but the key features to all the State laws is that they impose assignee liability on holders of high-cost home loans, and not on all residential mortgage loans. These laws are aimed at high-cost mortgage loans.

Is there a preferred approach that Congress could take at this time, that would alleviate the growing loss of home ownership? The answer is yes and no. Hardly anyone funds or makes HOEPA loans that are sold into the secondary market under the existing Federal high-cost home loan law. So, if Congress is about expanding the HOEPA law, the Federal high-cost home loan law, you can expect that any loans that are included and covered by the HOEPA law, likewise, will not be saleable into the secondary market.

And I think it's important to know that borrowers who unwittingly obtained, or had inappropriate mortgage products pressed upon them in the last few months, could suffer greatly if they do not have the ability to refinance out of those loans. And so, Federal activity in this area—

Chairwoman MALONEY. The Chair grants the gentleman an additional 60 seconds.

Mr. LAMPE. Thank you, Madam Chairwoman. The ability of borrowers actually to refinance out of some of these products that may be inappropriate to them now is very important. And so, I would think that Congress needs to be very careful in its efforts to regulate the secondary market at this time, so that consequences that could be even more severe for troubled borrowers would not be brought upon them.

Again, thank you for having me here today, and I am happy to answer any questions.

[The prepared statement of Mr. Lampe can be found on page 119 of the appendix.]

Chairwoman MALONEY. Mr. Litton.

**STATEMENT OF LARRY B. LITTON, Jr., PRESIDENT AND CEO,
LITTON LOAN SERVICING LP**

Mr. LITTON. Good morning, Chairwoman Maloney, and members of the subcommittee. One of the things I have to clear up real quick, though, is that I am not the founder of Litton Loan Servicing. It's my father. So I don't want to get in trouble whenever I get home.

[Laughter]

Mr. LITTON. So, Litton Loan Servicing was founded by my father in 1988, in the midst of a similar real estate and mortgage default crisis that was concentrated in Texas. My father's vision was to create a new kind of mortgage servicing company that focused sub-

stantial efforts on providing very high levels of quality customer care with an emphasis on curing delinquent loans.

Over the years, we have developed a host of flexible options that we offer to borrowers who have experienced financial hardships. Today, our business has grown to where we service about 400,000 loans, totaling about \$60 billion. We are regarded as the industry leader in servicing subprime and Alt-A type loans.

And I believe, in general, the mortgage industry is committed, as well as—and we also have the capacity, in terms of finding ways to help families maintain home ownership whenever they have problems.

As a mortgage servicer, we are accountable to two key parties. One of them is borrowers, and the other one is investors. We are in a very unique position, and we function at the crossroads, where the capital and the secondary markets intersect with consumers' interests. The interest of investors and consumers are perfectly aligned, and foreclosure is generally the worst outcome for all involved.

In fact, the average foreclosure costs investors 50 cents on the dollar, as well as it is devastating to the communities in which these properties are located.

Now, over the years, you know, we have developed a wide array of loss mitigation options, but we strongly believe that providing loan modifications to consumers is the number one tool that we have available to deal with the impending issue of ARM resets.

During the last few years, Litton has modified in excess of 10,000 loans with tremendous success. These modifications provide payment relief for the consumer by restructuring loan terms, based on the borrower's demonstrated willingness and capacity to pay. When done properly, modifications provide the borrower with payment relief, while reducing credit losses to investors.

On average, we are able to reduce rates by about 3 percent, and we are able to drive payments down, on average, \$200 to \$250 per month, which is significant.

I must emphasize that this current wave of defaults that we're seeing today has very little to do with ARM resets. This initial wave is a result of early payment defaults associated with 2005 and 2006 originations, and we believe it is merely the tip of the iceberg. These early payment defaults are generally the result of lax underwriting standards, improper documentation, or fraud.

The real impact of ARM resets will be seen in increasing defaults later this year, and into 2008, as many borrowers experience payment increases associated with their rate adjustments.

We do not advocate an across-the-board modify everybody approach; this would create an adverse economic impact on those investors who have purchased mortgage-backed securities. And, as we have already said, a lot of borrowers—most borrowers—are able to make their payments. We believe that modifications have to be made one loan at a time, as each borrower, his loan, and his financial circumstances are different.

Now, one problem we have is that more work needs to be done on accounting rules which prevent servicers from being more proactive, in terms of reaching out to borrowers with pending resets, even though they may be current.

The idea of a foreclosure moratorium—there has been a lot of talk about that—is a bad idea. Denying investors the ability to recover invested capital would accelerate a flight of capital out of these markets.

We encourage the adoption of a 2-week foreclosure delay, which we have already implemented at Litton. This achieves the same goal by slowing the process down, without driving expenses up. That 2-week delay gives us additional time to communicate additional options to borrowers, and it gives the borrower more time to explore additional options, as well as to find help available through their neighborhood groups.

In any discussion of a legislative solution to this crisis, it is important to note that securitizations has allowed home buyers access to international capital markets without excessive concentration risk being born by the GSEs.

We do believe that regulation of mortgage brokers who currently have no fiduciary obligation to either the borrower or the lender would go a very long way towards helping reduce misrepresentation of loan terms to trusting borrowers, as well as reduce the misrepresentation of the borrower's financial ability to lenders.

Another thing is, historically, escrow accounts have not been required for subprime loans. We believe that escrow accounts should be required, so that borrowers have a better understanding of what their financial obligations are.

Finally, it is very important to understand that variations in local economies create pockets where some communities are harder hit by troubled times than others. We conduct very aggressive outreach to borrowers in areas that are experiencing high delinquencies. However, in many cases, borrowers are more comfortable speaking to their neighborhood organizations than directly to us.

We are very much in favor of not only providing more funding and support to these organizations, but in creating deeper relationships to assist in efforts to reach home owners who want to make a sincere effort to save their homes. We don't care how borrowers get in contact with us, just as long as they do.

I would like to thank the chairwoman, and the members of the committee for this opportunity to share our perspectives on this market, and I would love to answer any questions that you might have. Thank you.

[The prepared statement of Mr. Litton can be found on page 129 of the appendix.]

Chairwoman MALONEY. Mr. Calhoun.

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT AND CHIEF OPERATING OFFICER, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Thank you, Chairwoman Maloney, Ranking Member Gillmor, and members of the committee. The Center for Responsible Lending is a nonprofit research group that works to prevent predatory lending, and works to encourage responsible lending.

As an affiliate of Self-Help, one of the Nation's largest community development lenders, we have provided more than \$4 billion of home financing to over 50,000 families. In doing so, we buy, sell,

and finance loans in the secondary market. Prior to my present position with The Center for Responsible Lending, I served as head of those secondary market operations.

The secondary market, including both private companies and the GSEs, greatly influenced the home loans that American families receive. Historically, this has been a positive influence, both in terms of price, and the terms of the loans. More recently, however, the secondary market has contributed significantly to the present problems that we see in the mortgage market, and particularly, the current subprime foreclosure crisis.

We have widespread loans with built-in payment shocks, undocumented income, unreliable appraisals, and underwriting that not only fails to determine the borrower's ability to repay, but actually ensures the borrowers must continually refinance to keep up their payments, thereby deleting their home equity, and often facing foreclosure.

In my testimony today I will address three points: how has the secondary market contributed to the present problems; what is its responsibility in reducing the number of families who will lose their homes in the next 24 months; and what is the secondary market's role in perspective efforts to void a repeat of the current situation?

The secondary market encourages and discourages practices by its demand for loans. In recent years, this demand has been very high, with little regard for loan quality. This was based on the rapid increase in housing appreciation, which covered up an abandonment of many long-held fundamental lending principles, and resulted in lending, often, on the home's value, rather than the borrower's ability to repay the payments.

In addition, the lack of accountability in the overall loan delivery system, as commented on by Mr. Litton, where other major contributors, such—where mortgage brokers and other originators were paid and then gone at loan closing, so they had little concern about the quality or sustainability of the loan.

I would urge you that one of the most important lessons, though, is that the secondary market will not—will not—correct the structures and incentives that have led to the current crisis. The secondary market measures risk, and allocates that risk. It can structure and handle loans where one out of five borrowers lose their homes. It can protect investors, even in those situations.

What is needed is accountability in this market must be re-established throughout the system, or will continue to produce the results we see today. As we sit here today, we looked at the securitizations for the first quarter of this year, and found that over 40 percent of subprime loans in those securitizations still are no-doc loans. This far into the crisis, the system still is producing problem loans, as we sit here today.

Quickly, the secondary market must help borrowers facing rate resets. Over 6 million families will be at risk in the coming months. We must help them transition, first, for those borrowers who qualify for prime rate loans—which will be a significant number—they must be provided transition to those prime rate loans. Others should continue with their current loan payments without payment shock resets or new fees, and some will require modifications that

reduce principal or interest. If voluntary participation is insufficient, regulatory or legislative measures may be required to make sure these efforts are successful.

Going forward, as Congress looks to improve the mortgage system, two things are needed. First, there must be additional substantive protections for families, for their largest, but least protected transaction: their home mortgage.

And, second, there must be incentives for the secondary market, and all of the market participants, to see that those protections are followed. This requires appropriate assignee liability.

First, it is important to make clear that by assignee liability, it does not mean that individual investors would be at risk, but rather, that mortgage securities must be held responsible. Just like with a stock, there would be a firewall in between the individual MBS investor, and any claim against the company issuing the securities.

Assignee liability is not a new concept in credit markets, or even in the mortgage market. The FTC rule, "Truth in Lending," and State predatory lending acts, have shown that these provisions can encourage compliance without restricting credit.

In summary, home ownership builds families, communities, and our economy. Conversely, large payment shocks and foreclosures stress and destroy these. In recent years, home ownership has been harmed, not aided, by subprime lending, and the secondary market has contributed to this home ownership loss. Additional protections with accountability in our mortgage system are required, so that home lending fully realizes its potential to sustain and build American families and communities. Thank you.

[The prepared statement of Mr. Calhoun can be found on page 66 of the appendix.]

Chairwoman MALONEY. Ms. Kennedy?

**STATEMENT OF JUDITH A. KENNEDY, PRESIDENT AND CEO,
NATIONAL ASSOCIATION OF AFFORDABLE HOUSING LENDERS**

Ms. KENNEDY. Thank you for the opportunity to talk about this. I have been at this issue for so long, I wish I had a singing voice, because I really feel like we could break this into three songs, and I picked up a fourth one today, from the discussion of Georgia.

From the standpoint of communities, "How Long Can This Be Going On?" From the standpoint of legitimate lenders, "Looking for Loans in All the Wrong Places," and from the standpoint, frankly, of the borrower, "Staying Alive." These are the songs that sort of sum up what we are about. And today, I found a new one in the discussion and that is, "The Night That the Lights Went Out in Georgia."

[Laughter]

Ms. KENNEDY. I think we have to maintain a sense of humor about this. Because, otherwise, I think we would go crazy. I have tremendous respect for your trying to solve this problem. Let me share with you what I know.

NAAHL represents America's leaders in lending and investing in low- and moderate-income communities, about 200 organizations, 50 major banks, 50 of the blue chip nonprofit lenders. We have been struggling with this issue since 1999, when Gale Cincotta, the

premier advocate for community reinvestment, sick, frail, close to death, made it to a NAAHL meeting to say, “You have to take this issue on. If you not you, who? If not now, when?” And she was talking about the Chicago experience.

So, we committed to be part of the solution. We convened the best and the brightest, through all of 2000, including Mike’s boss, from the lending industry, from government, from government-sponsored enterprises. The best and the brightest. And we came up with a report that Senator Sarbanes was kind enough to call “The Road Map.”

Mel Martinez was a recent HUD appointee to the Secretary’s job. He came to share his own experiences as a Cuban emigree, and as a county executive in Orange County, Florida, with predatory lending. And at the end of it, trying to be upbeat, he said, “Juntos podemos.” Together, we can.

And, thanks to Senator Sarbanes’s tremendous effort to have States attorneys general and Members of Congress understand this road map, he constantly reminded any audience he spoke to of the quote from the report that says, “If the sheriff’s out of town, the bad guys are in charge.”

Well, a lot happened between 2001 and 2005, and you know it well. Bipartisan efforts by this committee and others to address the issue, we spent quite a lot of time, frankly, on updating HMDA and HOEPA. We fell—all of us, I think—into a HUD/Treasury predatory lending task force that made enormous strides in clarifying the issues, at least in four markets, including Atlanta.

But despite all of this activity—not the least of which has been bank regulatory focus on this issue for the last 5 years, so that as of last year, less than 10 percent of subprime loans emanated from national banks, and the default rate on them is half of the national average—we come to this point, and we say, “How long can this be going on? How could this still have happened, be happening, and why?”

And, frankly, I think it comes back to unintended consequences surrounding the absence of a sheriff in the secondary market.

Mr. Watt spoke about the dough boy. I think of it more as whack a mole, you know, you slap it down here, it moves over there.

There is plenty of responsibility to go around. But let me suggest that the lack of GSE oversight, and the Secondary Mortgage Market Enhancement Act unwittingly created this mess.

Let me sum up. For the past several years, Fannie Mae and Freddie Mac’s best seller servicers—among them Mrs. Maloney’s constituents, and many of yours—have been complaining to the GSEs that their refusal to help primary lenders meet the credit needs of their communities under the Community Reinvestment Act was causing these lenders to lose legitimate prime borrowers, who walked down the street to subprime lenders who may be offering loans with abusive or predatory terms, and that Fannie and Freddie were financing those very competitors. Didn’t sound logical, didn’t sound right. We knew the GSEs had a fear of buying legitimate single family loans.

Not until the end of 2006, and the focus on the portfolios of the GSEs with OFHEO cooperating with HUD to get to the bottom of what was in them, did we learn that the well-intentioned action of

this committee in 1992 to ask GSEs to lead the industry by taking less of a return on affordable housing resulted in the GSEs chasing yield from subprime loans. They have been the principal financiers of mortgage-backed securities, and worse. They use these AAA-rated, presumably safe risk-free AAA tranches for HUD affordable housing credit.

So, we used to say that everyone loses in foreclosures, but that is probably not true anymore. The investors holding the AAA-rated pieces, hopefully, will be okay, or all of us are in tremendous trouble.

We tried to keep a sense of humor about this. I presented to 150 OFHEO employees who examined the GSEs bumper stickers, which I asked them to leave under the windshields of cars at Fannie Mae and Freddie Mac, saying, "You're looking for loans in all the wrong places. Call NAAHL." And I brought copies for every member of the committee.

So, where are we now? Well, because Fannie Mae and Freddie Mac really are our Nation's market—

Chairwoman MALONEY. The Chair recognizes the gentlelady for 60 additional seconds.

Ms. KENNEDY. The market has evolved by adapting to what the GSEs will buy. We need H.R. 1427. We need a serious regulator with tough enforcement authority.

We need to look at the Secondary Mortgage Market Enhancement Act. Within months of enactment, financial engineers had figured out ways to turn off the safety valves that were intended in that legislation.

We need a level playing field—whack a mole, dough boy, whatever you want to call it, legitimate lenders are doing the right things, and they are losing market share. Freddie Mac estimated that 50 percent of all subprime loans are made to people who qualified for prime.

Finally, we know what works. We have great nonprofits—and this is in report number two, that I hope you will access. On June 25th, we are announcing a national media campaign, supported by lenders and nonprofit organizations to have borrowers call a 1-800 number. This is a huge development, where they will talk to certified counselors, anonymously, who will then, if they want them to, link them up with the right help.

We have lots to do. Together we can.

[The prepared statement of Ms. Kennedy can be found on page 87 of the appendix.]

Chairwoman MALONEY. Thank you very much for your testimony. And I thank all of the panelists for their testimony.

There is one fact on which we all agree, and that is our prime goal should be to help borrowers stay in their homes. Everyone benefits, beginning with the borrower, and the lender, everyone.

In our last hearing, we had the GSEs and FHA testify about the corrections in their activities, the actions that they were taking to help people stay in their homes. Some analysts believe that the GSEs can solve 50 percent of the challenge, and some analysts have indicated that the private sector could do a great deal more to help people stay in their homes.

And one of the reasons that we invited Wells Fargo to come today is that people have cited the initiative that Wells Fargo has taken to voluntarily follow the guidance of the Federal Reserve, and not give out loans that people cannot repay, and not making option ARMs or negative amortization loans, which helps the challenge, and Mr. Litton also, the ways that you have worked to help people refinance their homes.

I would really like to ask—beginning with Mr. Calhoun—why do we, as a Congress, need to take action? Won't the market correct itself?

I would like to begin with Mr. Calhoun, and then go to Mr. Litton, Ms. Heiden, Ms. Kennedy, and anyone else who would like to comment.

Mr. CALHOUN. Thank you. As I touched on briefly in my testimony—and I think it's been echoed by Moody's and it's just part of the market—the secondary market directs capital, and it assesses the risk of the loans that are backing the bonds that it is issuing. But it can issue securities on almost anything.

There are securities based on delinquent credit card receivables. There are securities based—you know, you get junk bonds. And they can be structured to protect the investors. But that is a totally different issue from whether they are sustainable for the borrowers.

The secondary market doesn't set the rules. Congress and the regulators need to do that. And then, Congress and the regulators need to set the incentives. What are the enforcement mechanisms to make sure that the rules are followed?

But my main point is, if you don't change the structure, don't change the incentives, then brokers still have the same incentive to originate loans, be paid at closing, and not worry about their sustainable. And the secondary market, almost no matter what the risk level of those loans, can price that, can protect a AAA layer to sell to institutional investors, and there will be other investors who will buy the lower rated risk, or there will be a trade-off between risk and price, but that does nothing to address the foreclosure crisis, and the inherent dynamics that we are dealing with today.

Chairwoman MALONEY. Thank you. Mr. Litton?

Mr. LITTON. Yes. What I would add to that—and I'm going to give you a kind of in-the-trench perspective, where I kind of live every day, working with, you know, borrowers that are having problems, is that when you looked at delinquency rates and first payment default rates for late 2005 and 2006 vintages, clearly, there was something awry.

First, payment default rates were up significantly. Delinquency rates were rising significantly. There was a significant number of consumers that we would speak to, who claim that they didn't—you know, that they weren't aware that they had an ARM loan. There were—you know, of the early payment default volume that we started to see for 2006, over 20 percent of those properties were vacant. So, something was awry.

Now, when we look at our portfolio today, and we look at the product that we're boarding today, we see a substantially different set of dynamics. So, my view—and I think the view of many—is

that the market has reacted substantially and dramatically, in terms of tightening underwriting standards, because we see that with a dramatic reduction in early payment default rates for the assets that we see today. We see that with a dramatic reduction in the number of inquiries we get from consumers a day.

And, if you look at the overall origination volume, origination volume is down significantly. So, I would say that the market has reacted, and recognized that we needed to do some significant tightening.

Ms. HEIDEN. I would like to step back and just say that the mortgage banking model has worked for many years. The lender and the servicer sits between the consumer and the investor. And the success of that model—which has been successful for many years—is when we all have the best interests of both in view, the best interests of the consumer and the best interests of the investor.

With respect to the best interests of the consumer, I believe that standards need to be adhered to at point of sale, at origination, because that is where it is determined whether the consumer does have the ability to repay. And with respect to that, I think Congress could be helpful, relative to the brokers.

Brokers are a huge source of mortgage loan originations, but they are non-regulated. With respect to investors, we applaud the efforts on GSEs. GSEs have been tremendous for the housing industry. They are strong, and provide liquidity and stability and affordability, and the bill to ensure that they have a strong regulator is extremely right.

I would be very careful in disrupting anything relative to the investors, but going back to ensure that the best interests of the consumer are in view, and ensuring that the non-regulated are regulated. Wells Fargo is regulated by the OCC, a very strong regulator. I would ask the subcommittee to consider regulating the non-regulated.

Chairwoman MALONEY. I agree that the risk should be shared. My time has expired, and I recognize Mr. Gillmor for 5 minutes.

Mr. GILLMOR. Thank you, Madam Chairwoman. I have a question for Mr. Kornfeld, of Moody's. Mr. Calhoun, with The Center for Responsible Lending, his testimony had some statements about rating agencies, that they are a part of the problem. And to quote, "Rating agencies chose to tolerate the increasingly high volume of poorly underwritten, extremely dangerous loans, including mortgage investment loans that any experienced underwriter would have seen were heading for foreclosure."

Since that is aimed at your industry, I wanted to give you an opportunity to respond.

Mr. KORNFELD. Thank you, Ranking Member Gillmor. Our role is a specific role. I do agree with Mr. Calhoun, in terms of what our role is, is to give an objective, independent view of the credit risk, of the bonds that we are asked to rate.

Our role is not to go and look—we do not look—at each loan, individually. We look at a pool of loans. We are not at all involved in the interaction between the borrower and the lender. We don't design, we do not structure. Our role, once again, is a limited role, and it's a focusing on the credit risk of the transaction.

Mr. GILLMOR. Thank you. Ms. Heiden, with Wells Fargo, what steps does Wells Fargo take to mitigate, or avoid, possible foreclosure when a borrower does fall behind in their payments?

Ms. HEIDEN. Clearly, our focus is to sustain home ownership and help the consumer, so, we have many options.

First of all, if any of you have a chance, what we need to do is have the consumers get in contact with us early. We do our job in attempting to get into contact with the consumer, the customer, but they don't always want to talk to us. So, encourage everybody to get in contact with their respective loan servicer quickly, or go to the many credit counseling nonprofit wonderful organizations that are local, that can also be of help. That is important.

When we do get in contact with the customer, we have many loan work-out opportunities. So, first of all—and with respect to non-primes, and specifically with respect to the non-prime ARM resets, we have opportunities to work with, hopefully, refinancing, right? Refinancing, hopefully, to a prime-priced loan. Or, refinancing to a fixed rate non-prime loan. Or, if need be, another adjustable rate mortgage.

We do have latitude, although we do not unilaterally act as a servicer in the securitization structure. We are bound by the pooling and servicing agreement, but we have latitudes with modification.

I believe that we, as an industry, can get this done together. We are working within the industry, along with the American Securitization Forum, to propose additional modification loan work-out options. Those might include, in addition to the typical modification, where you reduce the interest rate, or you add the arrearage to principal, or you extend the term, it would be, potentially, waiving part of the principal.

Or, imagine a short refinance. If you can't refinance the entire loan, because the loan to value is too high, relative to the new restrictive credit policies in the industry, maybe it's a short refinance. Take down the principal and refinance the remaining. Those are just two examples of where we need to expand our loan work-out options.

And then, unfortunately, there are situations where they will move to foreclosure. But there we can offer a deed in lieu, as an example, or a short sale, protecting the credit situation for that customer better than if they moved to foreclosure. Hopefully that is helpful.

Mr. GILLMOR. Yes. And, Ms. Kennedy, what type of mitigation programs do you find works best for borrowers who are in trouble?

Ms. KENNEDY. That's a great question. I was struck at our second symposium in Chicago last year, that two very different community-based nonprofit organizations—NHS Chicago and Century Housing of Los Angeles—had, on their own, not just figured out how to get people with very little cash, but otherwise qualified, into homes and keep them there, but they were being inundated by hundreds of victims of predatory lenders.

And what they immediately started doing was everything that Wells Fargo's witness has just described, but as a nonprofit intermediary. In other words, what we learned in Chicago and Los An-

geles is that, you know, call your lender when you're in trouble? Call your bank when you're in trouble? Not going to happen.

But they will call nonprofits whom they trust, and with the non-profit intermediary, there is anonymity, there is a discussion of borrower options, lender options. And then, if needed, you have the nonprofit intervening, as NHS Chicago has, with the help of the City, to do the modifications that we're talking about.

Mrs. Maloney asked if FHA and the GSEs could cure maybe 50 percent of the problem. What they are talking about is borrowers who have been current for the last 12 months. That's not going to help anybody who is already in trouble, who will be more in trouble.

Chairwoman MALONEY. But how much of the market would it help that is facing this challenge? They anticipate that it would help a great number.

Ms. KENNEDY. I don't know how many have not missed a payment. I think that's the issue. And if you have missed a payment, you automatically—you fit in Wells Fargo's model, but you don't fit in the GSE model. That's number one.

Let me suggest there is a precedent for public/private partnership. Early 1980's mortgage rates, as some of us are old enough to remember, were in double digits, 18 or 20 percent. The CEO of Fannie Mae approached the Congress and said, "To whom much is given, much is expected. We will step up," because the mortgage market was literally frozen. Rates are at 18 percent, buyers can't qualify, and sellers can't sell.

And what Fannie Mae did was to split the difference. They said, "If we are holding a 9 percent loan on that home that, under law, they have to pay off when they sell, but they can't sell, and the current rate is 18 percent, we, Fannie Mae, will split the difference, as a matter of good public policy, and offer 13.5." That's what you need.

Chairwoman MALONEY. Thank you very much, and the gentleman's time has expired. Mr. Watt.

Mr. WATT. Thank you, Madam Chairwoman. We seem to be talking past each other here, in some respects, and I am puzzled.

Mr. Lampe said that when Georgia corrected, and there was assignee liability, a limit to the assignee liability, the subprime market couldn't get securitization, couldn't get—none of them in the secondary market in Georgia? Is that what—did I understand you correctly?

Mr. LITTON. Yes, Congressman Watt. But the way the original Georgia law was structured, and with the caveat that it was in 2002, very early in States trying to puzzle out—

Mr. WATT. I don't want to get into the Georgia law, I am just trying to make sure I understand what the impact was.

But, then, I hear Mr. Calhoun say that the secondary market can account for anything, whether—regardless of what the—so how do I square those two things?

Mr. CALHOUN. If I may add, I was on the phone with S&P, with Mr. Price and Mr. Scott's colleague, the Republican chair of the banking committee, and the issue was that the original Georgia law had no caps on liability. So, you could have a punitive damage award that could be, you know, many, many times the face amount

of the mortgage, even. And the feedback from S&P was, “We need a quantifiable” —

Mr. WATT. So you could not securitize it, because the risk couldn’t be determined. That’s really what you’re saying.

Mr. CALHOUN. And they put in writing, at that time, to Senator Cheek, that, “If you will put a cap on these damages, we can rate them and the market will proceed.”

Mr. WATT. All right. Now, but under the new law, the secondary market is buying these loans. Am I missing something?

Mr. LITTON. Congressman Watt, what happened in Georgia was—

Mr. WATT. Just tell me either yes or no.

Mr. LITTON. No, high-cost home loans are not being sold and securitized—

Mr. WATT. Okay.

Mr. LITTON.—no, sir.

Mr. WATT. So—and why is that, if they have been able to quantify? Tell me why that is.

Mr. CALHOUN. That is more of a pricing differential and reputational risk, more. But, for example, in North Carolina, our State, we have had—we were the first State, and we had built in assignee liability on all home loans, but with a cap and a limitation on damages and with some safeguards for lenders, all—

Mr. WATT. And the secondary market is buying those loans?

Mr. CALHOUN. They buy all North Carolina loans, with no—

Mr. WATT. Okay.

Mr. CALHOUN.—premium, as to price, and no extra credit enhancement required.

Mr. WATT. All right. I am not trying to—I am just trying to understand what is driving this. But if you had a Federal standard that had some limited assignee liability, the secondary market would adjust to that, wouldn’t they?

I mean, they couldn’t just stop writing loans in Georgia, they would have to stop writing loans, or they would have to stop being a secondary market all together, if we had a national standard. Isn’t that true, Mr. Lampe?

Mr. LAMPE. Well, it’s hard to answer the question yes or no, because it’s assignee liability for what.

Mr. WATT. No, limited, of the kind that North Carolina and/or Georgia has.

Mr. LAMPE. What—

Mr. WATT. I’m not talking about unlimited liability, I am talking about limited assignee liability.

Mr. LAMPE. I think a very carefully designed statute, which provided safe harbors for lenders, and had damages capped, that was coupled with a law that was easy to understand and comply with—

Mr. WATT. Okay, all right. I am—

Mr. LAMPE.—would—is an approach that—

Mr. WATT. We can’t write that law today, so I will—give me your thoughts on what it ought to say.

Let me go to Ms. Heiden. I am—again, I am kind of at a loss here, because the bottom of page two and the top of page three of your testimony, you talk about the standards that your company applies, and they seem to pretty much parallel the standards that

we were prepared to write into the Federal predatory lending standard. And yet, we were having—I mean, it was like impossible to get the industry to go along with it.

You approve applications for loans, if you believe the borrower has the ability to repay. We were trying to kind of force that to happen. All—the whole thing, list of things that you have here, are the standards that we were trying to set up at the Federal level. So what—I mean, why is the industry saying, “We can’t do this, this is terrible?”

Ms. HEIDEN. Specifically related to the standards, and having that incorporated into a national predatory lending law, I think, is a very good thing. And I would add to that, that we need—

Mr. WATT. You’re saying it ought to be voluntary?

Ms. HEIDEN. Would be a very good thing, to incorporate all those standards in a national—

Mr. WATT. Into a Federal law?

Ms. HEIDEN. Yes, with—

Mr. WATT. Okay. Now—

Ms. HEIDEN. With regulation for the non-regulated. So we also need to add the oversight provision.

Chairwoman MALONEY. The Chair grants the gentleman an additional minute.

Mr. WATT. All right. And who ought to be regulating the brokers? Should that be on the State law? At the Federal level? Should it be Federal regulators or State regulators? You—several of you—were unequivocal about regulating the brokers.

Ms. HEIDEN. I strongly—

Mr. WATT. Who ought to be doing it?

Ms. HEIDEN. I strongly think that the brokers should be nationally—

Mr. WATT. Okay, that’s fine.

Ms. HEIDEN.—federally regulated—

Mr. WATT. That’s—

Ms. HEIDEN.—consistently, with oversight.

Mr. WATT. Okay. Now—

Chairwoman MALONEY. The gentleman’s time has expired, and I would like to note that—

Mr. WATT. I didn’t get my 60 seconds.

Chairwoman MALONEY. Okay. An additional 60 seconds to the great gentleman from the great State of North Carolina. But I wanted to note that Chairman Bernanke noted in testimony before the Joint Economic Committee, that they do have the power to regulate the brokers under HOEPA. And I hope they will.

Mr. WATT. I yield back, Madam Chairwoman.

Chairwoman MALONEY. Okay.

Mr. WATT. There are a number of—

Chairwoman MALONEY. Could I just build on the gentleman’s excellent questioning by asking Wells Fargo—Ms. Heiden—has your position cost you market share, because of the responsible approach that you have taken towards fair lending practices? Have you lost market share to other brokers, or mortgage bankers because of this?

Ms. HEIDEN. We have, Madam Chairwoman, and we are okay with that, because we're in it for the long haul, and for the customer relationship.

I just wanted to give you a few examples. We are not originating option ARMs with negative amortization. In 2006, that represented 20 percent of the market. That's 20 percent of the market that we didn't play in, so it follows that we lost market share.

In addition, when I mentioned that we had controls on prime—when a customer comes, and they have a prime—or a credit profile that would give them a prime-priced product, when we receive an application from a broker, we review that application. And if it's proposed as a non-prime loan, we put that application back to the broker—or we communicate with the customer, I'm sorry—that they may qualify for a prime-priced loan.

That's another example of where we play, and we are probably harder to do business with, because of our attempts to also follow through on our responsible lending principles with the brokers.

Chairwoman MALONEY. Thank you. Thank you very much. The Chair recognizes Mr. Price from Georgia.

Mr. PRICE. Thank you, Madam Chairwoman, and I appreciate you granting a little more time, because this is an extremely important issue, especially with the history that we have had in some States, Georgia being one of them, as you and others have mentioned.

The unintended consequences of the act that was passed down in Georgia were severe, and we saw Moody's and others pulling out of our State, as you all well know.

I want to focus on the point that Mr. Hensarling brought up in his opening statement, and that was, "First, do no harm." As a physician, that's what we try to do, and as a legislator, that's what we ought to try to do all the time, as well.

So, I would like to ask folks, other than not—if the Federal Government were to pass legislation, if we were to pass legislation, other than not having just limited liability, or not limiting liability, how far is too far for us to go that would harm, significantly, the market?

I understand that we have limited time. If you wouldn't mind just kind of heading down and—is there a place that is too far to go, from a congressional standpoint?

Ms. HEIDEN. I will start. And with respect to the secondary market and the liability, I am of the opinion that we shouldn't go there, and that we should go back to the standard, responsible principles, and manage the point of sale and the interaction with the consumer.

Mr. PRICE. Voluntary, or mandatory?

Ms. HEIDEN. Mandatory, with respect to the standards?

Mr. PRICE. Yes.

Ms. HEIDEN. I would pass, or recommend legislation national, Federal, for responsible lending principles, or anti-predatory lending, and insure that the non-regulated are regulated.

Mr. PRICE. Mr. Kornfeld?

Mr. KORNFELD. As, once again, as now our focus is on the credit risk, we don't opine as to this legislation, or that regulation.

What we would look for, in terms of any legislation, in terms of whether we can rate it, is whether we can quantify the risk. And in that, we would have to make sure that it is clear as to which loans qualify, and how they're treated, if they do qualify under various different sections of a particular regulation.

Then, if they qualify, what are the various different processes that an originator can do from a safe harbor, from a safeguard, to minimize their particular risk. From our standpoint, it comes down to, "Can we quantify the risk?"

If I could also, just really quick, in terms of—remember, not all loans are securitized. When you go back to Georgia, it's not just the rating agencies or the investors, it was the GSEs. It was the lenders themselves that said, "This risk we cannot quantify, and therefore, we cannot lend."

Mr. PRICE. Right. That was the problem. Mr. Mulligan?

Mr. MULLIGAN. I would respectively suggest that in legislating, that Congress consider the impact on the overall securitization market, which is a tremendous market, and to think about the perspective of the investors in that market.

And there are two things that investors need to know at the time of their transaction. First is that the risk they take at the time they enter into the transaction will not change, subject to the imposition of a legislative change. The investor needs to know that the deal he cuts at closing is not going to be changed by application of legislation.

The second thing an investor needs to know is that he won't bear liability, based on conduct of parties outside of his control. And also, to stay away from any kind of subjective determinations of whether certain types of loans are in the best interests of borrowers. I think they are two main factors that should be taken into account.

Mr. PRICE. Thank you. Mr. Lambe, a comment?

Mr. LAMPE. From a Federal law standpoint on assignee liability, it's a bit of a conundrum now, because the Federal HOEPA law has a very powerful assignee liability provision, which negates the holder in due course status, and so the secondary markets have decided they are not going to purchase HOEPA loans.

So, in a sense, the Federal law, if you use HOEPA as a model, the Federal law has already "gone too far," from the standpoint of the secondary market. So, if you want to look at something that may be workable in the secondary market, you could tee up the HOEPA law, and see how it could be modified, in order to make the secondary market "more comfortable," along the lines of what Mr. Mulligan has talked about.

And so, there are various tools that can do that. It's a complex legislative task, as you all know. But there are ways that you could take a HOEPA-like law, and peel away some of these issues, and perhaps satisfy investors and the secondary market, that the liability is quantifiable, the liability is known.

Chairwoman MALONEY. The Chair grants an additional 60 seconds.

Mr. PRICE. If you could wrap it and then move down?

Mr. LAMPE. Yes, sir. I would just add, just very, very simply, that if you focus on the brokers, where there is no regulation today, that

that's where the vast majority of the focus should be, very, very simply.

Mr. PRICE. Thank you. Mr. Calhoun?

Mr. CALHOUN. Very quickly, you need some assignee liability, because there are so many mortgages made, so many players, regulators will never have—and don't want to build up that big a police force to try and monitor it—there need to be incentives in the market, both—

Mr. PRICE. So, a cap of some variety?

Mr. CALHOUN. As Mr. Lampe said, start with HOEPA, and look for some adjustments there to make sure you respond to the secondary market—

Mr. PRICE. Ms. Kennedy, you've been itching.

Ms. KENNEDY. Well, I just—Greenlining Institute commented to the bank regulators just last week, expressing concerns that the strength in guidance on subprime loans could have the unintended consequence of forcing an increasing number of low- and moderate-income home owners into the unregulated subprime market of 75,000 mortgage lenders. Less than 25,000 involve insured institutions, and so, are subject to rigorous examination and guidance.

So, 50,000 lenders are out there. As you—again, getting back to whack a mole, as you tighten down here, but don't tighten the rest of the market—

Mr. PRICE. Thank you. Thank you, Madam Chairwoman.

Chairwoman MALONEY. The gentleman's time has expired. Congresswoman Waters.

Ms. WATERS. Thank you very much, Madam Chairwoman. I'm sorry that I couldn't be here earlier. I was in another hearing in another committee, but I really appreciate your holding this hearing.

We are all not only baffled, but extremely concerned about what has happened with the subprime market, all of the complaints that we are getting, and all of the people that we see in foreclosures asking us for help. But there is, perhaps, something I could be assisted with, in understanding here today.

I do not have all of my information, but I can recall that when we worked with the predatory lending issues some time ago, we discovered that many of our major institutions have subsidiaries, or units, that do nothing but subprime.

And they kind of separate themselves, or distance themselves, because they are not known under the national bank name, etc., but that not only have loan originators, brokers, etc., others who initiate loans and bring them in, they actually own units. I think Merrill Lynch even purchased a unit, and they very much involved with, as was described to me, the private label securities.

So, if someone could help me to understand the extent of the ownership of major financial institutions of some of these subprime special operations, or the units within some of these major institutions that do nothing but subprime lending, perhaps—who would like to help me with that? I don't know who is best qualified to answer that question. Ms. Kennedy?

Ms. KENNEDY. Sure. I would defer to Wells Fargo's expertise, but we addressed this issue in both symposia.

According to Federal Reserve Governor Ned Gramlich, who has since departed back to the University of Michigan, if you added in current affiliates—there is a legal structure under which the bank is examined. And, as I understand it, there are holding companies in which there may be affiliates that, unless the bank asks for it to be examined, and get credit for it, it would not be examined.

Fed Governor Gramlich estimated that you could add 10 percent to coverage, so if coverage is currently one-third, you could add another 3 percent to the coverage. That still leaves, what, 54 percent uncovered.

Ms. WATERS. Wells Fargo, are you familiar with what I am asking about the ownership, the subsidiaries of banks? Does Wells Fargo have a subsidiary that does nothing but prime, subprime?

Ms. HEIDEN. I would offer a couple of thoughts. First of all, Wells Fargo, when I spoke previously—and you weren't here, but I walked through our responsible lending and servicing principles. All of those principles are adhered to by Wells Fargo Home Mortgage, which I lead—it is a division of the bank—and also, Wells Fargo Financial, which is another entity that does originate—

Ms. WATERS. What is Wells Fargo Financial?

Ms. HEIDEN. It is a consumer finance company, which is part of our—

Ms. WATERS. What's the name of it?

Ms. HEIDEN. Wells Fargo Financial.

Ms. WATERS. Financial? And what do they do? What is different about what they do and what you do?

Ms. HEIDEN. They originate auto loans, and non-prime real estate loans—

Ms. WATERS. So you have a unit that specializes in subprime. Is that right?

Ms. HEIDEN. It serves customers in—

Ms. WATERS. It specializes in subprime. It's what you don't do, but this special unit does.

Ms. HEIDEN. No, we both do them. So I lead Wells Fargo Home Mortgage, and we originate mortgage loans, both for prime and—

Ms. WATERS. Yes, but I want to know about the ownership of units or subsidiaries that do nothing but subprime. Do you have such a thing?

Ms. HEIDEN. Yes, Wells Fargo Financial is owned by our holding company, and—

Ms. WATERS. Okay.

Ms. HEIDEN.—originates auto and—

Ms. WATERS. That's okay.

Ms. HEIDEN.—non-prime—

Ms. WATERS. Do you know of others—beg your pardon? Yes, unregulated, yes. Can you help us to understand—

Ms. HEIDEN. They are regulated.

Ms. WATERS. Can you help us to understand, if this is a practice by all of the banks or financial institutions, do you know of others? For example, can you identify, or help us to understand, whether Bank of America or other big banks, also have special units or subsidiaries who specialize in subprime?

Ms. HEIDEN. I don't think that I can factually—

Ms. WATERS. Well, just tell me what you think you know about it.

Ms. HEIDEN. They may very well have consumer finance companies, along with their mortgage companies. I would leave it at that.

Ms. WATERS. All right. Let me ask Mr. Michael Calhoun, president and chief operating officer for The Center for Responsible Lending. Do you know who these—

Chairwoman MALONEY. The gentlewoman's time has expired. The Chair grants her an additional 60 seconds.

Ms. WATERS. Thank you very much.

Mr. CALHOUN. We would be happy to provide you with a list of—there are a number of banks that have subprime affiliates, or subsidiaries, and that is increasing. Several of the largest subprime originators have been purchased, or are under option to be purchased by either banks, or in some cases, by the Wall Street security firms that purchased more than half-a-dozen subprime lenders, just in the last 3 or 4 months.

So, larger financial players, both banks and secondary market securities firms already have significant subprime participation, and that participation is increasing—

Ms. WATERS. Thank you very much. Madam Chairwoman, I just want us to be sure to understand that when we have banks or financial institutions that claim that they don't do them, you have to ask the questions, "Does your subsidiary do it? Do you have a special unit?" Because this is what we are discovering, and this is what we are going to have to get at. I yield back the balance of my time.

Mr. WATT. Madam Chairwoman, who regulates those subprime lenders?

Chairwoman MALONEY. The Federal Reserve does.

Mr. WATT. Are they regulated?

Ms. HEIDEN. For Wells Fargo, Wells Fargo Financial is regulated by the Federal Reserve, and we are regulated by the OCC.

And I wanted to make certain that when I mentioned all responsible lending standards that I previously went through are adhered to, that also includes when a customer comes in and their credit profile can qualify them for prime, we have controls. It's called a prime filter. And that also applies to our Wells Fargo Financial subsidiary—

Ms. WATERS. If the gentleman would yield, do you do interest-only loans in the—

Chairwoman MALONEY. The gentlelady's time has expired. I would like to clarify that in an article that was in the Wall Street Journal, they said that 25 percent of the subprime market was in the mortgage subsidiaries of bank holding companies, and a big question is whether or not the Fed regulates them.

Right now, they are regulating banks, but they are not regulating these subsidiaries. But they have the power to do so, that is—

Ms. WATERS. Thank you, Madam Chairwoman. We just need to associate with them, and let people know that they own them, that they can't separate themselves that way.

Chairwoman MALONEY. The gentlelady has a very valid and important point. The Chair recognizes Congressman Castle.

Mr. CASTLE. I thank the chairwoman, both for the recognition, and obviously, for the hearing today.

Let me start with you, Mr. Litton—and I may have this wrong—but I thought you said something to the effect of—that escrow accounts are generally not required for subprime loans. That caught me by surprise. I would think, of all the people for which you want escrow accounts, I assume for the payment of taxes and insurance, it would be subprime loans.

How did this come to be, if that is a correct statement?

Mr. LITTON. That's a great question. It is one that we have been asking for a number of years.

If you take a look at the prime markets, generally the GSEs—you know, Fannie/Freddie loans—there was a requirement to establish an escrow account if you had loan-to-value ratios greater than 80 percent.

With subprime loans, for years and years, there have not been escrow accounts. You know, we have been relying on the customer to ultimately pay those taxes and insurance. In many, many cases, the borrower is not able to pay their taxes and insurance, and, as a result, the servicer ends up advancing those dollars.

Now, some servicers will advance those dollars, and carry those dollars, and give the borrower more time in which to repay them. Some of them will actually, you know, start demanding the borrower pay those taxes and insurance back more quickly, which accelerates the default.

But the fact of the matter is, the vast majority of subprime loans, historically, have not had escrow accounts established. We think it's kind of a silly practice, and it's one fraught with a lot of peril, in terms of driving up future delinquencies.

Mr. CASTLE. Just as a comment on that, it would seem to me that it would automatically drive up the possibility of foreclosures and other problems in lending.

Mr. LITTON. It absolutely does.

Mr. CALHOUN. If I may add very quickly?

Mr. CASTLE. Yes, sir. Mr. Calhoun?

Mr. CALHOUN. The numbers are that only about a quarter of subprime loans have escrow for taxes and insurance, and that's almost flipped from how it is in the prime market. And the driving factor is that when a broker is selling a loan to a borrower, if they exclude the escrow for taxes and insurance, they can present what appears to be a lower monthly payment than if they include that in the loan quote that they give the borrower.

So, they—and particularly if the borrower has an existing loan, where there is escrow and taxes and insurance, we see very frequently they are offered a teaser loan, saying, "I can lower your monthly payments by several hundred dollars a month," without the borrower understanding that a lot of that reduction comes by deleting the escrow for taxes and insurance.

Mr. CASTLE. The brokers are generally independent of the agency which is making the loan. Is that correct? So that particular financial entity, whatever it is—and it's probably not a big bank, but a smaller entity—could make the requirement of the escrow account, but they're probably playing the same game. They want to bring the people in at a lesser price kind of thing.

Mr. CALHOUN. They could, but the—right. The problem is right now, without rules and protection, the players with the lowest standards drive the market.

Mr. CASTLE. Right. Mr. Kornfeld, I get—I think securitization is something which has helped tremendously, in terms of spreading mortgages. We could have been having a hearing about people not being able to get mortgages, that's not what this is about.

On the other hand, I worry about it a little bit, and I worry about it from the point of view of Moody's. And you said something, and I wrote it down. I may not have this right, so you may want to correct it, but that you do not see the actual financial data of the individual borrowers, but I think you take the representations—or I don't know what you actually get—from whomever the lender was, and that's the basis of your rating. And you can correct that, if you will.

But in preparation for this hearing, our staff indicated that on your Web site you indicate that, "Moody's has no obligation to perform, does not perform, due diligence with respect to the accuracy of information it receives or obtains in connection with the rating process. Moody's does not independently verify any such information, nor does Moody's audit or otherwise undertake to determine that such information is complete." So—and it goes on there for a while.

But that concerns me. I mean, I have always looked up to Moody's as being extraordinarily reliable, and if you make a recommendation at whatever level, I assume that's factual. Now, I am confronted with the fact that you are apparently taking information from this lending agency, and making a recommendation as to what the security levels should be. And then you have this disclaimer, which would indicate that you're not standing behind much of anything. Can you help me out of that conundrum, please?

Mr. KORNFELD. Sure. Absolutely. That's a lot in there, but let me try to do so.

First, we do receive loan level information. We see many, many characteristics about loan level information. What we do not receive, however, is identifying information. We do not know the name of the borrower. We do not know the specific address. What we do know is the loan amount. We know the loan-to-value of the loan. We know the interest rate on that loan. We know what type of loan it is.

And based on those loan level characteristics, we come up with a credit estimate, a loss estimate, for how that particular loan is going to perform. One of those items is, let's say, escrows. Does that loan have escrow or not? A loan which does not have escrows, absolutely, we view—

Chairwoman MALONEY. The Chair grants an additional 60 seconds.

Mr. KORNFELD. Thank you—than a loan which is escrowed.

We do do originator reviews, but we're not involved with—what I want to stress is—no, we're not involved when the lender is making that particular loan. We do not see loan files, we do not go into individual loan files. Our analysis is a statistical analysis, it's an actuarial analysis of an entire pool.

What our expertise is, it's credit. Our expertise is risk. Our expertise, though, is not compliance. For that, we have to, and do, rely on accountants, lawyers, and other parties who have that kind of expertise.

Mr. CASTLE. Thank you, Mr. Kornfeld, and I yield back, Madam Chairwoman.

Chairwoman MALONEY. Thank you. The Chair recognizes Mr. Green from Texas.

Mr. GREEN. Thank you, Madam Chairwoman, and I thank the ranking member, as well, for hosting these hearings. I think they are exceedingly important, especially to persons in my county, wherein we have foreclosures up, we have persons who are more than 30 days late during the first quarter of this year. That number is up, as well.

I would like to start with what I believe to be a premise that we can all agree upon, and that premise is that a loan to purchase a home should not be a crap shoot. I think that's a fairly safe statement to make.

Now, if you happen to think that a loan to purchase a home should be a crap shoot, and you're on this panel, would you kindly extend your hand into the air? Okay, shouldn't be a crap shoot.

Given that it shouldn't be a crap shoot, must a person qualify, not only for the teaser rate, but also for the adjusted rate? Do you think a person ought to qualify for the adjusted rate, as well as the teaser rate? If you do, would you raise your hand, please?

So, there are some folk who don't think the person should qualify for the adjusted rate, I see. Or—lower your hands. If you did not raise your hand then, raise your hand now. All right, sir, why is it that you think a person who qualifies for a teaser rate should not qualify for an adjusted rate?

Mr. KORNFELD. From a corporate standpoint, that's not our role. I mean, our role—

Mr. GREEN. I'm not—excuse me. Kind sir, please, this is not a question in terms of the corporate personality. We are talking about the borrower. Should the borrower who qualifies for a teaser rate of 5 percent also qualify for a 10 percent adjusted rate? Should that borrower qualify? Please.

Mr. KORNFELD. What the lender needs to look at is, can the borrower repay the loan.

Mr. GREEN. So, is that a kind way of saying yes?

Mr. KORNFELD. It's one aspect of the loan.

Mr. GREEN. But let's just deal with that aspect. Do we want borrowers to get teaser rates, and we know they can't pay the adjusted rate?

Mr. KORNFELD. We want to make sure that the borrower can repay the loan. Maybe the loan-to-value is very, very low. And—

Mr. GREEN. And if you will hold for a moment, let me move on. I have several other questions.

Should a borrower who can barely pay P&I be given a loan without an escrow account? If you think that a borrower who can barely pay P&I should receive a loan without an escrow account, would you kindly raise your hand?

Now, this is where the rubber meets the road. Should this be regulated? If you think that it should be regulated, raise your hand.

This is the dilemma and the enigma that we constantly have to cope with. We agree that there is a problem, but we don't want to do anything about it, it seems. How do we deal with what is an apparent problem without taking some apparent action? This is the question.

So, let me allow the lady from Wells Fargo—and, by the way, man, let me tell you, you are looking good, because these two ladies are beautiful bookends on you, holding you up.

[Laughter]

Mr. GREEN. But let's have the lady give her terse and laconic comment, please.

Ms. HEIDEN. Thank you. I just quickly wanted to say that the loan should be underwritten considering PITI, principal, interest, tax, and insurance. And that is also in accordance with the regulation—

Mr. GREEN. You're in agreement with me. I need someone who is not in agreement. Is there someone who thinks that a person should receive a loan who can barely pay P&I, that this person should have a loan that does not include escrow. Anyone?

Okay, now, we don't want this to occur, but we don't want to regulate it. Why should we not regulate it? Let's go to someone who doesn't want to see it regulated. And I am going to try to move expeditiously, Madam Chairwoman. What about Mr. Mulligan?

Mr. MULLIGAN. Yes, sir. Yes, Congressman, I think a way of handling this was not so much regulation, but any kind of legislative initiative should provide for consumer education and disclosure, so the consumer that is entering into the loan knows precisely the risk that he is undertaking, and also credit counseling—

Mr. GREEN. Okay. Excuse me. Let me just intercede, and say this. Having purchased at least one home, probably, without getting into my personal business, I understand what it's like to be there, and have this opportunity to have the American dream fulfilled.

When I purchased my first home, I would have signed anything, because I wanted the home. So I appreciate what you're saying. But let me go on to another point. Quickly, now, this is a final point.

Should there be some additional regulations on adjustable rates, since we agree that adjustable rates should be—the borrower should qualify not only for the teaser rate, but also for the adjustable rate? We agree, right?

Chairwoman MALONEY. The Chair recognizes the gentleman for an additional 60 seconds.

Mr. GREEN. Thank you. And if you would, friends, if you think that there should be some additional regulation of the adjustable rate, would you raise your hand, please? One person.

Now, if we agree that you should not only qualify for the teaser, but also for the adjusted rate, why, then, would we not regulate this? Yes, ma'am?

Ms. HEIDEN. Congressman Green, in the interagency guidance from the regulators, that is all incorporated. So when I don't raise

my hand for additional legislation, it's because we have additional—

Mr. GREEN. Well, let's not talk about you specifically.

Ms. HEIDEN. But add—

Mr. GREEN. Let's talk about the industry.

Ms. HEIDEN. Add the non-regulated—

Mr. GREEN. Let's talk about industry-wide.

Ms. HEIDEN.—regulated, and under that guidance, it works.

Mr. GREEN. Okay. So, industry-wide, should there be some regulation?

Ms. HEIDEN. Yes.

Mr. GREEN. I see one. Is there another? This is almost like service on Sunday morning.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. GREEN. Thank you, Madam Chairwoman. You have been more than generous. Thank you.

Chairwoman MALONEY. Mr. Hensarling.

Mr. HENSARLING. Thank you, Madam Chairwoman. And we have heard a lot of testimony in this committee about how we have reached unparalleled heights of home ownership. And, certainly, the risk-based pricing in subprime lending, and the liquidity provided by the secondary mortgage market, has played a significant role in these incredible levels of home ownership, particularly among low-income people.

Does anybody wish to debate that premise? If not—oh, we do have a taker.

Mr. CALHOUN. Yes, Congressman.

Mr. HENSARLING. Please, Mr. Calhoun.

Mr. CALHOUN. In fact, the data is very clear. The Mortgage Bankers Association shows that, of subprime loans, only a little more than 10 percent of them go to first-time home buyers. The remaining go to borrowers who already own homes, the majority of them refinancing a cash-out.

And when you compare the number of borrowers over the last 8 years who become home owners through subprime lending, it is less, by a considerable margin—

Mr. HENSARLING. I see the horizontal nodding of his head. Mr. Lampe seems to have a different opinion. Would you care to comment?

Mr. LAMPE. Well, I guess I think of Churchill, of, "Lies, damn lies, and statistics," but I would challenge those statistics from the get-go. And so I think we wind up in a statistical balancing argument, of whether there is a net benefit by having loans available to credit-challenged borrowers, or that it goes down the drain, because of an anticipated foreclosure rate.

And I just disagree with Mr. Calhoun's characterization of the statistics.

Mr. HENSARLING. Mr. Calhoun, in your testimony, and when I heard—maybe I didn't hear it correctly—it seems to be a little bit at odds with what I read, but on page one you stated, "Accountability for loan quality must follow the loan wherever it goes," so I assume you're speaking of assignee liability. Correct?

Mr. CALHOUN. That's correct.

Mr. HENSARLING. And, "We follow that chain wherever it goes," let me use an analogy. There are a lot of families in the fifth congressional district of Texas, who have mutual stock funds. And within those mutual stock funds that they were using to try to fund a college education for their children, might have been a stock of one particular Enron Corporation.

So after Enron engages in fraud, and goes belly up, and some of these people lose their capital, lose their rate of return, and can't send their children to college, would you assign to them increased liability, and then have the government fine them for the actions of Enron?

Mr. CALHOUN. No. I tried to address that point in my oral testimony, to make it very clear that all the—

Mr. HENSARLING. What does the phrase "follow the loan wherever it goes" mean?

Mr. CALHOUN. In the case of a mortgage-backed security, the individual investor does not own the loan; it's held by the trust. And that is who should have the responsibility.

Because, for example, that trust is the party to whom you are making your payments through a servicer, and the trust is the one who would institute a foreclosure action.

And so, families need, just as a matter of fairness, if they have been a victim of predatory lending, to have both relief and defense against whoever holds their loan. That's how it's done for car loans, manufactured homes, and home improvement loans. It's not a novel concept in the credit markets.

Mr. HENSARLING. Well, perhaps it's not a novel concept, broad assignee liability provisions, but Mr. Lampe, I think you spoke earlier in your testimony—perhaps it's worth reviewing—what has happened for the secondary market with the Federal HOEPA standard?

And if—I would love to hear your opinions on what has happened in New Jersey, and earlier, in Georgia and North Carolina, when these broad assignee liability provisions were imposed.

Mr. LAMPE. Well, the secondary market reacts differently to assignee liability provisions in home mortgage lending, because the market is so much larger, and it's so much—the automobile loans and the other loans, manufactured homes that Mr. Calhoun is talking about, the baseline interest rates on those are a lot higher, and very few of them, in relative terms, are securitized.

So, it's not a good analogy to say that we have assignee liability for other types of consumer credit, therefore it just ought to land on mortgage. And when you impose that negation of holder and due course liability, and you say, "It follows—liability to the full extent of liability follows the loan into the secondary market," the secondary market reacts by saying, "We are not buying into unlimited liability here."

And that's what—that has been our experience in the States. It's predictable. It's known. And so, it provides a template, or an example, for what Congress probably should not do.

Mr. HENSARLING. Thank you. And in the time remaining, a number of panelists have spoken about the fact that the market apparently cannot correct itself—although I think perhaps Mr. Litton

and Mr. Lampe have a different opinion—but we have heard testimony—

Chairwoman MALONEY. The Chair grants the gentleman an additional 60 seconds.

Mr. HENSARLING. And I thank the chairwoman. We have heard previous testimony, I believe, if I recall right, from the mortgage bankers and Freddie Mac, that roughly \$40,000 to \$60,000 is involved in the foreclosure cost, which would provide a pretty strong incentive to make sure that you're doing reasonable due diligence in the loan origination in the first place.

And then, second of all, if I read press clippings correctly, New Century has just gone belly up for, apparently, pressing the risk reward ratio a little far, which would also seem to send a rather strong signal to the market place. And I believe, Mr. Litton, you said earlier that we are seeing fewer and fewer originations in this subprime area.

So, aren't there a lot of systems and incentives built in here—and now we're talking about replacing individuals within a free marketplace—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. HENSARLING. Thank you.

Chairwoman MALONEY. I would like the panel to clarify one of the gentleman's questions. There seemed to be a disagreement on the numbers, and I would like to ask Mr. Lampe and Mr. Calhoun to submit their numbers in response to what percentage of subprime loans are to first-time home buyers. Not refinancing, but first-time home buyers.

And if you could, submit in writing the answer to the question, since there appears to be a disagreement. There is a disagreement. And footnote your numbers to the committee, so that we can see this and study it further.

The Chair recognizes Mr. Miller from the great State of North Carolina.

Mr. MILLER. Thank you, Madam Chairwoman. The answer to that question in previous testimony was 11 percent. Only about 1 subprime loan in 10 is to a first-time home buyer. Mr. Mulligan?

Mr. MULLIGAN. Yes?

Mr. MILLER. You testified that your clients are issuers, underwriters, servicers, bond insurers, rating agencies, and securitization and other structured finance transactions, including the securitization of home mortgages.

Those sound like very sophisticated clients. They are large financial institutions, they are well heeled, they're dealing in volume, they're seeing lots of mortgages, they're not reading them as they come in, as they buy them, but they're approving the forms in advance. They're lawyered up, they have you.

And they probably are buying securities that are backed by a portfolio of mortgages. So, if any number go into foreclosure, that's sort of part of the risk. And even if a high percentage—higher than anticipated—percentage goes in, they probably have many investments, and you win some and you lose some.

Mr. MULLIGAN. Yes, and that's contemplated by the structuring of the transactions.

Mr. MILLER. Right. On the other hand, the borrower, 69 percent of American families own their own homes, so you are dealing with a great deal of—range of sophistication. For most middle-class families, they are not lawyered up, they don't have a lawyer on retainer, a law firm on retainer. Legal services is not a line item in their family budget.

They are seeing one set of loan documents that they got at closing, a fixed set. Why would you think that the risk—and the consequence of foreclosure for a middle-class family, the consequence for foreclosure is they fall out of the middle class into poverty, probably for the rest of their lives—why would the risk that a mortgage violated the law be on the borrower, not your client?

Mr. MULLIGAN. Well, the risk would not be to the borrower. The securitization thrives on standardization. In the securitization structure, there are transaction documents that have evolved, and they're often fairly typical.

And there is a good deal of flexibility in the servicing agreement that allows a servicer to work with a borrower to work out certain loans to grant extensions—

Mr. MILLER. Okay. But if it's just—if the transaction violates the law, whether a State law or a law that Congress may pass, why would the burden not be on the folks who buy it, who buy the— the secondary market? Why would it—who are very sophisticated, that have outstanding legal counsel? Why would it not be on them, rather than on the middle-class family who is borrowing money against their home?

Mr. MULLIGAN. Because, in the case of the buyers, you would be imposing liability on the buyers for people who are outside of their control. People earlier in the chain commit a violation, and then you are penalizing the downstream buyer.

Mr. MILLER. Okay. Well—

Mr. MULLIGAN. That creates a great deal of unpredictability and—

Mr. MILLER. You mentioned that in your testimony later. You did mention that there are some subjective standards: suitability, ability to repay—

Mr. MULLIGAN. Right, that can be applied in an arbitrary and capricious manner.

Mr. MILLER. Right. I read that in your testimony. Wouldn't the vast majority of—or with respect to those violations of the law that would appear on the face of the documents, that are not based upon a subjective application to a particular subjective standard for a particular borrower, but would appear on the face of the documents—why would the liability not be with your clients?

Mr. MULLIGAN. Well, in very many cases, why not just enforce existing State and Federal laws that are already on the books? It's very likely that one of the violations that you mentioned anecdotally, who may have violated a State or other law.

So, the robust enforcement of existing laws is one way to curb abuses in the system, rather than a Federal initiative, or a sweeping legislative mandate. If we would—

Mr. MILLER. I'm not sure I heard an answer to my question, so let me go on to another question.

The kinds of things that you point to, the suitability standard, the ability to repay, I think Mr. Calhoun mentioned that if you're consistently getting no-doc loans, if you're getting 2.28 or 3.27 teaser rates with an adjusted rate, wouldn't that be an indicator that maybe you ought to look more closely at that loan, as being potentially one that was not suitable to the borrower?

Mr. MULLIGAN. Yes, Congressman, I would agree. And I think, overall, the market agrees with you, as well. The securitization market has responded, and responded proactively, as some of the abuses that occurred in underwritings in 2005 and 2006 are now abundantly clear. Underwriting standards have tightened a lot of the—

Mr. MILLER. But your testimony is that the secondary market should not be responsible for a loan that was not suitable to that buyer.

Mr. MULLIGAN. Well, it should fall on the underwriter of the loan, not a purchaser in the secondary market.

Mr. MILLER. All right. One other point you made—

Chairwoman MALONEY. The Chair grants the gentleman an additional 60 seconds.

Mr. MILLER. Thank you. One other point you made in your testimony was that since North Carolina in 1999, many States have passed so-called anti-predatory lending legislation, and you said that one result was that the cost of these protections had gone up for consumers.

Now, I have been on this committee the entire time I have been in Congress, and in the 4½ years we have heard testimony many times. We have heard from the commissioner of the banks of North Carolina, Joseph Smith, on several occasions, at least more than one occasion, saying that he had seen no diminution in the availability of credit in the subprime market. He had not seen any change in the terms available here and elsewhere.

An industry publication, "Inside BNC Lending" looked at the rate sheets for a variety of subprime lenders, and said they could see no differentiation between North Carolina and other States.

You heard Mr. Calhoun just a moment ago say that subprime loans generated in North Carolina, pursuant to North Carolina law, were, in fact, being purchased in the secondary market on exactly the same terms as loans from everywhere else.

What—and there was a study at the Kenan-Flagler School of Business at the University of North Carolina Chapel Hill, finding the same thing. No difference in terms, as a result of North Carolina's law, no difference in availability of credit, no difference in interest rates, or any other aspect.

What is your evidence that North Carolina loans are more expensive to consumers than loans of other States that don't have predatory lending protections?

Mr. MULLIGAN. Well, Congressman, it's not just North Carolina, but other States that have enacted anti-predatory lending legislation. A lender, then, has to look into and comply with a whole polyglot of various, often conflicting, State statutes. And this increases legal costs, it increases the need for legal opinions. And, ultimately, these very expenses are then passed on to consumers.

I do not, Congressman, have evidence that the North Carolina statute, per se, has driven up costs. When you think of the patchwork of regulations enacted by the various States, rather than a more market-friendly, uniform, objective, across-the-board standard, by having to comply with these various and often conflicting State statutes, lenders have to do the analysis, they have to have the opinions done. They have to look into the various trip wires that they could trip in this State or that State, and that threat does drive up costs, and that cost is ultimately passed on to the consumer/borrower.

Chairwoman MALONEY. The gentleman's time has expired. But the gentleman from North Carolina raised, I think, a very interesting point, and the chairwoman recognizes herself for 2 minutes.

Why shouldn't the secondary market also be held to enforce strong underwriting standards? For example, in our last hearing, Freddie Mac said that it would voluntarily follow the guidance of the Federal regulators, and that it would not buy loans that did not conform with the guidance, loans that the borrower cannot repay.

And why shouldn't the rest of the secondary market follow the same suit, be required to do the same thing? It's basic common sense. Why buy a loan that the borrower cannot repay? If anyone would like to comment?

Ms. KENNEDY. I would. Absolutely. You know, we are at a point in time where, whether or not it's a crisis, a lot of people are hurting. And I would submit that—Freddie Mac told you they voluntarily complied? I would submit the most dramatic development against predatory lending is that the OFHEO director, at the beginning of 2007, directed Fannie Mae and Freddie Mac to follow the guidance.

My understanding is Freddie Mac has said they will comply in 6 months. I don't—if Fannie Mae has agreed to comply, I don't know that. I want you to think about the comptroller issuing guidance, and having Chase say, "We will comply in 6 months," and Bank of America not agree.

Chairwoman MALONEY. The gentlelady's point is valid. Why not level the playing field and prevent the race to the bottom?

The Chair recognizes the gentleman from Louisiana, Mr. Baker.

Mr. BAKER. I thank the gentlelady for recognition. Ms. Heiden, I want to move through this pretty quickly, because 5 minutes is a very short period of time. So, as best you can, respond succinctly.

There is a distinction between subprime and predatory, is that not correct?

Ms. HEIDEN. That is correct.

Mr. BAKER. And subprime, in your business, is somewhere—a lower 600 kind of credit score, along with other issues. So, if a person comes into your shop and applies for a mortgage loan, you look at the credit score. And, as I understood your explanation in the case where a person's score comes back a little higher than expected, or there are other qualifying reasons, you could bump that person over to the prime side of the lending shop, if your suitability evaluation determined that that person was eligible for that type of treatment, is that correct?

Ms. HEIDEN. You are correct.

Mr. BAKER. So, if a person is on the subprime side, that means they have a likelihood of a credit failure at some point. Therefore, the cost associated with the extension of that credit might be a little bit higher than it would be for that prime person who has a lower probability of default. Would that be correct?

Ms. HEIDEN. That is correct.

Mr. BAKER. So, when you are processing this loan, you have completed it, the person has closed out the deal, you now have a loan which you're going to bundle with a bunch of others, and possibly sell off yourself, or to Fannie Mae and Freddie Mac into the secondary market through a process called pooling. That's correct?

Ms. HEIDEN. That's the way it works.

Mr. BAKER. Now, when you're doing that pooling, and you're looking at those loan characteristics of that package, does anyone in your shop, or does anyone at Fannie Mae, look at every single loan closing criteria, and determine if every loan in the package—or do you do a sampling technique to determine whether those loans, in general, in the pool, are subprime, prime, or worthy of secondary market acquisition?

Ms. HEIDEN. We have looked at every one of those loans in the pool, by virtue of we have originated, underwritten it, and closed it, and we know exactly what it is and in what pool it is.

Mr. BAKER. But the person doing the acquisition in the secondary market does a sampling technique, because they're not the originator, whereas you are, is that correct?

Ms. HEIDEN. The investor typically does a sampling technique.

Mr. BAKER. So that in the case—

Ms. HEIDEN. We provide them with a lot of data, in order to understand the entire—

Mr. BAKER. So, let's jump to the investor who is trying to put their money at risk into a pool of loan products. They are typically not going to sit down, the investor, and look at the credit criteria of each of the loans they are acquiring.

They are going to rely on Moody's, who does a sampling, or they are going to rely on someone, some other professional, who also does a sampling, to determine the risk characteristics of the pool in which they are about to invest, by buying the securities.

Ms. HEIDEN. In our case, I would also add that they rely on the strength of Wells Fargo, and what we have originated—

Mr. BAKER. Your reputation—

Ms. HEIDEN.—past, and the performance of our securities over time. Our reputation.

Mr. BAKER. So they are investing in your reputation. I give you that.

My point is that the benefit of this process is that investors, who have a lot of money, provide the industry with a great deal of liquidity by buying on the strength of reputational risk, on professional assessment that does not necessarily come from an instrument-by-instrument examination, but were relying on the professionalism of the industry to provide me with the product which I am being told I am acquiring.

Therefore, there is more money to lend. Therefore, we can go further out on the risk curve, and lend to people who have lower credit scores, which may be designated as subprime—not necessarily

predatory—so that the asset that we gain by this methodology is to have a 70 percent home ownership rate in this country, which we otherwise would not have.

The solution to the problem of weeding out inappropriate subprime credit extension is not to make them; just don't take that risk. As one witness indicated, the secondary market doesn't buy HOEPA loans. Why don't they buy them? Because there is a risk associated with that acquisition, which goes to your reputation, as to criminal penalties, as to civil penalties, if you engage in an activity which is later discovered to be inappropriate.

Now, how did that investor participate in that extension of credit? Were they at the closing table? No. Did they actually participate in the extension of credit, and make a wrongful judgement? No.

Do most of the regulated entities that extend the credit have a standard of conduct for which they are held responsible, not only to the Federal Government, but to the management of that corporation? Yes, they do. Thanks for that answer.

[Laughter]

Mr. BAKER. The point is, there is a downside consequence to unwarranted regulatory intervention in this market place. The individuals buying the loan did not make them. They did not review the credit criteria of the person who benefits from the loan.

And, consequently, if we are to arbitrarily engage in an intervenist program in saying to people who buy, liquidity will shrink, less loans will be made, and the people for whom many members have expressed concern, those trying to buy the first time, or those with lower incomes, will be shut out of the credit market. That is an untoward result that is, I think, fairly obvious will occur if we proceed on this path.

What should we do, therefore? We should look to the originators. There are thousands of unregulated entities who make a fee from approving somebody's credit score, and getting them in to the mortgage purchase process. They then hand that off.

And I would also add, Madam Chairwoman, the FHA bill we just passed out of this committee had a subprime credit score of 560. The generally accepted industry standard is somewhere in the 620 range. We also then lowered the mortgage broker's financial credibility, by reducing the amount of financial assets the mortgage broker must possess, who is supposed to be the gate keeper for the consumer's best interest.

We, with our own credit extension program in the FHA bill, are creating a set of circumstances which will likely lead to an under-performance, and not serving the needs of uneducated or lesser educated or not properly prepared home buyers, by reliance on a system which now we have helped to erode.

And we are attacking, with this hearing, the performance of an industry which has standards in place because they do not want their investors to lose money. And, therefore, there is a financial incentive and reason to conduct your business in an appropriate and professional manner.

And, by the way, if anybody can tell me what is predatory that isn't already against a State or Federal law already, I will sign on the bill and co-sponsor it. But I do believe that, in most cases

where there is misrepresentation, or a lack of information, that is an actionable—

Chairwoman MALONEY. The gentleman is making many good points, but his time has expired. The Chair grants him an additional 60 seconds.

Mr. BAKER. I have expired as well. I thank the chairwoman.

[Laughter]

Chairwoman MALONEY. Okay.

Mr. CALHOUN. Madam Chairwoman, if I could just—

Mr. SCOTT. Well, to the gentleman from Louisiana, Mr. Baker, I can certainly say I feel and hear your passion. Thank you—

Chairwoman MALONEY. Mr. Calhoun mentioned he would like to respond. So if you would allow, Mr. Scott, for Mr. Calhoun to—

Mr. CALHOUN. Just very quickly, the majority—exploding ARM 228s have not been illegal. They are a core part of this problem. So many of the problems in this market are not presently illegal.

Second is, in the discussion of this structure, it's been alluded to a few times, but there is an important component that protects the investor who bears assignee liability. As has been mentioned, the purchaser of the loans invariably requires that the seller of the loans both guarantee that the loans were made legally, and second, and very importantly, promised to indemnify the purchaser of the loans for any illegal acts and claims that arise from those loans.

And so, the investor who has assignee liability—I think there has been this assumption that they're out there on a limb, all on their own. But they are well-positioned to evaluate the reputation and the creditworthiness of the seller of the loans, and they have the legal club to go back against them if there are claims that come up against the purchaser of the loan.

Chairwoman MALONEY. Thank you. Mr. Scott.

Mr. SCOTT. Thank you very much, Madam Chairwoman. Again, I certainly applaud you and the panel for a very, very extraordinary and very informative discussion, and each of you have made some great contributions to this issue.

First of all, Ms. Kennedy, I think you are absolutely right, with your reference to the song, "When the Lights Went Out in Georgia." But I might add there was another song that pre-dedicated that, and that was called, "A Rainy Night in Georgia," that caused the lights to go out in Georgia.

And I thought I might take a moment, because my State has been talked about a lot here, and I want to kind of set the record straight for Georgia, so folks will understand where we found ourselves.

We were targeted. And we were not targeted by shadow operators, or people who operated in the corners. Sixteen years ago, my State was targeted by one of the biggest financial concerns, legitimate, in this Nation. Fleet Finance, of Boston Massachusetts, came down into our State, a foremost setting, a foremost record as a predator, by coming down and taking advantage of our usury laws, in which we had on the record, on the books, a 5 percent interest per month. And they turned that around and used it, 5 times 12, as a 60 percent interest on second mortgages.

We were targeted. People came in and took advantage of us. And so, we have had to respond to that. So, when we look at how we

got to assignee liability, and when you look at and measure Georgia, in terms of the overreach of the assignee liability, it is important that you measure us right. We were moving in uncharted waters, and attempting to respond to our constituency and to consumers who were victims of predators, of predatory lending, and certainty by legitimate outstanding financial folks.

But I also want to say that, as a result, as you pointed out, Mr. Lampe, in your testimony, Georgia has, indeed, rebounded. We have a very vibrant mortgage market. And, as a result of our effort, while there was an overreach—and I was in the Georgia legislature, I spent my last year there, just prior to moving up here to Congress—there was some feeling that, as I said, there were uncharted waters.

And we did want to have the strongest law on the books. Why? Because we had the biggest problem in the Nation. We were targeted. And so, I want to set the record straight on that.

But as a result, we have a vibrant market now. And, as a result, we enacted what, in effect, caused us to, while we didn't have the strongest anti-predatory lending law, we have emerged with the strongest mortgage fraud law in the Nation, and we strengthened our regulation of non-bank mortgage lenders and brokers.

So, for those of you who have been watching this debate, I wanted to make sure we set the record straight for Georgia, and that we are moving very strong down there with our market.

Yet, the problem exists, and assignee liability is on the table. Assignee liability is very complicated issue, in terms of pooling debt, reselling. It obscures who is responsible for this loan.

I want to ask, though, am I hearing this committee say, "We need to move forward and entertain a national standard for assignee liability in this legislation?" Is that the general thesis here? Mr. Lampe, anybody?

Mr. LAMPE. I think the—yes, sir, Congressman Scott, and I agree with everything you said, and I even touched on it in my written testimony. And Georgia, particularly those that served ably well in the legislature there, such as yourself, should not be subject to open criticism, if that would emerge from this panel.

I think what lenders would want is a national standard that is clear and objective, and that can be complied with by them that care about complying. And the industry players that care about their borrowers, and care to comply with the law. And it's not simply ambiguous, and creating traps for the unwary, and creating more opportunities for litigation. I am not aware that class action litigation has done much, for example, to keep people in their homes at foreclosure. That's not how the system works.

So, to answer your question, yes, a national standard that everyone can understand and comply with in good faith would seem to me to be preferable over a patchwork of State laws that are difficult to comply with.

Mr. SCOTT. How would—

Chairwoman MALONEY. The gentleman's time is—

Mr. SCOTT. May I get 60 seconds?

Chairwoman MALONEY. 60 seconds.

Mr. SCOTT. All right, thank you.

How would you address the concerns, then, if we were to move on that, that a broad assignee liability might eliminate liquidity, increase costs, and reduce the availability of credit for some of the people who need it most, as was referred to very passionately by Mr. Baker?

Mr. LAMPE. Fortunately, or unfortunately, Congressman Scott, the devil is in the details in this type of legislation, because the lawyers take it apart and look at it very carefully, as to how it allocates risk.

But I will tell you that the approach the States have taken so far, including Georgia, is to limit assignee liability to the class of loans known as high-cost home loans, or HOEPA loans. So that's the example we have been looking at so far. Congress may want to take that a little bit further, in connection with these deliberations, but if it does, it would be useful to realize that that's the current way that these laws work.

Mr. SCOTT. Thank you very much.

Chairwoman MALONEY. Okay. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Madam Chairwoman. Mr. Kornfeld, I wanted to kind of go back to what you were saying a while ago. You were analyzing the portfolio, and not the issuer. And so, under your scenario today, if I were to put together a package of loans and Wells Fargo put together a package of loans, and basically, those loans had the same characteristics, they would be rated the same?

Mr. KORNFELD. We analyze a portfolio, we don't analyze individual loans.

Mr. NEUGEBAUER. No, I'm talking about—

Mr. KORNFELD. We do—

Mr. NEUGEBAUER.—if I put together a portfolio loan, and Wells Fargo puts—

Mr. KORNFELD. Right.

Mr. NEUGEBAUER.—together, and they—those portfolios have the same characteristics.

Mr. KORNFELD. Okay, yes.

Mr. NEUGEBAUER. Although this is my first issue, and this is Wells Fargo's 90,000th issue, are they going to be rated the same?

Mr. KORNFELD. No, they would not. Our loss expectations would be very different.

Mr. NEUGEBAUER. And so—and that would be based on history and performance? So history and performance is one of the criteria?

Mr. KORNFELD. That's correct.

Mr. NEUGEBAUER. Would you do me a favor? I have a lot of questions. Go back and look in the last 3 or 4 months in the defaults on the securitized mortgage bonds, and could you, you know, take the 10 top—or the 10 largest defaults, or something like that, and give me a rating.

And I'm not picking on your agency, but rating by—just in the industry, of those loans at origination, and in what their rating just prior to default was, just to give me a kind of an idea of how those ratings are taking place?

Mr. KORNFELD. Okay. Can you calculate, as far as 2006 originations, 2006 subprime transactions?

Mr. NEUGEBAUER. I mean, that's fine. Just pick a—

Mr. KORNFELD. Yes.

Mr. NEUGEBAUER. Yes. And then, you know, what was the—

Mr. KORNFELD. Right.

Mr. NEUGEBAUER.—you know, rated—

Mr. KORNFELD. Most of them are rated—by the time they go into default, are rated C, or rated very low, speculative grade, before a particular bond would go into default.

Mr. NEUGEBAUER. But I want to know what their rating was, if you go back historically, and give me the rating at origination, when the bonds were issued.

Mr. KORNFELD. Right. Historically, it's going to be the lowest rate of bonds, it's going to be speculative grade bonds—

Mr. NEUGEBAUER. And I appreciate your testimony, and I'm not—if you would put that in writing for me.

Mr. KORNFELD. Sure. Absolutely, absolutely.

Mr. NEUGEBAUER. I would appreciate that.

Chairwoman MALONEY. I think that's a very good question, and I think all committee members would like to see a response to it.

Mr. KORNFELD. We do publish that on an ongoing basis. It's published, and we will definitely provide it to you.

Mr. NEUGEBAUER. And I appreciate that. Ms. Heiden, I heard you say that you believe that the playing field, as far as origination, ought to be leveled, and that the people who are not currently being regulated are the brokers. Is that correct?

Ms. HEIDEN. That's correct.

Mr. NEUGEBAUER. And so, if that's the consensus, should that be at the State level, or should that be at the Federal level?

Ms. HEIDEN. I would ask you to consider the Federal national level, so that there is a licensing that is standard, that is consistent, that they have to adhere to—call them responsible lending principles, or call them what you want—and that there is oversight, so we know that—what's happening at point of sale, and it's responsible and fair.

Mr. NEUGEBAUER. In order not to burden the American taxpayers with any more bureaucracy cost, who would be an existing agency that we could use, rather than creating a new agency?

Ms. HEIDEN. That's a very good question. I think we have to tackle it as a country.

Mr. NEUGEBAUER. Yes, I think that's one of the problems I have with creating a new Federal agency, or bureaucracy. I think we—if we're going to look at this, we have to look at—you know, the standards, back in the 1970's, when I was originating mortgage loans, you know, the standards we were using was basically the standard documents became the Fannie Mae and the Freddie Mac documents.

Since then, have we moved away from that, and everybody has kind of created their own, or is everybody still using basically those same templates?

Ms. HEIDEN. You know, the documents, to the extent it's a full-doc loan, are pretty much standard. But there are products that, actually, have been very good to advance home ownership that don't require a complete set of documentation.

Mr. NEUGEBAUER. One last question for you. How are you currently doing your—when you securitize your mortgages and sell

them, what are you doing with assignee language on yours? Are you assigning those with or without recourse?

Ms. HEIDEN. The loans are securitized within the standard language that does not afford assignee liability on up.

Mr. NEUGEBAUER. Okay. So you're saying you keep that liability?

Ms. HEIDEN. We keep the liability, related to the fact that we originated that loan, in accordance with our reps and warrants, yes.

Mr. NEUGEBAUER. But any loss of principal or interest, you're not retaining any of that in any kind of a repurchase agreement?

Ms. HEIDEN. You're not retaining the credit risk on the securitization, that is correct.

Mr. NEUGEBAUER. So you don't offer any repurchase on any of your—

Ms. HEIDEN. On repurchase liability, only to the extent that we didn't originate it the way that we said, in our reps and warrants—

Mr. NEUGEBAUER. You would buy—

Ms. HEIDEN. We would buy them back, yes.

Mr. NEUGEBAUER. And, Mr. Mulligan, I want to go back to something. This whole question of assignee liability, you begin to inject—and I think this is what I heard you say, but I want to have you back on the record—if you inject too much of that upstream, into the secondary market, that begins to cloud, then, obviously, what is the risk that I am taking, as an investor.

In other words, am I taking risk of principal and interest, and then am I taking some other form of risk, that I don't even know how to measure?

Mr. MULLIGAN. Yes. That's correct. The securitization market thrives on certainty, and it loathes uncertainty. And investors in structured finance transactions are attracted to this asset type because of the certainty. And when, by application of a statute, the terms of a deal that that investor has signed on for change, that creates a lot of unpredictability, and could really have an impact in chilling the market.

Mr. NEUGEBAUER. And I just—and for the record—and I would also make this available to the rest of the committee—I would be interested to get your written statement on—

Chairwoman MALONEY. The Chair recognizes the gentleman for an additional 60 seconds.

Mr. NEUGEBAUER. I thank the chairwoman. This question of besting the deal, where we have had, say, a particular portfolio that has had a high default rate, and now the work-out capability of the servicer, in order to be in compliance with the documents of the securitized transaction, come into conflict.

If you all have some suggestions, you know, on how that process might be made better, and still keep this—the integrity of, you know, me buying, you know, a securitized transaction, you know, there is a certain level of risk that I want to take, and flexibility—you could submit that to us in writing, it would be helpful.

Mr. MULLIGAN. Yes, Congressman. I would be happy to do that. Securitization documents are pretty much standard across the board, but there is a good degree of flexibility for servicers to work with borrowers to avoid a foreclosure, and avoid having a home owner lose his home.

And the market has reacted. And servicers, over the past 6 months, have been proactive in working with borrowers, and taking advantage of the flexibility that is built in to the servicing agreements, to work with borrowers to give extensions to re-amortized loans.

And what I would largely be concerned about was if the servicing documents were too constrictive, and did not give this leeway and latitude to servicers. But, fortunately, the market is understanding that this flexibility is in the documents, and that servicers are taking advantage of this flexibility, to address a lot of the turbulence in the market.

Chairwoman MALONEY. Thank you. The gentleman's time has expired. Congressman Cleaver.

Mr. CLEAVER. Thank you. Ms. Heiden, Senator Dodd, the chair of the Senate Banking Committee, pulled together a large number of individuals who represent your industry. And they were asked, and agreed to, sign up with a number of principles for dealing with home owners with high-priced loans. And many of those—I think almost every one of the companies—signed up, except for Wells Fargo.

Can you explain the reasoning why Wells Fargo didn't join in with Fannie Mae and Freddie Mac, and others?

Ms. HEIDEN. Thank you, Congressman Cleaver. I want you to know that we attended that summit. I applaud Senator Dodd's efforts on home ownership preservation. We were right in there. And what he was proposing mirror our responsible lending and servicing principles.

So, from the very beginning, we were aligned with his principles and his goals. After the summit, and the participants raised the issues at the summit, there were discussions around the legal, tax, and accounting issues that were inherent in the proposals, or principles, around modification. And Wells Fargo, we were working through those issues to ensure that when we sign on, we can comply.

So, we subsequently sent a press release, and said that we are supportive and aligned with the principles. And, as an industry, we are going to continue to work on those legal, tax, and accounting issues, much of what we are talking about today that are inherent in the securitization contracts.

Mr. CLEAVER. So, your—Wells Fargo does, in fact, plan to sign on to the principles—I am repeating, I think, what you said—at such a time as you are able to comply with the—all of the components of the principles, and that, at present, you are not able to do so.

Ms. HEIDEN. No. We have communicated with Senator Dodd that we are aligned with his principles, to the extent that they are in accordance with legal, tax, and accounting issues inherent in the securitization agreements.

Mr. CLEAVER. Well, would not that impact all of the others, as well?

Ms. HEIDEN. It does.

Mr. CLEAVER. But they all signed.

Ms. HEIDEN. I can't speak for them.

Mr. LITTON. Sir, if I can add to that real quick, I think I can shed some light.

We subscribe to the principles, generally. I think what Ms. Heiden is referring to is point two in the Dodd principles. There is a concept and a restriction on the modification of current loans that are at risk of going in default. There is a FAS-140 rule out there that has been interpreted by accountants to provide a restriction against servicers from modifying those current loans.

We have been working strenuously to try to get a reinterpretation of that accounting rule. I spoke with the Chair about that this morning. We have made tremendous progress. Deloitte and Touche has recently issued some language reinterpreting and providing additional flexibility for modification of current loans that are at risk of eminent default. We are putting pressure, and bringing pressure to bear, to get a FASB ruling to further clarify that.

That's the single last remaining hurdle, to be perfectly clear, about going out and modifying a current loan that is at risk of eminent default. There are no REMIC issues, we have been advised by counsel. There are tax issues to consumers. There has been a lot of things out there in the press about that, in terms of debt forgiveness, and things like that.

But in terms of servicer flexibility, we have to be able to modify a current loan that is at risk of eminent default, and not wait for that loan to be 90 days delinquent, because it's going to cost the borrower more money, and it's going to cost the investor more money. But that has been the primary hurdle to date, sir.

Chairwoman MALONEY. The gentleman raises a very important point, and I certainly will be writing FASB, reaching out with him, along with other members of the delegation, to get this clarified, so that we can move forward, as you have said. Thank you for raising it, Mr. Cleaver.

Mr. CLEAVER. Thank you, Madam Chairwoman. I yield back the balance of my time.

Mr. NEUGEBAUER. Madam Chairwoman, I just would say that I think it is a very important issue. Because back in the 1980's, when we had the RTC issue, there were—a lot of deals were being cut with RTC, and forgiveness and settlements, only—some of them think they had ended their liability, but Uncle Sam then sent them a bill, then, for, you know, tax on the ordinary income rates for all of the forgiveness on that. So it was one of those gifts that kept on giving.

[Laughter]

Chairwoman MALONEY. Thank you for adding that. Melissa Bean, Congresswoman Bean?

Ms. BEAN. Thank you, Madam Chairwoman, and thank you to our panelists for a long testimony, going through all of our questions on this complex issue.

I would like to go to Mr. Kornfeld first, from Moody's. In reading your testimony, you talked about how the 2006 portfolio of loans has had a higher level of defaults, both in terms of volume and severity, relative to those that originated in the 2006 to 2005 time frame, which really weren't worse than previous—you know, looking at the history—previous periods of time.

You mentioned a couple of factors that contributed. One was that with home prices falling, credit scores dropping for a lot of folks, it was a more competitive market, and there was—standards were more lax, and so there was an increase in no-doc loans, teaser rates, interest-only loans, option loans.

And so, I have some questions about that. The first is to what degree was there an increase in the percentage of borrowers who were misrepresenting their ability to pay? And also, overvalued appraisals that would have contributed to potentially putting loans almost in an upside-down situation.

Mr. KORNFIELD. Okay. In regards to the last, as far as overvalued appraisals, and borrows misrepresented. From an anecdotal standpoint, yes. We are—is it 10 percent of borrowers, or 50 or 75 percent? It's also very difficult to know if someone misstated by 5 percent versus someone misstated by 100 percent.

The things I do want to, though, sort of sum up on this, as far as performance, we did communicate what was going on, in terms of the riskiness of the loans. We significantly—as I mentioned in my testimony, we significantly increased our loss expectations by 30 percent over a 2-, 3-, or 4-year period of time.

Ms. BEAN. My next question is, oftentimes, as some of these loans that originated may be based on documentation that wasn't accurate, or wrong appraisals, it usually gets found out in the secondary mortgage market.

When they're going to buy those portfolios of loans from the originators, they're going to do the due diligence, they're going to discover that the appraisals were wrong, that the income or asset information was inaccurate, and they're going to discount those loans, and only pay so many cents on a dollar before they're going to pick them up.

So, inside the industry, there is an awareness that these are not good loans, and that they have a higher level of risk.

Is there, at that time—or should there be, in your opinion—communication back to the borrower, that their loan has been discounted, based on a higher level of risk in that loan?

Mr. KORNFIELD. I'm not sure if I'm in the position, as far as—

Ms. BEAN. In other words, we're protecting the investors who are participating.

Mr. KORNFIELD. Right.

Ms. BEAN. Are we letting, early on, borrowers know that they are at a higher rate of default, potentially?

Mr. KORNFIELD. Right. You know, personally, that does make sense, from a corporate standpoint. I'm not sure, really, if we're the right people to answer that question.

Ms. BEAN. Okay. I just wanted to kind of get your perspective on that.

Relative to transparency and consumer awareness, clearly, financial literacy is not strong in this country. And you know, we have heard about folks who say, "I didn't know my rate was going to go up, even though I was in an ARM, you know, and it said how much the percentage of the loan could go up." I know, in my own loans, they're complex, but certainly they are pretty well-documented bits of information.

Where are we not providing, in your opinion—and I guess I would open this up to others—enough transparency, or consumer awareness, to let people know, for instance on a teaser rate, “This is what you pay now, but this is what can happen, and what you would have to pay.” Or, on an interest-only loan, “You’re not touching principal, and you’re never going to own this home if you don’t pay more than that payment, or refinance,” or, in an option ARM, where there is negative amortization, that, “You can owe more at the end of this loan than you did when you started it.”

Are we not making that clear, or are people—you know, we heard one of my colleagues say even, “I would have signed anything to own a home.” Is there just, again, consumers willing to say anything, without looking at what is available? Ms. Heiden?

Ms. HEIDEN. Congresswoman, I would like to answer that question. I think over time, the documentation, when you get a mortgage loan, has just become so much.

Ms. BEAN. So cumbersome.

Ms. HEIDEN. So burdensome, that we really, together—the industry and regulators and legislators—have an opportunity here to just make it simpler.

What we are working on is can we put a customer-friendly package on top, that is customized for their loan, that does project exactly how those cash flows will work for them, or how it differs in an appreciated market or a depreciated market.

Ms. BEAN. Right.

Ms. HEIDEN. So there is just tons of opportunity there to be better for the consumer, and it’s a job we have to do.

Chairwoman MALONEY. The Chair grants the gentlelady 60 additional seconds.

Ms. BEAN. Thank you.

Mr. KORNFELD. You know, on both points, one, financial literacy education—Moody’s has been a very big supporter of that. And then, concurrent with Ms. Heiden, in regards to disclosure, it needs to be simple. It gets factored in our risk analysis that borrowers do not always fully understand the terms of the loans that they are entering into.

Ms. BEAN. And I have one last question, and that is to Mr. Kornfeld, again. I didn’t get a chance to look at your latest outlook, or the S&P outlook, but to what degree do you think the market has self-corrected, given that some of the originators who, you know, weren’t following responsible lending standards have gone away, and certainly, you know, the market has tightened?

Mr. KORNFELD. I think it has corrected. Risky loans are definitely down. Volume is definitely down. Risk is down. There is still more to go. And we will still continue to self-correct.

Ms. BEAN. Thank you. And can I—do I have time—

Chairwoman MALONEY. The gentlelady’s time has expired. Mr. Ellison, Congressman Ellison.

Mr. ELLISON. Thank you, Madam Chairwoman, and let me thank all of the participants today. This has been a great hearing.

Mr. Calhoun, I believe earlier in the hearing you said that you could help provide a list of those banks which held subsidiaries which specialize in, well, subprime loans. I would be very grateful

if you could share that information with me. I think it's information that a lot of people would like to have.

Mr. CALHOUN. Yes, Congressman.

Mr. ELLISON. And then, also, Ms. Heiden, thank you again for all of your remarks today. I notice that you are an advocate for a national standard on—for—to prevent this massive foreclosures, good banking practices. Did I get that right, that you would favor a pre-emption of State law to try to have a more reliable, understandable system of good lending practices and anti-predatory lending practices? Did I get that right?

Ms. HEIDEN. I advocate a national or a Federal law, that does incorporate standards.

Mr. ELLISON. Yes.

Ms. HEIDEN. And I also commented that I think the non-regulated should be regulated.

Mr. ELLISON. Yes, you said that, too.

Ms. HEIDEN. I just want to comment. We're regulated by the OCC—

Mr. ELLISON. You did say that. You said that—

Ms. HEIDEN. And many of our—

Mr. ELLISON. And I only have 5 minutes, so I'm going to insist that I get to ask a few questions.

Ms. HEIDEN. Okay.

Mr. ELLISON. So—but my question is—to you—is this. With pre-emption, don't we lose more regulators? I mean, isn't one value of having sort of a shared, or dual jurisdiction that we will have more eyes on the problem, which could help prevent, you know, this foreclosure epidemic we're facing right now?

Ms. HEIDEN. A couple of comments on that. From a recipient of being nationally examined by the OCC, I can tell you that, nationally, it is efficient—

Mr. ELLISON. Excuse me. Who pays the fees to the OCC, for it to run? Who provides money for their budget?

Ms. HEIDEN. We do.

Mr. ELLISON. And, basically, people in the industry, right?

Ms. HEIDEN. Yes.

Mr. ELLISON. So, everybody—so the OCC functions based upon the people in the industry paying their—you're their paymaster, isn't that true?

Ms. HEIDEN. We pay fees.

Mr. ELLISON. Yes. And they don't get government money, they exist based on what you give them. So you have a lot of say-so in what they do, wouldn't you say?

Ms. HEIDEN. I can tell you, as a recipient of being regulated by the OCC, they are very strong regulators.

Mr. ELLISON. And I could say that if I don't want anybody to tell me what to do, then any telling me of what to do is too much.

Ms. HEIDEN. They tell me what to do.

Mr. ELLISON. Yes, and you have a lot of influence over what they tell you, because you have a role in their financing, right?

Ms. HEIDEN. I don't see it that way. They have laws and regulations—

Mr. ELLISON. Let me ask you this question.

Ms. HEIDEN.—how to comply—

Mr. ELLISON. Let me ask you this question. Well, and let's just be frank about it. I mean, you know, Wells Fargo has gotten into trouble over predatory lending, at least in California, right?

Ms. HEIDEN. I'm not familiar with those details.

Mr. ELLISON. Okay. And—

Ms. HEIDEN. If it's—

Mr. ELLISON. I guess I want to get back to this question of regulation. You know, if we had, for example, State regulators—I guess what you're saying is the OCC is sufficient, and we don't need any more eyes on the problem. Is that right?

Ms. HEIDEN. They are sufficient, when it comes to a nationally-regulated entity, as we are. That is—

Mr. ELLISON. Do you think that's true, Mr. Calhoun? Excuse me, ma'am, I'm going to ask Mr. Calhoun.

Mr. CALHOUN. We think that you need a strong Federal standard that sets a floor, not a ceiling.

And if, for example, predatory lending legislation that was proposed last year had been enacted, it would have not—the legislation did not deal with these exploding ARMs, and it would have taken away the authority of anyone to regulate the State-chartered lenders who originate most of these exploding ARMs.

Mr. ELLISON. Now, do you think that there is a role for States to play in the regulation of banks, lending institutions? Excuse me, Mr. Lampe, I want to hear from Mr. Calhoun. Do you think so?

Mr. CALHOUN. Historically, we have had a dual banking system and regulation, where the Federal Government, the Federal agencies, have had supervisory authority, but banks were required to comply with State consumer laws.

Mr. ELLISON. Right.

Mr. CALHOUN. Unless, essentially, it prevented them from engaging in an activity.

Mr. ELLISON. So—

Mr. CALHOUN. That's the—

Mr. ELLISON. So did the State regulatory role actually bring a greater amount of accountability to the industry, or did it diminish and hurt the industry?

Mr. CALHOUN. The State role had worked well, historically, and should be continued and strengthened.

Mr. ELLISON. Okay, thank you. Ms. Kennedy?

Ms. KENNEDY. I wanted to go back to our Chicago symposium, because what we learned there is that, unfortunately, over the 5-year period that we covered, very few States had done what North Carolina did. And so, the challenge is to have a floor in all of those other States that either don't have protections, or they're not enforcing them.

Mr. ELLISON. Right, right. And the question in my mind is more what Mr. Calhoun said, you know, not that we would—I'm—my concern about pre-emption is that we would eliminate a group of regulators that we could have.

Now, if the States don't step up to the plate, well, that's their business. But if—the ones that want to—North Carolina, Minnesota just passed a bill—I think it's a good idea to encourage it.

Chairwoman MALONEY. The Chair grants the gentleman an additional 60 seconds.

Mr. ELLISON. Yes. The last question I wanted to ask is could anyone share with me—I mean, after we see loans securitized on the secondary market, and we see this foreclosure epidemic that we're experiencing now, what mechanisms, what financial instruments, are in place to sort of make sure that the investors don't lose on these investments?

Are these generally insured in some way, to make sure that if—that the foreclosure epidemic doesn't ultimately hurt the investor of these mortgage-backed securities? Mr. Litton, would you like to comment? Mr. Lampe?

Mr. LAMPE. The way the transactions are structured, the risk is layered into series, so that different interest rates apply to different series. There may be something called bond insurance in there, as well. But there are a variety of techniques, whereby, under the current system, that investors can be protected against financial losses, depending upon which type of securities that they may wish to purchase.

Mr. LITTON. But also, just to be perfectly clear, if they are not insured, they are clearly looking for servicers to be able to mitigate their losses. And they're depending on servicers to be able to mitigate their losses by modifying debt, restructuring loans, and doing things like that.

Because, in many cases, there is no bond insurance out there, and a servicer is the last line of defense interacting with that consumer, trying to find a way to mitigate the loss.

Mr. ELLISON. So that service agreement we have been talking about does not require bond insurance?

Mr. LITTON. Well—

Mr. ELLISON. Or they generally don't?

Mr. LITTON. Those service agreements that we're talking about, in many instances—in most instances—there is not bond insurance out there. There is not—and, in many instances, there is not mortgage insurance. These agreements give the servicer wide latitude, in the vast majority of the instances.

There are some instances where some servicers have caps on how many loans they can modify, and things like that, and we're working very closely with the rating agencies, to make sure that we can get investors to work with us on removing caps.

Some servicers have more restrictions than others, but generally, there is a tremendous amount of latitude for servicers to go and work with investors, to be able to work with delinquent home owners.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. ELLISON. My time has expired. Thank you.

Chairwoman MALONEY. Before recognizing Congresswoman Biggert, I would like to ask unanimous consent to put in the record written testimony from the National Association of Realtors, and an article entitled, "Predatory Lending in NY Compared to S&L Crisis, As Subcrime Disparities Worsen" which includes a statement by the new commissioner of banking in New York.

Without objection, they are now made part of the record.

Congresswoman Biggert.

Mrs. BIGGERT. Thank you very much, Madam Chairwoman, and I am sure you all thought you were going to get out of here. But

I will be brief; I know it has been a long morning and into the afternoon.

Ms. Heiden, have you—the committee, the full committee, recently approved a bill to modernize the FHA program. As one of the largest lenders in the FHA market, what role do you see that this—if this passes—you know, it has passed the House—or not passed the House, but passed the committee. If it becomes law, what role do you see the FHA program playing in this subprime crisis?

Ms. HEIDEN. We applaud the efforts of the legislature to modernize FHA. We are the number one FHA originator and servicer, and we have always thought that it is a product that does serve the needs, particularly of the low- to moderate-income segments. And we look forward to that being a very viable alternative, going forward, and a complement to the current subprime product set.

Mrs. BIGGERT. Have you looked at the legislation?

Ms. HEIDEN. Yes.

Mrs. BIGGERT. Do you have any problems with it? I know that one of the issues that I am concerned about is the cap has been raised on the premium for the downpayment, but the annual rate hasn't been raised. I am afraid this is going to slow down being to use FHA, the subprime.

Ms. HEIDEN. That's a very important product to us, and I think what's probably best here, Congresswoman, we would submit comments to you in writing about the details of the modernization bill.

Mrs. BIGGERT. Okay. The other issue that is in the bill is that the Secretary of FHA would have the ability to authorize counseling. And I am a big proponent of financial literacy, and Ruben Hinojosa and I, from this committee, have the financial literacy caucus.

And this applies to any of you who care to answer this, but I am worried, and I know that it was discussed, about counseling and financial education for so many of these clients, it's such an important part. But I worry about whether this authorization would make it mandatory.

And I am also concerned about what has happened in Chicago on this issue, that there has been—one of the counties that first mandated counseling on the mortgages before—by zip codes, and this caused a big problem, that mortgage brokers got out of the business there, so they changed that to the entire county.

It sounds like it is going to be a big business there, but people are going to have to wait an awful long time to get approval of their mortgages. Would somebody like to comment on that? Ms. Heiden?

Ms. HEIDEN. I am not a proponent of mandatory counseling. I think counseling is most effective when that borrower has the desire. And, hopefully, we, as the lending community, motivate them to search out the local agencies, nonprofits, there are wonderful nonprofit credit counseling organizations, locally, that can be very effective. I think it's better done at the local level.

Mr. LITTON. Ma'am?

Mrs. BIGGERT. Yes, Mr.—

Mr. LITTON. Sorry. What I would like to add is that, you know, there are clearly many, many instances where the consumers that

we deal with on a day-to-day basis could benefit tremendously from more financial education.

I mean, if you think about it, everything else in your life that you get—you buy a car, you get a user's manual; you buy a toaster, you get a user's manual—you get a user's manual with anything you buy. You buy a yo-yo, there is a user's manual, okay? But your single biggest investment that you make in your life, where all your net worth is tied up, there is no user's manual.

Well, you know, we are committed to that. Every one of our borrowers—and one of the things that we're working on is we're giving them a home owner's manual. "This is what your escrow is, this is," you know, where it explains what an ARM loan is. I think there needs to be a tremendous amount more disclosures and education at the point of sale with these consumers, because many of them are first-time home buyers, or they're brand new to our country, or they've never been in this situation before, and they have to know what they're getting into.

And I think we owe it to them to be able to, you know, heighten—

Mrs. BIGGERT. But isn't that the job of the loan originator, or—
Mr. LITTON. I absolutely think so. Go ahead.

Mr. CALHOUN. And Congresswoman, I think there is another analogy there, that disclosure is important, but it's not going to solve the problem, nor is the counseling.

Just like Mr. Litton said, if you're buying a toaster, or you're buying a car, we don't give you counseling to make sure that you're not buying a toaster that will explode. We don't give you counseling about buying a car that won't explode. We have substantive standards that protect consumers, and set standards for the market. And that is what is missing in today's mortgage market.

Mrs. BIGGERT. Thank you. Just one other thing.

Chairwoman MALONEY. I grant my good friend an additional 60 minutes.

Mrs. BIGGERT. Thank you.

Chairwoman MALONEY. 60 seconds.

[Laughter]

Chairwoman MALONEY. It has been a long day.

Mrs. BIGGERT. Just one—there—you have talked about the reasons for—you know, or we've talked about foreclosure. But it always seems to appear that it's because people don't understand the mortgage, or whatever.

But according to the Federal Reserve, the four top reasons, I think, for foreclosure are things like health, death, loss of a job, or divorce. And I just—it seems like, you know, we have to keep that in mind, too, that it's not—does anybody have a comment on that?

Mr. CALHOUN. Those fundamentals do drive a lot of foreclosures. But this huge spike that we have seen recently aren't—

Mrs. BIGGERT. Okay, well, yes, yes—

Mr. CALHOUN.—because any of those fundamentals have doubled in the last 6 months. They are because loans with unprecedented abusive terms are being marketed to a wide segment of the subprime market.

Mrs. BIGGERT. Thank you. I yield back.

Chairwoman MALONEY. Thank you. And the gentlelady recognizes herself for the last question, and I ask you to respond, anyone on the panel, either in writing or in comments now.

Who loses when borrowers cannot make their payments? The borrowers, or the investors? Is the loss equally shared, or how is—who suffers? Do the originators, the bankers and the broker—what is their loss?

And as a part of this question, subprime lenders have indicated to me and my staff that the types of products that they offer, and how they underwrite them, is largely investor-driven.

And I would like to give the rather frank acknowledgment by the chief executive officer of Ownit Mortgage Solutions, a State-licensed, non-bank mortgage lender, that recently filed for bankruptcy protection after investors asked it to buy back well over \$100 million worth of bad loans.

Ownit's chief executive, Mr. Dallas, said—and I quote, I think it's a very startling statement that he made—he said, “The market is paying me to do a no-income verification loan, more than it is paying me to do the full documentation loans.”

As a former loan officer in a bank, I find this a rather startling statement from a CEO. And so, my question is, given Mr. Dallas's comment, would you agree that the secondary market fueled a race to the bottom with no-doc loans, where originators and brokers were—really had an incentive to engage in practices that were worse for the borrowers?

And I just throw that out as the last question, and you can respond, either in writing or in statements. And I think it's been an extraordinary panel, and I thank all of you for your life's work, and your contribution today. Would anyone like to comment?

Mr. CALHOUN. I would just like to add that, again, as we are here today, payment shock loans, no escrow loans, no-doc loans are the typical products in today's subprime market. And I think one thing we have assumed, that since those problems have been highlighted, they would disappear.

Now, the comment period for the statement on subprime loans closed yesterday. And I think the first order of business is to make sure that at least that modest restoration of lending standards is protected. There have been a lot who have called for big loopholes, for refinancing, for longer-term loans that already are seeking to undo what the regulators have proposed as a modest progress of getting us back to responsible lending. And the first thing we have to do is to complete that unfinished work.

Chairwoman MALONEY. Mr. Litton, who loses when borrowers cannot make their payments?

Mr. LITTON. I think that—

Chairwoman MALONEY. Borrowers or investors? Is it an equal pain, or is it a—who loses, in your—

Mr. LITTON. I think both parties lose. And I would even characterize it as there are three significant parties. I think, first, you have the borrower. The borrower loses in a foreclosure situation. It can be devastating to their family, to their life. I mean, it changes your life forever. It's a very, very bad thing.

The community, where the property resides, is a big loser. We all pay for foreclosures in our neighborhoods. It's just—it's devastating

to neighborhoods. I travel around, and I spend 1 week a month out in the field, and I can tell you that I go through neighborhoods, and I see what foreclosures have done to them. It is very, very bad.

The third constituent that pays for foreclosures is the investor. Investors, in good faith, invest in mortgage-backed securities, seeking to get a return on their invested capital. And when foreclosures occur, they absolutely lose dollars.

So, again, I think we all have a responsibility, and we are all committed. And I do believe that the industry has a lot of focus on this issue right now, to kind of, you know, help make sure that we mitigate this problem. And I think you have seen a lot of positive changes recently that are kind of a step in the right direction.

Chairwoman MALONEY. There have been a lot of positive changes, and I hope they keep going in the right direction.

Mr. LITTON. Yes, ma'am.

Chairwoman MALONEY. Ms. Kennedy and Ms. Heiden, you have the last comment. Ms. Kennedy?

Ms. KENNEDY. I would agree with everything he just said. I would add two thoughts.

What has changed is that you now have investors holding securities that have a AAA rating. And, you know, the speculation is those who are holding the AAA pieces won't be hurt. So, the old rule of everybody loses in a foreclosure has been invalidated.

And I think we have to re-establish the balance in the market that takes care of that problem, but that also levels the playing field.

Chairwoman MALONEY. Okay, thank you.

Ms. HEIDEN. I just wanted to react to the comment from Bill Dallas, and say that, as an industry, we have the opportunity, and I believe the responsibility, to stand up tall and be able to say, "We did right by the consumer, and we put them in the right loan."

Chairwoman MALONEY. Well, thank you. Thank you. That's a strong statement to conclude our hearing. We are adjourned. Thank you.

Ms. HEIDEN. Thank you.

[Whereupon, at 1:18 p.m., the hearing was adjourned.]

A P P E N D I X

May 8, 2007

Remarks
Rep. Carolyn Maloney
Financial Institutions Subcommittee
May 8, 2007

This is the third in a series of hearings that the full Committee and this Subcommittee are holding on the topic of subprime lending and what legislative action, if any, might be appropriate to address the rapidly growing subprime mortgage crisis.

We started with a hearing March 27th in which we heard from the federal regulators on their proposed guidance to strengthen underwriting and correct abuses in subprime lending, and from industry and consumer representatives on what the likely effect of that guidance might be.

We then had a hearing on April 17th on how subprime borrowers presently facing default or foreclosure could be assisted by the housing GSEs, the FHA, or the private sector.

Our topic today is the role of the secondary market in subprime mortgage lending.

We will specifically examine how that market has contributed to the expansion of the subprime mortgage sector and what characteristics of the secondary market should be considered when proposing remedies for borrowers or reform of the subprime lending system.

The crisis in subprime lending is wide-ranging and complex, of several of our Subcommittees. I want to specially acknowledge the prior work of Congressman Kanjorski, Chairman of the Capital Markets Subcommittee, and his staff, their contributions in this particular area, and to thank them for to this hearing.

I also want to welcome all the witnesses, and to thank them for making time to appear before us today to help us understand and grapple with the highly complicated and powerful dynamic of securitization.

There is no question that the huge growth of the secondary market from 1986 on has greatly supported the expansion of credit and the availability of mortgage financing on a much wider basis than ever before.

With the legal structure put in place by the Tax Reform Act of 1986, and its predecessor the Secondary Market Mortgage Enhancement Act of 1984, mortgage backed securities burst out of the GSEs and became private sector business.

Private label issuers moved quickly to utilize the full range of the market opportunities available through the creation of REMICs - Real Estate Mortgage Investment Companies.

REMICs not only offered tax advantages but also made mortgages an investment in which large investors could participate, since they could structure the risk to meet their needs.

Since the tax laws and accounting rules made it very difficult to alter the securities in the “static pool” of a REMIC, investors could take a fixed part of the payment stream and know what risks they were exposed to.

In the popular press, the irresponsible growth of the subprime market is often blamed on the securitization process. We read every day that borrowers were put in mortgages they could not repay because of the pressure on Wall Street to satisfy the appetite of investors, both foreign and domestic, and the vast fortunes to be made doing so.

I hope the witnesses today will put some facts and structure to those generalities and explain how we can make sure the incentives in this market are aligned with sound policy and not against it. Also, I hope they can explain the difficulties and issues that are presented by current proposals to restructure loans that have been securitized.

To some extent, we began this discussion in our last hearing when the housing GSEs and the FHA came in to tell us what they are doing to help borrowers move out of loans that are resetting to unaffordably high rates.

By some estimates, the GSEs and the FHA can help 50 percent of the borrowers in this predicament, because by having made twelve months of regular payments on their loans these borrowers qualify for a better, fixed rate loan from these entities.

That still leaves a lot of borrowers in need of help. Also, while in our last hearing we discussed how to help the borrowers in this crisis, in this hearing I also want to explore what we can and should do to avoid a repeat of this vicious cycle in the next housing bubble.

One point that all players in the industry have been quick to point out is that no one makes money when a borrower gets put on the street.

If true, that should provide a strong motivation for all participants to help borrowers stay in their homes through a market based solution.

That is the guiding principle behind recent efforts such as the FDIC conference three weeks ago, or Senator Dodd’s summit last month.

I am generally a supporter of market based solutions, and I am hopeful that these efforts at dialogue provide a way for the private sector to find a solution.

But, as these hearings should make clear, this Committee is by no means waiting for the private sector to do what it thinks is right to solve this rapidly growing crisis. Market-based solutions sometimes don’t provide sufficient protections to those with little market power – in this case, our constituents who face the loss of their home.

To help shift the balance, states have pioneered assignee liability protections that have had some good results, although the Georgia fiasco demonstrates what happens when one state goes too far, and the power of the ratings agencies and the market to shut down a remedy that does not meet market needs.

My intent in this hearing today is to elucidate what Congress or regulators can do to encourage, support, or if necessary mandate changes to the incentives that created the problem we face today, without creating unanticipated problems in the market.

It is a difficult assignment but one we must take up.

Opening Statement

Congressman Paul E. Gillmor (R-OH)

May 7, 2007

Hearing Entitled: The Role of the Secondary Market in Subprime Mortgage Lending

I thank the Chair for calling this important hearing today. The turmoil in the subprime lending market continues to cause all of us great concern. Ohio remains one of the leaders in subprime mortgage foreclosure at a time when we would prefer to be number one in something else.

This is the third Committee hearing this year on the causes and potential solutions to the increase in subprime defaults. It is my continued hope that the Committee take a deliberative approach when considering ways to respond. An overreach by Congress during this cyclical downturn in the housing market could put up significant roadblocks to those prospective homebuyers looking to join in the American dream.

The evolution of the secondary mortgage market has been critical to the levels of homeownership experienced over the last few years. The securitization of subprime loans alone is now close to half a trillion dollars. Today we have both increased liquidity and a market downturn in home price appreciation. Unfortunately, lenders in recent years loosened underwriting standards. All of these factors have led to the wave of defaults we are currently experiencing.

There is no silver bullet to solve this problem, but I look forward to considering all the various legislative proposals that will come before us. We have a great panel of experts assembled today and I look forward to receiving their testimony.

With that, I yield back the balance of my time.

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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

“The Role of the Secondary Market in Subprime Mortgage Lending”
May 8, 2007

Chair Maloney, Ranking Member Gillmor, and members of the Committee, thank you for holding this hearing to focus on the secondary market’s role in subprime mortgage lending. The secondary market has had, and will continue to have, an enormous impact on the quality of home loans received by families in this country, and I commend you for focusing on this vital issue.

My remarks today will emphasize these five points:

- There is an urgent need to address the epidemic of foreclosures in the subprime market today—the highest rate of home losses in the modern mortgage era.
- Wall Street has been a key driver in supporting these devastating losses.
- In fact, even now, lenders and mortgage investors continue to have strong incentives to encourage—and they continue to offer—dangerous loans that go directly against the best interests of home buyers.
- A typical mortgage loan passes through a number of hands, moving from broker to lender to loan servicers and investors. Accountability for loan quality must follow the loan wherever it goes.
- The most powerful entities in the mortgage industry—investors, rating agencies and the government-sponsored enterprises (GSEs)—have an obligation to take an active role in preventing even more losses on existing high-risk subprime loans. Wall Street must not stand in the way of modifying mortgages or other options to assist struggling homeowners.

I serve as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

CRL is an affiliate of Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home

loans. Self-Help has provided over \$5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Our loan losses have been less than one percent a year.

Before I took my current position with CRL, I oversaw Self-Help's secondary marketing operations, where we purchased low-income and minority home loans, often made to borrowers with blemished credit. We bought these loans from banks, held on to the credit risk, and resold the mortgages to Fannie Mae. We have used the secondary market to provide \$4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth. Through this direct experience, I understand the importance of the secondary market in providing capital for future lending. In fact, the mortgage market as we know it today would not be possible without the vital support of the secondary market.

Historically, mortgages have been safe investments with a commensurate rate of return for investors. But the growth of the subprime market offered mortgages that provided a higher-risk investment with potential for higher returns. Wall Street became ravenous for these loans, seeking mortgages that provide a high yield. This demand from Wall Street encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan.

Responding to Wall Street's demand, lenders created dangerous loan products that appeared deceptively affordable to borrowers, and brokers pushed these products to earn high fees. In turn, rating agencies chose to tolerate the increasingly high volume of poorly underwritten, extremely dangerous loans included in mortgage investments—loans that any experienced underwriter would have seen were heading for foreclosure. The result is the rash of losses occurring today, as subprime lenders shut down, investors lose money, and worst of all, hard-working families lose their homes, their credit standing, and their financial security. Ultimately, the harm is extended to entire neighborhoods where foreclosures are concentrated, stripping wealth from communities and lowering the quality of life for all residents.

It didn't have to be this way. Mortgage underwriters are well aware of what kinds of loans are most likely to fail. Lenders have long experience with determining whether a borrower has the ability to repay a loan. It is well established that loans with certain traits—for example, subprime loans with adjustable interest rates, loans with built-in payment shock, subprime loans with prepayment penalties, loans that do not escrow for taxes and insurance, loans where borrower income is not documented—have a much higher risk of foreclosure. Yet, subprime lenders have been piling all of these characteristics into mortgages for people who are already financially stretched with a high debt burden. And Wall Street has colluded by taking these loans and calling them quality investments.

For Wall Street bankers, mortgage loans represent paper they trade—a financial instrument backed by mortgages that can be highly profitable. The performance of

individual loans is of little concern as long as the loan pool as a whole provides the expected return. Because loans are sold on the secondary market, the parties who actually interact with the borrowers during the loan process—mortgage brokers and lenders—have very little financial interest in whether the loan performs beyond an early payment default period. But for the average American, a loan is much more than a piece of paper. Each individual loan represents the roof over their head and the bulk of their savings for the future. Families that get mortgages are seeking long-term security, but Wall Street has been seeking fast profits.

I. The Current Situation: An Epidemic of Foreclosures

Last December, the Center for Responsible Lending published a report that represents the first comprehensive, nationwide research projecting foreclosures in the subprime market. The report, “Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,” is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and high housing appreciation during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose or have lost their homes and up to \$164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years.¹

Since we issued that report, the condition of the subprime market has deteriorated rapidly, and subsequent events have shown our projection to be conservative. A recent study by the investment bank, Lehman Brothers, shows that the number of 2006-originated loans likely to face foreclosure is 30 percent.²

Why does a foreclosure epidemic in the subprime mortgage market matter? First, subprime mortgages are no longer a niche market; they have become a significant share of all new mortgages made in America, making up well over 20 percent of all home loans originated recently and currently representing \$1.2 trillion of mortgages currently outstanding.³ Second, homeownership is the best and most accessible way most families have to acquire wealth and economic security. If home loans are actually setting citizens back rather than helping them build for the future, there are serious ramifications for local economies and the nation as a whole. The problem is particularly serious for communities of color, since more than half of African-American and 40 percent of Latino families who get home loans receive them in the subprime market.⁴ If current trends continue, it is quite possible that subprime mortgages could cause the largest loss of African-American wealth in American history.

There are several factors driving massive home losses, including dangerous products, loose underwriting, broker abuses and federal neglect. In these remarks, I will focus on one other important factor: support by investors. In the simplest terms, the secondary

market has enabled the subprime crisis. Much of the growth in subprime lending has been spurred by investors' appetite for high-risk mortgages that provide a high yield. While investors eventually do react and become more conservative when losses mount, the problem is that the market reaction occurs only after foreclosures are already rampant and hundreds of thousands, if not millions, of families have lost their homes, or have been placed into unsustainable loans that will lead to the same result.

II. Wall Street's Role in Subprime Foreclosures

The mortgage business has changed drastically since the days when families went to their local savings and loan to get a mortgage, and the thrift held that loan among its own investments. Today, most lenders sell their loans into the secondary market, where mortgages are pooled together and then divided into segments, or "tranches," which are then sold as securities to large numbers of investors. The investor has the right to collect payments and enforce the loan terms, including foreclosing on the home if the borrower defaults. As of June 30, 2006, mortgage-backed securities were the largest segment of the United States bond market, accounting for 23 percent of all bond market debt outstanding.⁵

Thus, a mortgage typically goes through a chain of players, some of whom take their cut of compensation immediately and pass the loan along to the next stage. The first link in the lending chain is typically a mortgage broker. Brokers, who originate 71 percent of subprime mortgages,⁶ have a strong incentive to close as many loans as possible, but very little reason to consider the loans' future performance.⁷ Brokers act as independent contractors for lenders, who in turn obtain capital and shield themselves from the full potential cost of foreclosures by selling their loans to investors. Together, third-party originations and the risk dispersion made possible through the secondary market help distance loan originators from seriously adverse consequences of foreclosures that occur after an early payment default period, which increases the prevalence of loans that fail.

Like lenders, mortgage investors use sophisticated financial tools to limit their financial exposure to losses from foreclosures. First, pools of loans in mortgage-backed securities typically contain both high-risk and lower-risk loans, and the income on the better-performing loans subsidizes the losses on defaulted loans. Second, mortgage-backed securities are often over-collateralized; that is, the amount of the loans backing the investment is greater than its face value. Third, investors may demand a premium from the lender/seller for investing in its subprime securities. Fourth, investors are protected by a legal doctrine called "holder in due course," which prevents borrowers from making claims against the purchaser of their loan, even if, for example, that loan contained abusive features.

Further, the only "regulatory" oversight of the secondary market comes from the third-party rating agencies, who evaluate the credit risk of mortgage-backed securities and award credit ratings that help determine the market price for the security. However, rating agencies make no determination about "the suitability of the underlying loans for individual borrowers."⁸ Instead, rating agencies are concerned with whether the pool

will perform overall and deliver the return promised to investors for the agreed-upon price. At the end of the day, there is one party always “on the hook” for a mortgage default: the homeowner.

Investor Demand for Dangerous Products: 2/28 “Exploding” ARMs

During the past few years, Wall Street became enamored with subprime mortgages. Subprime-backed investments worked well for the market when housing appreciation was high, but Wall Street’s demand for subprime volume continued in spite of widespread warnings about a slow-down in housing appreciation. To feed growth in the market, lenders loosened underwriting guidelines and developed more dangerous products, and Wall Street continued to accept these loans.

Subprime lenders have indicated that the types of products they offer and how they underwrite them are largely investor-driven. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that filed for bankruptcy protection after investors asked it to buy back well over one hundred million dollars worth of bad loans. According to the *New York Times*, Ownit’s chief executive, William D. Dallas “acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other subprime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. ‘The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,’ he said. ‘What would you do?’”⁹ Similarly, an article from yesterday’s *Washington Post* shows, at the ground level, the impact that investor demand has had in the actions of one company, New Century, in encouraging abusive lending.¹⁰

The major way lenders fed demand for subprime loans was by offering dangerous hybrid adjustable-rate mortgages (ARMs), which they continue to offer today. These loans start with deceptively low monthly payments, even though those payments are certain to increase at the end of an initial period, usually two years. As a result, these loans result in significant “payment shock,” meaning that the homeowner’s monthly payment quickly skyrockets to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical risk that comes with the overwhelming majority of subprime home loans. (For a specific example of payment shock, see the Appendix.) Today the dominant type of subprime loan is a hybrid mortgage called a “2/28” that effectively operates as a two-year “balloon” loan.¹¹ This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.¹² Commonly, this interest rate increases by between one-and-a-half and three percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.¹³ This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name “exploding” ARMs. Hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become “the main staples of the subprime sector.”¹⁴ Through the second quarter of 2006, hybrid

ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.¹⁵

While teaser rates already make the borrower's monthly payment artificially low, many subprime lenders also do not escrow for taxes and insurance. Subprime lenders often tout their low monthly payments without disclosing that the failure to escrow is the reason for much or all of the "discount" over the monthly payments offered by responsible lenders who do escrow. This creates a trap for borrowers who cannot afford the tax and insurance bill when it comes due, and makes it virtually impossible for responsible lenders, whose payments include escrows, to compete. A recent study by the Home Ownership Preservation Initiative in Chicago found that among low-income borrowers facing difficulty in managing their mortgage payments, for as many as one in seven, tax and insurance payments are a contributing factor.¹⁶

Because of the proliferation of hybrid ARMs with dangerous features, payment shock for subprime borrowers is a serious and widespread concern. According to an article in the financial press that ran a year ago, homeowners face increased monthly payments on an estimated \$600 billion of subprime mortgages that will reset after their two-year teaser rates end.¹⁷ Fitch Ratings calculated that by the end of 2006, payments would have increased on 41 percent of the outstanding subprime loans.¹⁸

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. These loans had extremely high prepayment rates caused by the scheduled payment shock—very few families could afford a 30 to 40 percent increase in their mortgage payment. In addition, since the monthly payment often failed to include payments for taxes and insurance, families that were stretched financially had difficulty coming up with these large lump sums every year. When housing appreciation was climbing, most borrowers refinanced before the payment shock hit—in fact, they were likely heavily solicited by brokers and subprime lenders to do so.

This high loan turnover accomplished several objectives for ratings agencies, investment banks, and investors. First, investors crave predictability of income streams above all else, and the average life of these loans was extremely short—recent cash flow assumptions from Fitch Ratings carry an assumed average loan life of two and one-half years for the most common variety of subprime ARM loans.¹⁹ Second, investors in the so-called P-classes received significant income from prepayment penalties paid by borrowers forced to refinance. Third, ratings agencies and investment banks received significant fees upon each refinancing. Brokers and lenders benefited too, since they are paid at each origination.

The only actor that doesn't benefit from these market dynamics, of course, is the family receiving the loans. Even under a best-case scenario, where the borrower is in an area with substantial property appreciation and is thus able to refinance, he or she will need to pay the costs of getting a new loan. The refinance can cost three percent in up-front points and fees, up to two percent in third-party fees, and about three percent in a prepayment penalty on the old loan if the refinancing is not timed just right, adding up to

eight percent of the loan amount. Based on current rate sheets that detail lenders' mortgage prices, a family saves only 65 basis points a year to get a hybrid ARM versus a fixed rate mortgage,²⁰ a loan they could potentially stay in for 30 years, saving 1.3 percent over two years. On a \$200,000 mortgage, the 6.7 percent needlessly expended constitutes \$13,000 in wealth stripped from the family simply because they were placed in a loan that they had no prospect of staying in versus one that they could maintain. Of course, if housing does not appreciate or declines, the family instead faces the very real prospect of losing their house to foreclosure.

III. Incentives Remain for Investors to Gamble on Families' Homes

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

In fact, dangerous products remain a staple in the market despite the lessons of recent months. One of the key findings in CRL's foreclosure report ("Losing Ground," cited above) is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit profile. Our findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: increases in mortgage payments after origination and poorly documented income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages

In spite of the known risks, subprime lenders are continuing to originate highly dangerous loans, and Wall Street is continuing to accept these loans. A review of five mortgage-backed securities offered in the first quarter of 2007 reveals that loans containing features shown to increase the risk of foreclosure continue to constitute a large portion of subprime offerings. The chart below compares the higher risk associated with certain products with the prevalence of those terms in these 2007 offerings.

Dangerous Products Remain Staples in the Subprime Market

| | Increased likelihood of foreclosure ¹⁵ (2000 vintage subprime originations) | Penetration rate of these high-risk loan features in five 2007 MBS offerings, (average). ¹⁶ |
|--------------------|--|--|
| ARM | 72% (117% - 2003 vintage) | 82% |
| Prepayment penalty | 52% | 72% |
| Stated income | 29% (64% - 2003 vintage) | 43% |

The proportion of product features that have been demonstrated to increase foreclosures in the subprime marketplace, compared to their relative infrequency in the prime market, belies any assertion that subprime borrowers freely and knowingly “choose” these riskier terms. These products and terms are supply-driven, not demand-driven, frequently promoted to satisfy originator and investor appetite for loans that regularly refinance and for higher-yields.

As foreclosure rates rise to alarming levels, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted, and in some instances investors have demanded the repurchase of loans that defaulted extremely quickly. In a few highly publicized cases, lenders have been forced out of business as a result.²¹ However, defaults that occur after a designated three-to-six month period are not generally the responsibility of the lender. And while recent investor attention may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

IV. Accountability for Loan Quality: Assignee Liability

One readily available approach for holding investors accountable for their role in driving the lending market is “assignee liability.”²² 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. Assignee liability would help ensure that when investors accept mortgages, with all the corresponding financial benefits, that they also accept reasonable liability for when the mortgages prove to be abusive and harm homeowners. Assignee liability would not only protect borrowers, but would also assist in preserving the integrity of the secondary market.²³

Since three-quarters of subprime home loans are sold on the secondary market,²⁴ assignee liability is a critical tool for addressing abusive mortgage lending practices. Without legal liability for assignees, a family that has been the victim of a predatory loan cannot stop the foreclosure of their home even if the originator is solvent and well-capitalized.

Instead, they end up losing their home, and then they must bring a separate action against the originator. This separate action can take years.

Assignee liability is even more important in light of the substantial involvement of mortgage brokers and other minimally capitalized originators who frequently go out of business before a homeowner recognizes a predatory loan.²⁵ For mortgage loans sold or otherwise assigned after closing, the party collecting and enforcing the note is not the one that the borrower dealt with and who originated the loan. In fact, while relatively few home loans were brokered ten years ago, about seventy percent of subprime mortgages are broker-originated today.²⁶

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. No one is more effective than investors who face financial and legal risk in ensuring that loans are originated to specified standards. Without assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. The lack of assignee liability provides little incentive to purchasers of such loans to determine if the loans were originated illegally or are so out of line with market norms that they present a substantial likelihood of abuse.

Assignee Liability in Context: A Common Component of Consumer Protection Law

Assignee liability is not a new concept; it exists in several other contexts related to lending. 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 instance, an assignee may not be considered a holder-in-due-course (and thus be entitled to enforce a promissory note without regard to a consumer's claim) if the assignee purchased a delinquent loan.²⁷ Furthermore, even a holder-in-due-course is subject to certain claims, including defenses based on duress, lack of legal capacity, illegality of the transaction, or fraud.²⁸

HOEPA itself provides for assignee liability in two instances. First, in instances where a homeowner did not receive the material disclosures required by HOEPA, the homeowner may rescind the loan (tender the principal owed on the loan and receive in return all interest and fees paid on the loan), even after it has been assigned.

Second, HOEPA provides that assignees of HOEPA high-cost home loans are subject to "... all claims and defenses ... that the consumer could assert against the original creditor...."²⁹ In instances where assignees are held liable pursuant to this provision, damages are capped at "the greater of (1) the applicable TILA damages or (2) elimination of the loan and recovery of all payment made."³⁰ In other words, without time limits

apart from those governing the underlying cause of action, an assignee may be liable for damages equal to amounts owed plus all amounts paid on the loan, including amounts paid before it took assignment of the loan. The only exception to this strict liability lies in instances where an “assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine ... [that the loan was a HOEPA high-cost home loan].”³¹

HOEPA’s legislative history provides the following helpful explanation of the motivation for and desired effect of this provision:

By imposing assignee liability, the Committee seeks to ensure that the High Cost Mortgage market polices itself. Unscrupulous lenders were limited in the past by their own capital resources. Today, however, with loans sold on a regular basis, one unscrupulous player can create havoc in a community by selling loans as fast as they are originated. Providing assignee liability will halt the flow of capital to such lenders.³²

As one would expect, when faced with potential liability, assignees have developed techniques that limit their exposure. For example, in virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Investors also conduct due diligence, such as loan sampling, to verify the integrity of the loans they are buying. Moreover, individual investors in securities backed by subprime home loans retain confidence since they have no individual liability under any assignee liability schemes designed by HOEPA or in the states since, as investors in securities, they are not “holders” or “assignees” of the individual loans and consequently may not be sued.

State Laws Strike a Balance

Building on HOEPA’s initial statement of assignee liability for high-cost home loans, states such as North Carolina, New Jersey, New Mexico, New York, Illinois, Massachusetts, and Rhode Island have developed and implemented provisions that establish different levels of assignee liability for investors, depending on whether they intentionally purchase high-cost loans as defined by those state laws. The provisions in those states attempt to satisfy several goals at once, balancing the interests of borrowers and investors. In short, they seek to (1) provide a clear incentive for the secondary market to conduct due diligence to prevent the unintentional purchase of high-cost home loans, (2) ensure that homeowners being foreclosed on or otherwise suffering harm arising from a predatory loan can defend their home, and (3) cap liability at the amount of the loan plus costs and prohibit class action lawsuits against good faith secondary market participants that unintentionally purchase a high-cost home loan.³³ They demonstrate that it is possible to strike a balance between having appropriate liability and addressing secondary market concerns.

Other than the prohibition against loan flipping, which has not been effective because the 2/28 defective product design leads to serial refinances, it appears that state anti-predatory lending laws are having their intended effects at curbing the abusive mortgage

terms they targeted. The Center for Responsible Lending examined this issue specifically in research issued last year in which we examined 28 state reforms by analyzing six million subprime mortgage loans made over a seven-year period. We found that in states with anti-predatory lending laws that go beyond current federal protections, borrowers get fewer loans with abusive terms without losing access to mortgage credit.³⁴

Typically, rating agencies responded to state assignee liability provisions by requiring extra credit enhancements in pools that included high-cost mortgages covered by such state laws. The credit enhancement requirement may have forced lenders to hold high-cost loans in their portfolios. In effect, then, assignee liability provisions discouraged lenders from making unnecessary high-cost loans while allowing those loans that truly merit high-cost pricing to be made by lenders with sufficient financial strength to stand behind their loans—exactly the outcome desired by those who have supported strong anti-predatory lending laws. It is also worth noting that the subprime market experienced extraordinary growth during recent years, when many states were strengthening anti-predatory laws, including, in some cases, stronger assignee liability provisions. Approximately two dozen states took action to give consumers stronger protections against subprime loans from 1998 through 2005 – the same period when the share of subprime mortgages increased from just three percent of the total market to over 20 percent.

V. Preventing Foreclosures and Improving Loan Quality – Leadership Urgently Needed

In addition to Congress preventing abusive originations in the future by holding the secondary market accountable, the secondary market also has an opportunity to play a role in limiting the damage caused by abusive loans that have already been made. Investors will have tremendous influence in how many more losses are suffered in the subprime market. As stated recently by an executive of Countrywide Mortgage, “The investor ‘owns’ the loan and determines which options are available to borrowers in default, while the mortgagor, the “servicer,” maintains the loan on behalf of the investor.”³⁵

It is critical that investors support servicers that are modifying existing subprime loans or lenders that are offering constructive refinances by purchasing these loans under attractive terms. This point was underscored recently when the Committee on Banking, Housing, and Urban Affairs, led by Senator Dodd, issued principles for preserving ownership for families who are now struggling with hybrid ARMs. The principles included a number of strategies for assisting homeowners in distress, including early contact and evaluation by loan servicers, low-cost refinancing to prime loans, and various options for modifying mortgages to create sustainable financing.³⁶ For borrowers facing an unaffordable increase in payments due to the scheduled reset of a 2/28 mortgage, a no-cost modification is the best solution.

There is an emerging consensus that servicers have the ability under the vast majority of Pooling and Servicing Agreements, IRS REMIC (Real Estate Mortgage Investment Conduit) rules, and accounting standards to proactively modify loans whenever they determine in good faith that it is reasonably foreseeable that the borrower will default.

A recent Credit Suisse report found that agreements “give servicers wide leeway in working with borrowers” and “most servicing documents have few restrictions on loan modifications.”³⁷ In fact, some servicers are already calling borrowers six months before rates are scheduled to reset to make sure that they are aware of this fact and to determine whether they will be able to handle the payment shock.³⁸

We are heartened by an announcement made just last week that Moody’s Investors Service is considering taking a major step to encourage loan modifications on subprime loans headed for foreclosure. Specifically, Moody’s would essentially penalize mortgage-backed securities that restrict the number of loans that can be modified. This is welcome news, especially since Moody’s rates more than 90 percent of subprime mortgage-backed securities.³⁹ We hope other rating agencies will follow suit and explore other ways they can encourage servicers and lenders to offer borrowers responsible loan modifications.

While it is clear that servicers will modify substantial numbers of loans facing reset, it is much less clear that these modifications will enable families to remain in their homes for the life of the loan.

We have heard reports that servicers are simply delaying the 2/28 reset for two years, placing the borrower right back where they started two short years later. The 2/28 is an irresponsible loan, and delaying the problem for two years is not what is needed. Instead, servicers should make the loan permanently affordable for the borrower by, for example, extending the teaser rate for the life of the loan, and/or reducing the interest rate and/or the principal balance.

Investors as a whole win when the servicer ensures a steady, even if lower, stream of principal and interest payments, since loss severity in a stable or declining property value environment, particularly given the epidemic of overstated appraisals, will often exceed 50 percent of the value of the loan. Investors have sound economic reasons to encourage servicers to engage in widespread permanent loan modification programs or low-cost refinance efforts. And, given that investors participated in and benefited from placing borrowers in highly unsuitable loans, they certainly have an obligation not to stand in the way of constructive efforts to repair abusive loans.

The Government-Sponsored Enterprises (GSEs)

Not all of the support for 2/28s came from private Wall Street firms. Even though Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), have a mandate to help families achieve homeownership, and over the years have made a significant contribution, they, too, purchased subprime securities backed by loans that were made without considering low- and moderate-income families’ ability to repay.

In February, however, Freddie Mac took an important step by announcing it would no longer purchase mortgage-backed securities backed by abusive subprime loans. In addition, both Fannie Mae and Freddie Mac recently announced substantial commitments to helping borrowers who are facing subprime rate resets.⁴⁰

Finally, although data is hard to come by, I believe that Federal Home Loan Banks (FHLBs) have continued to fund subprime loans that are likely abusive. Enabling subprime lenders to hold these loans in portfolio through their advance program is functionally equivalent to purchasing the loans, and therefore equally problematic. The Federal Housing Finance Board or Congress should impose more demanding anti-predatory lending guidelines on FHLB advance programs, just as HUD and Ofheo have done for Fannie Mae and Freddie Mac mortgage purchases.⁴¹

Rating Agencies

As discussed above, mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with loans that could be easily resold, despite a high likelihood of foreclosure. For example, approximately 80 percent of subprime mortgages included in securitizations issued during the first nine months of 2006 carried an adjustable-rate feature, the majority of which are 2/28s.⁴² Yet, until very recently, the rating agencies raised no red flags about securities backed by subprime mortgages. We urge the rating agencies to develop stronger internal policies to screen for and guard against abusive loans, and to give weight to origination and servicing practices that provide sustainable homeownership opportunities.

Securities and Exchange Commission

Given that the securities market is regulated by the Securities and Exchange Commission (SEC), that agency has an opportunity to take an active role in preserving homeownership among subprime borrowers today. The SEC should join other federal and state regulatory agencies in urging lenders and servicers to work with borrowers to modify unsustainable loans so that borrowers can keep their homes for the life of the loan. The SEC should also make public its efforts to investigate Wall Street's role in the current foreclosure crisis, and offer a proposal for working with industry to provide immediate relief to the millions of families at risk of losing their homes.

Conclusion

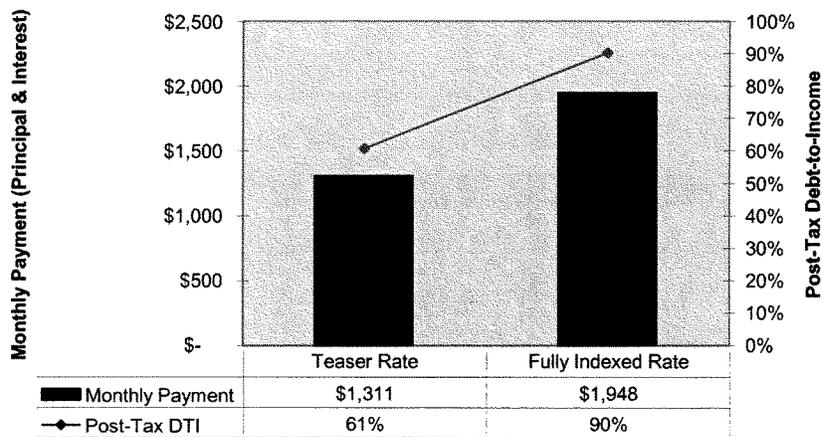
Subprime lending and the secondary market involve many complexities, but it is important to bear at mind that the fundamental policy issue is sustainable homeownership for families. The rest is just a means to an end. Whether families achieve lasting ownership has huge implications for the future economic health of our nation. The current situation has produced neither sustainable profits nor sustainable ownership, and the losses have adverse consequences for all parties involved. Both Wall Street and homeowners stand to lose from a market that offers unsustainable loans. Placing incentives on the secondary market to self-police the loans it buys is one of the best possible ways to ensure that families receive loans that they can keep.

APPENDIX

Payment Shock

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

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



For the 2/28 ARM shown in the chart above, we are making conservative assumptions that correspond with typical mortgages of this type. To make the example even more conservative, we are assuming no general increase in interest rates, even though rates have increased substantially in the past three years. The example is based on an introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent.⁴³ The loan amount used in this example was \$200,000, and, given the common practice of extending loans where the pre-tax debt-to-income ratio is 50 to 55 percent, we assume that this homeowner had a pre-tax income of \$31,452, which equates to a post-tax income of \$25,901.

At the end of the introductory rate period, this homeowner’s interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped from \$1,311 to \$1,716, and again six months later to \$1,948, an increase of over \$600 a month.⁴⁴ This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At \$1,948, this leaves only \$210/month for all other expenses – including

property taxes and hazard insurance, food, utilities, transportation, healthcare, and all other family needs.

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

NOTES

¹ A full copy of the “Losing Ground” foreclosure study and an executive summary appear on CRL’s website at <http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189>.

² Mortgage Finance Industry Overview, Lehman Brothers Equity Research, p. 4 (December 22, 2006).

³ *Inside B&C Lending* (Sept. 1, 2006); see also *Inside Mortgage Finance* – MBS Database, 2006.

⁴ Nearly 55 percent of African Americans who purchased homes in 2005 received higher-rate loans; 49 percent received such loans to refinance their homes. Slightly more than 46 percent of Latino borrowers received higher-rate purchase loans; about 34 percent received higher-rate refinance loans. See CRL internal analysis of HMDA data, www.responsiblelending.org/pdfs/HMDA-Comment-9-28-06.pdf.

⁵ By comparison, corporate bonds accounted for 20 percent of the market, and Treasury debt accounted for another 16 percent. *U.S. Bond Market Debt*, Bond Market Association (June 30, 2006) at <http://www.bondmarkets.com/assets/files/Outstanding%20Level.pdf>.

⁶ According to the Mortgage Bankers Association, mortgage brokers now originate 45% of all mortgages, and 71% of subprime loans. MBA Research Data Notes, “Residential Mortgage Origination Channels,” September 2006.

⁷ Ren S. Essence and William Appgar, *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.

⁸ Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (June 19, 2006) at SSRN: <http://ssrn.com/abstract=910378>.

⁹ Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*, New York Times (Fri. Jan. 26, 2007) C1, C4.

¹⁰ David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*, Washington Post (May 7, 2007).

¹¹ A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

¹² See, e.g. *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 [Fitch Ratings Credit Policy](#) (August 21, 2006).

¹³ Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

¹⁴ See *Structured Finance*, note 12.

¹⁵ See *Structured Finance*, note 12.

¹⁶ *Partnership Lessons and Results: Three Year Final Report*, p. 31 Home Ownership Preservation Initiative (July 17, 2006) at www.nhschicago.org/downloads/82HOPI3YearReport_Jul17-06.pdf.

¹⁷ Jonathan R. Laing, *Coming Home to Roost*, p. 26 [Barron's](#), February 13, 2006.

¹⁸ See *Structured Finance*, note 12.

¹⁹ Fitch Ratings, U.S. RMBS Intex-based Cash Flow Model (last verified Feb. 7, 2007).

²⁰ The industry itself has acknowledged that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, with a rate difference that is “commonly in the 50 to 80 basis point range:” indeed, often a fixed rate loan can have a lower interest rate and monthly payments than a stated income exploding ARM loan. January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. A review of rate sheets from eight subprime lenders showed that the fixed rate premium in the spring of 2007 ranged from 40 basis points (available with a 3-year prepayment penalty) to 75 basis points. See, e.g. Appendix B, October, 2006 rate sheet with a 65 basis point fixed rate premium.

²¹ Patrick Crowley, *Repurchases Sting Subprime Sector*, [MortgageDaily.com](#) (Jan. 5, 2007). See also, “Subprime Status Report,” [American Banker](#) (April 2007).

²² An “assignee” is a party who purchases or otherwise takes a financial interest in the loan. The assignee has the right to collect payments and enforce the terms of the loan, including foreclosing on a house if a borrower defaults.

²³ Recently Harvard issued a study that also recommended lifting current restrictions on assignee liability – see note 7.

²⁴ *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market* (April 2, 2007), cited by Sheila Bair, Chair, Federal Deposit Insurance Corporation in a statement to the Committee on Financial Services, U.S. House of Representatives (April 17, 2007).

²⁵ Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. See Wholesale Access, “New Research About Mortgage Brokers Published,” (August 6, 2003) (available at: <http://www.wholesaleaccess.com/8.6.03.mb.shtml>) and Eggert, Kurt, “Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,” [Creighton Law Review](#), v35, n3 (April 2002).

²⁶ See note 6.

²⁷ See e.g., NCGS 25-3-302 (detailing this and other prerequisites to holder-in-due-course status).

²⁸ See e.g., NCGS 25-3-305(a)(1).

²⁹ 15 U.S.C. 1641(d).

³⁰ See e.g., *In re Murray*, 239 B.R. 728, 733 (Bkrtcy. E.D. Pa. 1999) (applying damages cap from 15 U.S.C. 1641(d)(2) and 15 U.S.C. 1641(d)(3)).

³¹ 15 U.S.C. 1641(d)(1).

³² S. Rep. No. 103-169, at 28 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1912.

³³ For example, under New Jersey's existing law, we estimate that the likelihood that an assignee who inadvertently purchased a high-cost home loan would face exposure is one in a million. The chances are this low because, in order for a good-faith loan assignee to face exposure on a given loan, all of these events must occur: (1) A high cost loan is purchased in spite of due diligence; (2) the loan contains a clear violation; (3) the borrower successfully prosecutes a claim; and (4) the seller of the loan is insolvent and can't indemnify the assignee.

³⁴ Wei Li and Keith Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (February 23, 2006), available at www.responsiblelending.org.

³⁵ Jerry Durham, Vice President – Homeownership Preservation, Countrywide, “Preserving the Dream of Homeownership,” presentation dated May 6, 2007.

³⁶ United States Senate, Committee on Banking, Housing and Urban Affairs, “Homeownership Preservation Summit—Statement of Principles (May 2, 2007).

³⁷ Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications, Fixed Income Research* (April 5, 2007), available at <http://www.credit-suisse.com/researchandanalytics>.

³⁸ See, e.g., “Option One Mortgage Corporation Announces Support of the Senate Banking Committee’s Principles for Mortgage Servicers,” press release issued by Option One Mortgage Corporation (May 4, 2007).

³⁹ Jody Shenn, “Moody’s May Penalize Subprime Bonds that Cap Changes,” *Bloomberg* (April 25, 2007).

⁴⁰

http://www.fanniemae.com/media/speeches/speech.jhtml?jsessionId=QHTBFLCBO5TAZJ2FQSHSFGA?repID=/media/speeches/2007/speech_267.xml&counter=1&p=Media&s=Executive+Speeches;
http://freddiemac.com/news/archives/corporate/2007/20070418_subprime_commitment.html

⁴¹ See Testimony of Martin Eakes before the Committee on Banking, Housing and Urban Affairs, Hearing on the Federal Home Loan Bank System, April 13, 2005, <http://www.responsiblelending.org/pdfs/041305-EakesTestimony.pdf> at 11-15.

⁴² *Inside B&C Lending*, Inside Mortgage Finance, p. 2 (November 24, 2006).

⁴³ The typical 2/28 rises to 6-month LIBOR (now 5.35 percent) plus an index of 6.5 percent, or almost 12 percent.

⁴⁴ Typically the rate increase at the first adjustment is capped somewhere between 1.5 and 3 percentage points. On this loan, the rate reached the fully indexed rate at the second adjustment two-and-a-half years into the loan.

83

Testimony Of

**Cara Heiden
Division President
Wells Fargo Home Mortgage**

Before the

**House Financial Services Subcommittee on Financial Institutions
United States House of Representatives**

May 8, 2006

Chairwoman Maloney, Ranking Member Congressman Gillmor, and Members of the Subcommittee, thank you for the invitation to testify today. Understanding your focus is on the secondary market, I've been asked to provide context for the role of the lender and servicer in the mortgage lending cycle. This includes the efforts we undertake every day to make the dream of homeownership achievable and sustainable for a wide spectrum of consumers, under terms that are appropriate for all transaction stakeholders.

I'm Cara Heiden, and together with Co-President, Mike Heid; I lead Wells Fargo Home Mortgage – the nation's leading mortgage lender and the largest servicer with more than 7.7 million customers and loan balances totaling 1.4 trillion dollars. 94 percent of the loans we service are for other investors, and the vast majority are packaged into mortgage-backed securities. We have consistently achieved the highest rankings for servicing practices by Fannie Mae, Freddie Mac, HUD, private investors, and the rating agencies.

Having spent the past 25 years at Wells Fargo, I can honestly tell you that our fair and responsible principles are not viewed as policies by which we have to abide – but instead are the moral fabric upon which our business operates.

Culturally, we have always been – and remain committed to the lifetime customer relationship. Our vision is to help consumers achieve financial success, and this includes treating nonprime borrowers fairly and responsibly.

Along with prudent credit underwriting, here are examples of the practices we consistently follow

- First and foremost, we only approve applications for loans if we believe the borrower has the ability to repay the loan.
- We provide consumers with the information needed, helping them to make fully-informed decisions about the terms of our loans.
- We do not make pay option ARM's or negative amortization loans.
- We have controls to ensure that first mortgage customers are offered prime pricing options when they qualify, based on their credit characteristics and the terms of their loan transaction.

- We advise customers who apply for loans with prepayment fees of the availability of loans without them – and help them understand the associated cost impacts. We also limit our prepayment fees to the lesser of three years or the fixed term of an adjustable rate loan.
- And, finally, we will only make a loan if it offers a demonstrable benefit to the consumer, such as reducing the monthly payment on debt, obtaining significant new money, or purchasing a home.

Our responsible lending principles have been publicly posted for years on our wellsfargo.com web-site for all consumers to read.

In addition, we have a series of long-standing responsible servicing practices that serve the needs of our customers and investors.

We proactively contact customers in default and work with them on a case-by-case basis to find solutions that help them remain in their home and protect their credit.

Most customers never miss a payment, but for those who do, we have experts dedicated to working with them early, often, and typically up to the actual point of foreclosure. In addition, we work extensively with local organizations and credit counselors that provide assistance to borrowers.

Importantly, the lending and servicing principles I have just described are 'evergreen' – meaning they are designed to survive every economic cycle. Occasionally, such as in the current unique economic environment, it is even more important to live by these principles.

For instance, we are collaborating with the investor community to develop more options to assist customers facing difficult adjustable-rate mortgage resets. This work involves introducing greater levels of flexibility in loan modifications and customer loan workouts. We do this, understanding that solutions must align with investor, trustee and master servicer contractual and credit obligations.

Also, in outreach to new borrowers or those refinancing we launched our Steps to Success program in mid-2006. This free program provides financial education; the means to be more familiar with credit reports; and information about banking products that can help make money

management, routine and effective. This program is proving to be beneficial to those who need assistance.

In closing, let me reiterate that Wells Fargo is firmly committed to continuing to lead the industry in advocating and conducting fair and responsible lending and servicing. It is critical that mortgage lenders and servicers live by principles that eliminate troublesome practices and help consumers through challenging times. We look forward to continually working with all the participants in the housing finance industry to find more solutions that benefit consumers – expanding homeownership and preserving it.

Thank you again, Chairwoman Maloney, ranking member Congressman Gillmor, and Members of the Subcommittee, for your time today and this opportunity to share Wells Fargo's day-to-day responsible lending and servicing practices. I will be happy to answer any questions the Subcommittee may have.

Wells Fargo Home Mortgage is part of Wells Fargo Bank, N.A. and Wells Fargo & Company, a diversified financial services company with \$486 billion in assets. Wells Fargo Bank, N.A. is the only bank in the U.S., and one of only two banks worldwide, to have the highest credit rating from both Moody's Investors Service, "Aaa," and Standard & Poor's Ratings Services, "AAA."

87

Statement

of

**Judith A. Kennedy
President and CEO**

**National Association of Affordable Housing Lenders
on
“The Role of the Secondary Market in Subprime
Mortgage Lending”**

**Subcommittee on Financial Institutions and Credit
House Committee on Financial Services
U.S. House of Representatives**

May 8, 2007



CELEBRATING 30 YEARS OF SUCCESSFUL COMMUNITY INVESTMENT

NAAHL represents America's leaders in moving private capital to those in need, 200 organizations committed to increasing lending and investing private capital in low- and moderate-income (LMI) communities. This "who's who" of private sector lenders and investors includes 50 major banks, 50 blue-chip non-profit lenders, and others in the vanguard of affordable housing, including insurance companies, community development corporations, mortgage companies, financial intermediaries, pension funds, and foundations.

TOGETHER WE CAN

In the fall of 1999, the premier advocate for increasing lending and investing in underserved areas challenged NAAHL to be a leader in finding practical solutions to the problem of predatory lending. Gale Cincotta, whom many of you knew, the founder of National People's Action in Chicago and a prime mover in achieving the Community Reinvestment Act 30 years ago, worked closely with NAAHL members. She knew that they were, and are, America's pioneering lenders and investors in low and moderate income communities. Even though Gale was ill and frail, she made the effort to come and speak to us about abusive lending practices in Chicago that were victimizing borrowers, their neighbors and their communities. Gale also emphasized that the consequences would undermine 20 years of our mutual, very successful effort to bring private capital to underserved areas. Our members agreed that NAAHL would commit to be part of the solution to this problem, which was also surfacing in other cities and states.

NAAHL's focus on ensuring that private capital was not only accessible to low and moderate income persons, but was provided on fair terms as well, culminated in our February 2001 symposium on the challenges and practical solutions to abusive lending practices. The symposium brought together mortgage experts from local and Federal governments, insured institutions, advocacy groups, and GSEs. This convening of practitioners, all people of good will and extraordinary knowledge and experience, included then Secretary of HUD Mel Martinez, who shared his own perspective on the problems and solutions from his experiences with Cuban immigrants and as a country executive. After acknowledging the very real challenges to ensuring that mortgages did not include abusive terms. Secretary Martinez assured participants that "Juntos Podemos, Together We Can."

The report from the first symposium was very well received by policymakers, with then Senate Banking Chairman Paul Sarbanes calling it "the roadmap" for ending abusive lending. Senator Sarbanes often credited NAAHL for sharpening his own focus on meaningful solutions, including recommendations for stronger oversight because, as he liked to quote from our report, "In a town with no sheriff, the bad guys are in charge." We take pride in the fact that policymakers adopted several of the recommendations from that symposium, including expanding greatly the universe of lenders required to report under the Home Mortgage Disclosure Act (HMDA), and increasing reporting under the Home Ownership and Equity Protection Act (HOEPA). In addition, the symposium emphasized the critical importance of a level playing field for all mortgage lenders, and

shared banks' and states' best practices in conducting due diligence of brokers, other consumer protection initiatives, and enforcement.

NAAHL also participated in the HUD/U.S. Department of Treasury Joint Task Force on Predatory Lending, and worked with Members of Congress, Federal regulators, states' Attorneys General, to raise awareness, but also hone in on practical solutions to ending abusive and predatory loans. Some of the Task Force recommendations have been implemented; others have not. But the report provided an excellent summary both of the problems in several urban markets, and some practical solutions.

Over the past 5 years there has been growing, bipartisan, Congressional attention to stopping abusive lending, and some states' and local governments have implemented significant reforms. The bank regulators' determination to stop abusive terms without ending legitimate loans to subprime customers, with strict examination and revisions to regulations and guidance governing insured institutions, has been evident. As Comptroller John Dugan recently pointed out "The plain fact is that national banks have relatively small share of the subprime mortgage market. Last year, they originated less than 10 percent of all subprime mortgages, and the delinquency rate for such loans has run about half the industry average."

How then, we all have wondered, could this extreme increase in subprime loans happen, especially after Freddie Mac reported that half of the borrowers with subprime-priced

mortgages could have qualified for a prime loan? How has the country moved so quickly to a 2-tiered system of mortgage lending?

While there is plenty of responsibility for this condition all around, the secondary market has a town with no sheriff. GSEs' role in the extreme rise of exploding loans is yet another, very painful example of the turmoil resulting from Congress' failure to enact H.R. 1427. The lack of GSE oversight and a bipartisan compromise signed into law more than 20 years' ago, facilitated the extreme increase in subprime loans.

LOOKING FOR LOANS IN ALL THE WRONG PLACES

For the past several years, even Fannie and Freddie's best "seller/servicer" customers have complained to the GSEs that they refuse to help primary lenders meet the credit needs of their communities. The GSEs *fear of buying* single family mortgages made to CRA-eligible, qualified borrowers with little cash to bring to the purchase was seen as outdated by experienced lenders. Fannie Mae and Freddie Mac's resistance to consumer-friendly, CRA-eligible, conventional, sound prime loans, banks and non-profit lenders told them, meant GSEs were leaving a lot of good business on the table. For example, in 2005 alone, \$314 billion dollars of CRA-eligible, consumer-friendly, single family mortgages were made.

Despite a charter change directing the GSEs to *lead the industry* in ensuring that access to mortgage credit is available to low and moderate income families, Fannie Mae and Freddie Mac have not yet brought the benefits of a government-sponsored secondary

market to the prime segment of the market. Unfortunately, the consequences the GSEs leaving too much good business on the table from single family and multifamily CRA-eligible mortgages on affordable housing are now becoming clear.

First, the primary market for CRA loans is increasingly *constipated* for lack of capital. Billions of dollars in CRA-eligible loans remain on the books of the originating lenders, unless and until the lenders can replenish their supply of funds to do more. Primary lenders, both banks and non-profits, have to peddle sound loans like Fuller Brush men of old. Investors include pension funds, insurance companies, and other organizations but involve mostly expensive, time consuming private placements.

Second, Fannie and Freddie have fueled the extreme increase in subprime loans through portfolio investments in the triple-A rated pieces of securities backed by subprime loans. Presumably, their investments will pay off. Others in the entire mortgage chain are clearly at risk.

Press reports on securitization of subprime loans in 2006 revealed that Fannie Mae and Freddie Mac are major financiers of subprime loans through purchase of MBS. In 2004 the two GSEs purchased 44% of the \$401 billion of securities backed by private label, subprime mortgages, for approximately \$176 billion; in 2005 they purchased 35% of the \$507 billion in MBS backed by subprime, for approximately \$178 billion; and the first half of 2006, they purchased about \$78 billion, about 25% of the total subprime MBS sold during that time period, according to *Inside Mortgage Finance* (September 18,

2006). There were about \$600 billion dollars worth of subprime mortgages originated in 2006. (*Standard & Poor's Weighs In On the U.S. Subprime Mortgage Market*, April 2, 2007). Subprime mortgages accounted for an increasing share of originations in recent years, from 7.9 percent in 2003 to 20 percent in 2005. (*Inside Mortgage Finance*, December 1, 2006).

Third, it appears that "a healthy chunk," perhaps \$200 billion dollars or more, of these subprime MBS were used by Fannie Mae and Freddie Mac for "affordable housing" goals' credit. As the Los Angeles Times reported on 1/18/2007, *"Several experts call Fannie Mae and Freddie Mac key enablers of sub-prime excess. 'What are they doing,' Chuck Cross, a former Washington State official, asked rhetorically, 'buying loans from a company that just suffered the second-biggest predatory-lending settlement in history?'"*

Because the GSEs say they only purchase the safest tranches of private label securities backed by subprime mortgages, they are well protected against defaults, and Fannie Mae says its average loan-to-value ratio on loans is only 54%. But because Fannie Mae and Freddie Mac truly are the nation's mortgage market makers, the practices had a troubling, if subtle, impact. Instead of the GSEs adapting to the needs of the affordable housing market, the market has evolved by adapting to what the GSEs will buy. Fortunately, OFHEO Director James Lockhart announced early this year that the GSEs should follow the same guidance issued by the bank regulators, both for loan purchases, and securities investments.

Issuing GSE debt to purchase triple A-rated, presumably risk-free securities backed by high-yielding, subprime mortgages with terms the GSEs renounced in their regular

purchase programs (higher debt to income ratios; less money down; lower credit scores), while rejecting prime loans from their best customers with similar terms because they are less lucrative, is still another example of why H.R. [1427](#) reforms are needed. Strengthening of the affordable housing goals, and tougher enforcement authority for OFHEO are critical to rebalancing the mortgage market.

WHERE DO WE GO FROM HERE?

LEVEL THE PLAYING FIELD

Close the barn doors on examination and reporting.

Less than one-third of all mortgage lenders are banks. The 50,000 non-bank lenders fall under the purview of HUD and the FTC, and do not undergo bank-like examinations.

Apply the same regulations and guidance to all mortgage lenders, and enforce them as strictly.

California's Greenlining Institute recently wrote to the bank regulators about their strengthened guidance on subprime loans. Greenlining expressed concerns that "these guidelines could have the unintended consequence of forcing an increasing number of low and moderate income owners into the unregulated subprime market. Perhaps it would be better for the regulators to consider supporting and encouraging Congressional legislation that would regulate all home loans and those who participate in originating or developing the secondary markets for such loans. That is, legislation should be considered to cover federally unregulated mortgage brokers (who are generally the largest abusers in the subprime market) and the Wall Street

investment bankers, such as Morgan Stanley and Lehman Brothers, that are responsible for most of the financing of the subprime market and, in fact, have shares in many subprime companies. Consideration should also be given to covering the insurance industry and hedge funds that adversely influence the housing market. (See for example, recent articles estimating that Wall Street investment bankers are responsible for 60% of recent subprime loans, Wall Street Journal 03/12/2007 and New York Times 03/13/2007 on New Century Financial and New York Times, 03/11/2007, “Crisis Loans in Mortgages”).”

For example, the ability to repay a loan should be required for subprime loans. Loans should not be made that require resources beyond current and expected borrower income for repayment (e.g. requiring collateral liquidation).

REVIST EXISTING “FILTERS” THAT FAILED

Well- intended statutes like the Secondary Mortgage Market Enhancement Act (SMMEA) of the mid-eighties, and the GSE Charter changes in the early nineties to clarify Fannie Mae and Freddie Mac’s responsibilities to affordable housing, have not had the intended results. SMMEA provided some of the benefits of government – sponsorship to investment banks to facilitate their issuance of MBS. As a precautionary filter, Congress restricted those benefits only to securities which qualified for the highest ratings of a national rating organization. Financial engineers quickly invented ways to get top ratings that had nothing to do with the quality of the underlying loans. In addition to enacting reform of GSE oversight and goals, Congress should hold oversight hearings on reforming SMMEA.

BUILD ON WHAT WE KNOW WORKS

In late 2004 NAAHL convened a second symposium “Together We Can –Again.” As before, NAAHL convened experts from all sectors to evaluate progress and brainstorm solutions to remaining problems. The report highlights:

- How comprehensive examination of banks acts as a deterrent to predatory practices among federally insured and regulated banks and thrifts
- The role of brokers and other non-bank lenders, and such practices as “push marketing” which encourage borrowers to take on more debt that they can afford or need
- Collaborative and creative partnerships to deal with this multi-faceted challenge, and the role of counseling and financial education
- The role of states as “laboratories of democracy”, and the issues involved in state versus federal legislative approaches

It also documents the novel mitigation efforts invented for communities struggling with victimized borrowers and neighbors. Particularly striking is that despite what appears to be in very different cities, NAAHL members Century Housing in Los Angeles and Neighborhood Housing Services of Chicago independently invented the exact same wheel to support LMI homeowners.

Both Century and NHS had found ways to cut through the complexity of the mortgage market, to get otherwise qualified homebuyers with little cash to bring to the table into homes, and keep them. But predatory lenders in each city caused many at-risk

homeowners also to approach these non-profits for foreclosure counseling. Two thousand miles apart, Century and NHS quite independently figured out in partnership with local government not only how to keep these families in their homes, but also how to resolve consequences of predatory abuse for the community.

On June 25, 2007 NeighborWorks, the umbrella organizations of NHS Chicago and 200 other NHS affiliates around the country, with backing from lenders and in partnership both with community-based and national organizations like NAAHL, will launch a national media campaign, with one toll-free number for any and all homeowners who feel at risk. The campaign hopes to drive struggling homeowners to call 888-995-HOPE, where HUD-certified counselors will be available 24 hours a day, 7 days a week, speaking in both English and Spanish. They can coach callers on lender options, non-profit resources, and credit counseling. As appropriate, the counselor can also link callers with their lenders, or a local NeighborWorks organization, for face to face counseling.

Finally, meaningful updating of CRA incentives by the bank regulators has provided a boost to all lenders' efforts. Updating decade-old CRA regulations to acknowledge the importance of community development lending would also make a real difference.

Together We Can!

LOOKING FOR LOANS IN ALL THE WRONG PLACES?

CALL NAAHL

202-293-9855



Moody's Investors Service

Testimony of Warren Kornfeld
Managing Director
Moody's Investors Service

Before the
Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives

May 8, 2007

Good morning Chairwoman Maloney, Ranking Member Gillmor, and members of the Subcommittee. My name is Warren Kornfeld, and I am a managing director for the residential mortgage backed securities rating team at Moody's Investors Service. On behalf of my colleagues, let me thank the Subcommittee on Financial Institutions and Consumer Credit for the opportunity to participate in today's panel on the role of the secondary market in subprime mortgage lending.

As you know, the subprime residential mortgage market has been attracting considerable attention recently because subprime mortgage loans originated in 2006 are experiencing more delinquencies and defaults than did loans originated during the prior few years. The steady increase in the risk characteristics of loans made to subprime borrowers over the past several years and the recent slowing in home price appreciation have been major contributors to this weakening performance. I have focused my statement on Moody's views on the credit performance of the subprime mortgage securitization market, the process of packaging subprime mortgages into bonds or other fixed-income securities, the role of rating agencies in the subprime mortgage securitization market, the credit factors that Moody's considers when rating mortgage-backed securities, and the structural features of securitizations that affect loan modification.

I would note at the outset that rating agencies have a limited and specific role in the securitization process: we provide an objective independent opinion on the creditworthiness of a security when we are asked to rate it. Moreover, Moody's opinions speak only to one aspect of the subprime securitization market, specifically the credit risk

associated with the bonds that are issued. Finally, the observations and information contained herein are largely based on data and experience related to the subprime mortgage securitizations that Moody's rates, and not on the broader subprime mortgage market, some of which was securitized by the originators and rated by rating agencies other than Moody's, and some of which was not securitized. Consequently, our comments should not be construed as representing the state of the entire subprime lending market.

I. Background on Moody's

Rating agencies occupy a niche in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, corporations, governmental entities, and pools of assets collected in securitized or "structured finance" transactions. Moody's is the oldest bond rating agency in the world, having introduced ratings in 1909. From its beginning, Moody's focused on rating debt instruments. By 1924, Moody's was rating nearly every bond in the United States bond market.

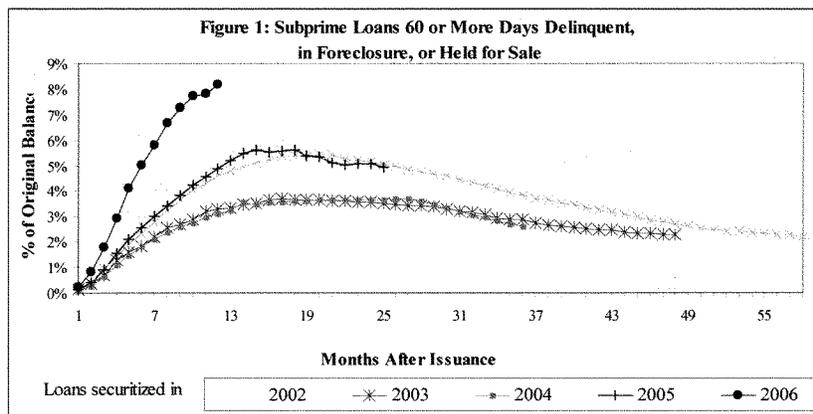
Today, we are one of the world's most respected, widely utilized sources for credit ratings, research and risk analysis and our Structured Finance Group is the leading source of credit ratings and research for the structured finance market. The firm publishes market-leading credit opinions, deal research and commentary, serving more than 9,300 customer accounts at some 2,400 institutions around the globe. Our ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers, and 96,000 structured finance obligations.

Moody's ratings are forward-looking opinions regarding relative expected loss, which reflects an assessment of both the probability that a debt instrument will default and the amount of loss the debt-holder will incur in the event of default. Our ratings are expressed according to a simple system of letters and numbers, on a scale which has 21 categories ranging from Aaa to C. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, a yet higher expected loss rate at the A level, and so on down through the rating scale. In other words, the rating system is not a "pass-fail" system; rather, it is a probabilistic system in which the forecasted probability of future loss rises as the rating level declines.

Therefore, while Moody's ratings have done a good job predicting the relative credit risk of debt securities and debt issuers, as validated by various performance metrics including default studies, they are not statements of fact about past occurrences or guarantees of future performance. Furthermore, ratings are not investment recommendations. Moody's credit ratings provide an opinion on only one characteristic of fixed income securities or issuers of fixed income securities – the likelihood that debt will be repaid. That is just one element, and in many cases not the most material element, in an investor's decision-making process for credit-sensitive securities. Credit ratings do not address many other factors in the investment decision process, including the price, term, likelihood of prepayment or relative valuation of particular securities.

II. Moody’s views on the credit performance of the subprime mortgage market

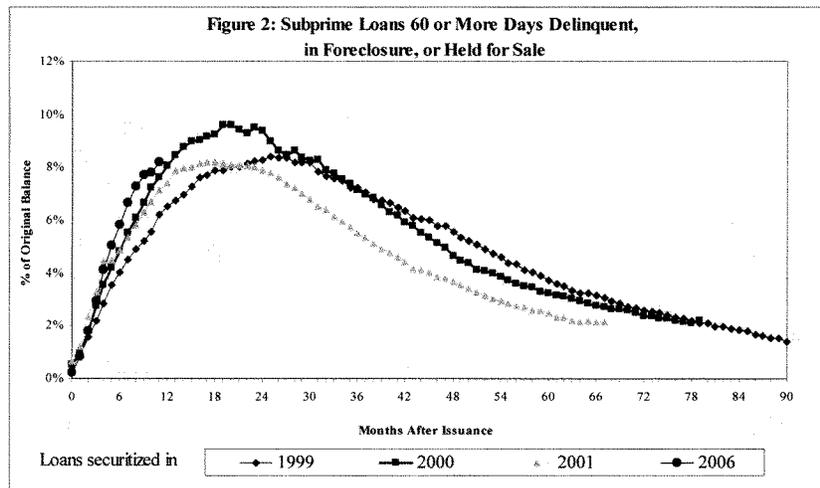
The majority of subprime mortgages originated between 2002 and 2005 have performed at or better than subprime loans have generally performed historically.¹ In contrast, the mortgages that were originated in 2006 are not, on the whole, performing as well. *Figure 1*² shows that the level of seriously delinquent subprime loans included in securitizations issued in 2006 and rated by Moody’s is significantly worse than those included in securitizations issued between 2002 and 2005. Put differently, more borrowers are becoming seriously delinquent on 2006 subprime loans than borrowers on loans originated between 2002 and 2005.



¹ This statement is based on the information that Moody’s presently has on the performance of these loans and is subject to change as the loans mature.

² The data presented in this figure relates only to loans used in the securitizations that Moody’s has rated, and therefore should not be construed as representing the entire subprime market.

However, it should be noted that the 2006 loans are thus far, on average, performing similarly to loans originated and securitized in 2000 and 2001 (see Figure 2).³



The performance of 2006 subprime loans follows a pattern that is a typical part of a residential housing credit cycle (although the amount of such loans outstanding is greater than the amount during the last cycle, both in absolute terms and as a percentage of total mortgage originations). During periods of growth in the housing market, borrowing demand increases, with existing mortgage lenders expanding their business and new lenders entering the market. Eventually, this leads to overcapacity in the mortgage lending market. If borrowing demand slows or falls (due to, for example, rising interest rates, slowing home price appreciation, or a slowing economy) competition among lenders for the reduced pool of borrowers intensifies. In order to maintain

³ The data presented in this figure relates only to loans used in the securitizations that Moody's has rated, and therefore should not be construed as representing the entire subprime market.

origination volume, lenders may lower their credit standards and make loans that are more likely to become delinquent and default.

Lending behavior in the subprime mortgage market over the past few decades has, in large part, followed this pattern, and through 2005 and 2006, in an effort to maintain or increase loan volume, lenders made it easier for borrowers to obtain loans. For example, borrowers could:

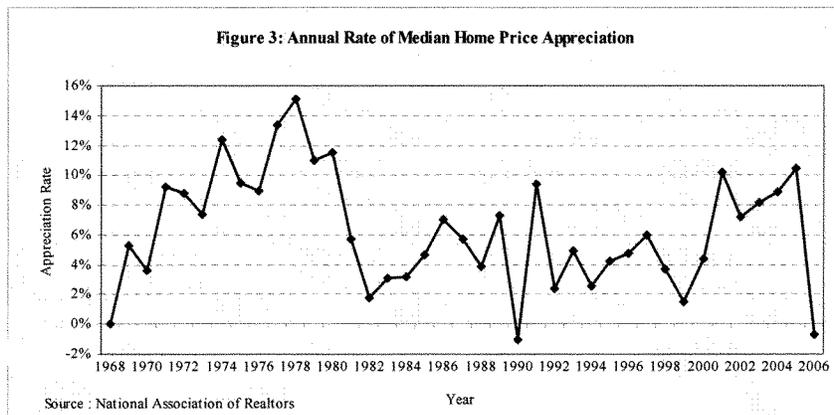
- obtain a mortgage with little or no money down;
- choose to provide little or no documented proof of income or assets on their loan application;
- obtain loans with low initial “teaser” interest rates that would reset to new, higher rates after two or three years;
- opt to pay only interest and no principal on their loans for several years, which lowered their monthly payments but prevented the build-up of equity in the property; or
- take out loans with longer terms, for example of 40 years or more, which have lower monthly payments that are spread out over a longer period of time and result in slower build-up of equity in the property.

The weaker performance of 2006 subprime mortgage loans is in large part due to the increasing risk characteristics of those mortgages. Often a loan was made with a combination of these characteristics, which is also known as “risk layering”.

In addition, slowing and in some cases declining home price appreciation (see *Figure 4*) has negatively impacted the ability of individuals to gain quick profits

from houses they purchased with the expectation that they would be able to resell them in the immediate future for significantly greater sums. In prior years, these speculators – generally referred to as “flippers” – could rely on rising home prices to trade out of a home and repay a mortgage that they could not otherwise afford to pay.

As the housing market has weakened, the monthly payment obligations on these loans have caught up with many such borrowers, resulting in higher delinquencies and defaults. Furthermore, many subprime lenders tightened their lending criteria in late 2006 and early 2007, which may reduce future refinancing options for troubled borrowers.



III. The process of securitizing subprime mortgages

The use of securitization has grown rapidly both in the US and abroad since its inception approximately 30 years ago. Today, it is an important source of

funding for financial institutions and corporations. Securitization is essentially the packaging of a collection of assets, which could include mortgage loans, into a fixed income “security” that can then be sold to bond investors. The underlying group of assets is also called the underlying “pool” or “collateral”. Securitization transactions vary in complexity depending on specific structural and legal considerations as well as on the type of asset that is being securitized.

Like other assets, subprime mortgages can be packaged into bonds using securitization. These bonds are commonly referred to as “mortgage-backed securities” (“MBS”) or “asset-backed securities” (“ABS”), which are then sold into the market like any other bond. As noted earlier, not all subprime mortgages have been securitized and Moody’s has not rated all of those that were securitized. Moody’s, therefore, cannot speak to the developments in the overall market. However, according to the Mortgage Bankers Association, total mortgage loan origination volume in 2006 was approximately \$2.5 trillion and of this, we estimate that approximately \$1.9 trillion (76%) was securitized. Moreover, according to Inside Mortgage Finance, approximately 20% of total originations were subprime loans and we estimate that roughly 25% of the total mortgage securitizations were backed by subprime mortgages.

Before discussing in greater detail the process of securitizing subprime mortgages, it is important to understand the role played by the various market participants:

- Subprime borrowers – borrowers who have weaker credit histories.
- Mortgage originators, or lenders – entities that make the loans, such as banks or mortgage finance companies.

- Intermediaries – generally banks or investment banks that structure the securitizations and sell the bonds that are issued to the investors.
- Trustees – entities that are responsible for administering the securitizations.
- Servicers – entities that collect all payments on the subprime mortgage loans from the borrowers.
- Investors – entities that purchase the bonds which are backed by the assets and their related cash flows. In the securitization market, the investors are typically sophisticated institutional investors who generally make their investment decisions based on their own analysis, with ratings being one of many factors that they consider.

In securitizing subprime mortgages, the following steps are generally taken. First, a large number of subprime residential mortgage loans (typically thousands) are identified for securitization by the mortgage originator. Second, the originator creates a trust, limited liability company or corporation,⁴ which is the securitization issuer. The originator then sells all of its legal right to receive monthly payments on the subprime mortgages to the trust. The trust is now the “owner” or “holder” of the loans. Finally, the trust issues and sells bonds to investors. The bonds obligate the trust to make monthly payments to the investors. The trust uses the monthly loan payments it receives from borrowers on their mortgages to make the payments to the bond investors.

Securitizations, including those of subprime mortgage loans, use various features to protect bondholders from losses. The more loss protection (also referred to as “credit enhancement”) a bond has, the higher the likelihood that the investors holding that

⁴ For ease of reference, we will refer to these types of new entities as the “trust”.

bond will receive the interest and principal promised to them. Some common types of loss protection are:

- a guarantee from a creditworthy entity, like an insurance company, that all or a certain portion of the losses above a certain level will be covered;
- “overcollateralization”, which is the amount by which the aggregate amount of mortgage loans exceeds the aggregate amount of bonds issued;
- “subordination”, which means that instead of all bonds in the securitization sharing losses equally, losses are borne by bonds sequentially in reverse order of seniority; and
- “excess spread”, which refers to the application of any excess amount of interest collected on the loans over the amount of interest payable on (and fees and expenses payable with respect to) the bonds to cover loan losses.

Figure 4 represents a simple subprime securitization transaction, where four classes, or “tranches”, of bonds totaling \$90 are issued and are backed by loans totaling \$100. In this structure, losses would first be applied to reduce the “\$10 net worth”, or overcollateralization. Only when the losses exceed the overcollateralization amount would the bond balances be affected. Losses would be applied to the bond tranches in reverse order of seniority, such that losses are not allocated to a given tranche until the balances of all tranches that have a lower priority have been reduced, or written down, to zero.

| <i>Figure 4</i> | |
|--|--|
| <u>Simplified Balance Sheet for a Typical Subprime Securitization</u> | |
| Assets (Loans) | Liabilities (Bonds) + Net Worth |
| \$100 Mortgages | \$65 Senior Bond |
| | \$10 Mezzanine Bond #1 |
| | \$10 Mezzanine Bond #2 |
| | \$5 Subordinated Bond |
| | \$10 Net Worth ("Overcollateralization") |

For example, if the losses on the pool of mortgages were \$20, as shown in *Figure 5*, then the outstanding balance of the mortgage loan pool would fall to \$80. At this point, the overcollateralization amount would be reduced, or “written down” from \$10 to zero, and the remaining \$10 of losses would result in losses for both the \$5 subordinated bond and the \$10 mezzanine bond #2. The principal amount of the \$5 subordinated bond would be written down to zero, and then the \$10 balance of mezzanine bond #2 would be reduced by the remaining \$5 of losses to a balance of \$5. Losses are not allocated to a given tranche until the balances of all tranches that have a lower seniority have been written down to zero.

| <i>Figure 5</i> | |
|---|---|
| <u>Securitization After Incurring \$20 of Losses</u> | |
| Assets (Loans) | Liabilities (Bonds) + Net Worth |
| \$80 Mortgages | \$65 Senior Bond |
| | \$10 Mezzanine Bond #1 |
| | \$5 Mezzanine Bond #2 |
| | \$0 Subordinated Bond |
| | \$0 Net Worth ("Overcollateralization") |

Consequently, the likelihood that an investor in a particular tranche will receive both the principal and interest due on the bond depends not only on the quality of the loans in the securitization, but also on the amount of loss protection provided. The higher the seniority of a bond issued in a securitization, the greater protection it will have against losses, making it more likely to be repaid in full—meaning it is “less risky.” Conversely, the lower the seniority of a bond, the less protection it will have against losses, making it less likely to be repaid in full. As a result, the tranches of a subprime securitization generally receive progressively lower ratings as the seniority of the tranches gets lower. Each progressively more subordinate bond has less loss protection because each has fewer bonds that can provide a cushion to absorb losses in case of defaults on some of the loans in the pool. Furthermore, because losses on subprime loans are generally expected to be much higher than losses on “prime” loans, a greater amount of loss protection is needed in a subprime securitization for a given tranche to receive the same rating as a similar tranche of a prime securitization.

IV. The role of rating agencies in the mortgage securitization market

Rating agencies come into the mortgage securitization process well after a loan has been made by a bank or lender and identified to be sold and pooled into a residential mortgage-backed security. We do not participate in the origination of the loan nor structure the security. Our role is to evaluate the overall credit risk of a securitization using statistical summaries and to give our credit opinion through assigning a rating, just as we do for other asset classes, such as auto loans, student loans or commercial real estate.

It is important to note that, in the course of rating a transaction, we do not see loan files or data identifying borrowers or specific properties. Rather, we rely on the information provided by the originators or the intermediaries, who in the underlying deal documents provide representations and warranties on numerous items including various aspects of the loans, the fact that they were originated in compliance with applicable law, and the accuracy of certain information about those loans. The originators of the loans issue representations and warranties in every transaction. While these “reps and warranties” will vary somewhat from transaction to transaction, they typically stipulate that, prior to the closing date, all requirements of federal, state or local laws regarding the origination of the loans have been satisfied, including those requirements relating to: usury, truth in lending, real estate settlement procedures, predatory and abusive lending, consumer credit protection, equal credit opportunity, and fair housing or disclosure.

V. How Moody’s rates and monitors mortgage-backed securities

Moody’s would not rate a security unless the originator or intermediary had made reps and warranties such as those discussed above. In rating a subprime mortgage backed securitization, Moody’s estimates the amount of cumulative losses that the underlying pool of subprime mortgage loans are expected to incur over the lifetime of the loans (that is, until all the loans in the pool are either paid off or default). Because each pool of loans is different, Moody’s cumulative loss estimate, or “expected loss,” will differ from pool to pool.

In arriving at the cumulative loss estimate, Moody’s considers both quantitative and qualitative factors. We analyze over 50 specific characteristics of the

loans in a pool,⁵ which help us project the future performance of the loans under a large number of different projected future economic scenarios. The data we analyze include:

- credit bureau scores, which provide information about borrowers' loan repayment histories,
- the amount of equity borrowers have in their homes,
- how fully the borrowers documented their income and assets,
- whether the borrower intends to occupy or rent the property, and
- whether the loan is for purchase of a home or for refinancing an existing mortgage loan.

Next, we consider the more qualitative factors of the asset pool such as the underwriting standards that the lender used when deciding whether to extend a mortgage loan, past performance of similar loans made by that lender, and how good the servicer has been at collection, billing, record-keeping and dealing with delinquent loans. We then analyze the structure of the transaction and the level of loss protection allocated to each tranche of bonds. Finally, based on all of this information, a Moody's rating committee determines the rating of each tranche.

Moody's regularly monitors its ratings on securitization tranches through a number of steps. We generally receive updated loan performance statistics on a monthly basis. Using this data, we assess the entire database of transactions we have rated on a monthly basis (sometimes more often), and flag potential rating "outliers" – securities

⁵ As noted earlier, we do not receive any personal information that identifies the borrower or the property.

whose deal performance indicates that the current rating may not be consistent with the current estimated risk of loss on the security. Once a specific rating is flagged, a Moody's surveillance analyst will further investigate the status of the transaction and consider whether a rating change should be considered. Moody's does not take wholesale rating actions based on market speculation. Moody's carefully and deliberately considers the data that we receive, on a transaction-by-transaction basis, relevant to the securities we have rated, and we conduct the rating process judiciously to make sure that such relevant information is appropriately considered.

VI. Moody's views on the subprime mortgage securitization market

Over the past several years, Moody's cumulative loss expectations for subprime mortgage securitizations have steadily increased, by approximately 30% in aggregate, in response to the increasing risk characteristics of subprime mortgage loans and changes in our market outlook. As Moody's loss expectations have increased over the past few years, the amount of loss protection on bonds we have rated has also increased. Consequently, bonds issued in 2006 which have been rated by Moody's have greater amounts of credit enhancement when compared to similarly rated bonds that were issued in prior years.

As discussed above, delinquencies and early losses of loans originated in 2006 are higher than in previous years, but are comparable to those of loans originated in 2000 and 2001.⁶ While the employment outlook today is stronger than what was experienced in the post-2000 period, the outlook for other major drivers of mortgage

⁶ See *Figures 2* above, which show that early delinquencies for the 2006 loans in securitizations rated by Moody's are tracking those of 2000 and 2001 loans (which had cumulative losses of approximately 6% after 72 months) but are showing signs of an increasing trend.

losses – home price appreciation, interest rates and refinancing opportunities for subprime borrowers facing rate / payment resets – is less favorable. As a result, Moody's is currently projecting that cumulative losses for loans backing 2006 subprime securitizations will generally range between 6% and 8% versus our original estimate of approximately 5.5% to 6%.

Given our increased loss expectations on 2006 subprime pools, we expect greater volatility of ratings on in the low investment grade (i.e., ratings in the **Baa** category) and speculative grade (i.e, ratings in the **Ba** and below categories) bonds than we have seen in recent years. It should be noted that 95% of all bonds backed by subprime mortgage loans are rated A or higher. Therefore, barring cumulative losses well in excess of current expectations, we do not expect a material number of downgrades in this category of bonds.

VII. Impediments to mitigating potential foreclosures

If a borrower misses a mortgage payment when due, and becomes “delinquent”, the servicer will remind the borrower of the obligation to make the required loan payment. If the borrower continues to be delinquent on one or more payments, the servicer will often try to work with the borrower to resolve the problem. It is up to the servicer to try to prevent borrowers from defaulting and to minimize losses if a borrower does default. Furthermore, if the servicer forecloses on and sells a house, the sales proceeds – after paying legal costs, real estate broker fees and other expenses – will usually be less than the amount owed on the loan. As a result, the servicer is generally

motivated to resolve problems and avoid foreclosures. One of the tools used by servicers to prevent foreclosures is to modify some of the terms of the loan.

Loan modifications are typically aimed at providing borrowers an opportunity to make good on their loan obligations and may include interest rate reductions, loan term extensions, payment deferrals, and forgiveness of payments, penalties or principal. Because these modifications are aimed at reducing or postponing borrowers' payments, they are particularly useful in mortgage environments such as the current subprime market, where delinquencies are increasing.

Moody's believes there will likely be an increase in the use of loan modifications, especially when borrowers face higher interest rates at the end of their initial fixed or "teaser" rate period and their loan payments increase beyond what they can afford in an environment where they are unable to refinance their loan. However, to determine whether a loan modification is the best course of action, servicers will generally have to review the borrower's current financial situation and re-qualify the loan. It is not advantageous to modify a loan without knowing if the borrower can afford the modified obligations. If they can not, a modification could simply serve to postpone an eventual foreclosure and increase, rather than decrease, the ultimate loss on the loan. This will be particularly important for the large number of loans originated in recent years that were made to borrowers who merely stated their income and asset information instead of providing documented proof (so-called "limited documentation" loans).

Some residential mortgage securitizations have limits on the percentage of loans in any one pool that the servicer may modify. Moody's believes that restrictions in securitizations which limit a servicer's flexibility to modify distressed loans are generally

not beneficial to the holders of the bonds. Loan modifications, when used judiciously, can mitigate losses on mortgage loans and increase the likelihood that bonds will be paid. Consequently, while loan modifications cannot eliminate losses or generate more credit enhancement for a given transaction, we believe that they can typically have positive credit implications for securities backed by subprime mortgage loans.

Pools of securitized 2006 mortgages have experienced rising delinquencies and loans in foreclosure, but due to the typically long time to foreclose and liquidate the underlying property, actual losses are only now beginning to be realized. However, it is likely that a number of factors will determine the ultimate level of loss. We believe that the magnitude and extent of negative home price trends will have the biggest impact on future losses on subprime pools. In addition, reduced availability of credit to subprime borrowers will limit refinancing opportunities and contribute to higher losses. Economic factors, such as interest rates and unemployment, will also play a significant role. Finally, mortgage servicers are expected to play a major role and will need to become more proactive as greater numbers of seriously delinquent borrowers become unable to refinance. Moody's expects creative payment plans, forbearance options and loan modifications to become more prevalent.

Nevertheless, in response to the increase in the riskiness of loans made during the last few years and the changing economic environment, our loss expectations steadily

rose by approximately 30% starting in 2003 through 2006. As a result, bonds that were issued in 2006 and that we rated generally have more loss protection than those with comparable ratings issued in earlier years. We believe that performance of the 2006 mortgages would need to deteriorate significantly for the vast majority of the bonds we have rated "A" or higher to be at risk of loss.

I would be pleased to address any questions that you may have.

**Testimony of
Donald C. Lampe
Partner, Womble Carlyle Sandridge & Rice, PLLC
Charlotte, NC**

Before

**Subcommittee on Financial Institutions and
Consumer Credit
U.S. House of Representatives Committee
on Financial Services**

**“The Role of the Secondary
Market in Subprime Mortgage Lending”**

May 8, 2007

Madame Chairperson, Ranking Member Gillmor, Members of the Subcommittee, thank you for the opportunity to appear here today. I am Don Lampe, a partner in the Charlotte, North Carolina office of Womble Carlyle Sandridge & Rice, PLLC. I have been involved on behalf of industry trade organizations, mortgage lenders and others, either as a legal consultant or registered lobbyist, in the enactment of state and local high-cost home mortgage loan or so-called “predatory lending” laws in Georgia, Kentucky, Tennessee, Oklahoma, New Mexico, Ohio, Rhode Island, Minnesota and Montgomery County, Maryland. I have also counseled clients on the enactment and impact of these laws in North Carolina, California, Nevada, the District of Columbia, New Jersey, New York, Illinois, Massachusetts, Indiana, Wisconsin, South Carolina and Florida, as well as county and municipal ordinances across the country.

I have been requested to testify today on the following topics related to the secondary market and subprime mortgage lending:

- Is there a need for additional legislation?
- Specifically, how would the imposition of assignee liability affect the secondary market?
- Are there state experiences we can look to as examples?

I will address these issues in reverse order, and conclude that any additional action by Congress should be very carefully crafted so as not to discourage the funding of home loans that credit-challenged homeowners facing default or foreclosure may need more than ever in the coming months and years.

First, the threshold question: just what is meant by “assignee liability” in home mortgage lending? This Subcommittee and other bodies within the Congress have heard testimony on the “secondary market,” which is the mechanism whereby residential mortgage loans are originated and then sold (sometimes, multiple times) into investment pools and ultimately to bondholders or noteholders. The bondholders or noteholders commonly are mutual funds, pension funds, private investment funds and individual investors – the same persons or entities that hold corporate bonds offered through Wall Street investment banks.

In short, “assignee liability” is a legal doctrine that imposes liability for legal violations committed by originators or “upstream” owners of residential mortgage loans, including securitization trusts and conceivably bondholders or noteholders. It is thought that “innocent”

bondholders or noteholders, who are passive investors who had nothing to do with the origination of the loans, should not bear the same quantum of legal (and thus economic) risk as loan originators.* To conclude otherwise would be to upset investors' economic assumptions about risk and return and discourage a wide range of investors from providing funds (liquidity) for mortgage lending. There is no debate surrounding the premise that robust secondary markets, established by Fannie Mae, Freddie Mac, the Federal Home Loan Banks and private (non-agency) securitizers has contributed to the democratization of affordable home mortgage credit in the country.

Limitations on assignee liability in mortgage lending are not themselves unlimited. The "holder in due course" doctrine under the Uniform Commercial Code does not insulate noteholders (assignees) from all liability that a borrower may assert; assignees remain liable for all claims of which they have knowledge and for fraud, incompetency and lack of capacity, so-called "real" defenses. Under the Truth-in-Lending Act (TILA), assignees of real-estate secured loans generally are liable for any violations that are apparent on the face of the documents and are subject to rescission claims. The federal high-cost home loan law, HOEPA, imposes special enhanced assignee liability, by saying that assignees of HOEPA loans are liable for legal violations of the loan originator (creditor) *unless* the assignee is able to demonstrate that a "reasonable person exercising ordinary due diligence, could not determine, based on [required TILA disclosures] that the mortgage was a [HOEPA] mortgage. . ." 15 U.S.C. 1641(d). This enhanced assignee liability standard, and the way courts have interpreted it, is notable in its impact. Because of HOEPA's existing assignee liability rule, few, if any, HOEPA loans are sold

* Assignees and other noteholders ordinarily bear legal and economic risks of foreclosures. Even the broadest exculpatory statutes do not immunize loanholders from claims directly related to the conduct of foreclosure proceedings.

into the secondary market. The House of Representatives has had under consideration for a number of years expansion of the HOEPA law. If Congress follows this path, it very well could expand the types of loans that would be off limits to secondary market funding, making them virtually unavailable to borrowers. This result may well have an adverse impact on the very consumers that Congress is seeking to protect, credit-challenged borrowers who are not eligible for prime or conforming loans.

We all are aware that the states have served as “laboratories” for different approaches to curbing abusive or predatory lending practices. Beginning with North Carolina’s groundbreaking high-cost home loan enactment in 1999 (S.B. 1149), over 40 states and localities have enacted high-cost home loan laws. Legislatures in the states have faced the same issues that are before this body now – what role has the secondary market played in the growth of the nonprime mortgage market? Shouldn’t Wall Street or the secondary market be liable for unlawful mortgage terms and practices? How can that liability be established and policed fairly and clearly, without denying legitimate loans to deserving homeowners? Our experience over the last five-plus years in the states shows that it is possible to overshoot the mark, such as occurred in Georgia and, to the lesser extent, other states, by over-regulating and effectively shutting down the secondary residential mortgage market. It is less clear, on the other side of the debate, whether the states have yet produced an example of well-balanced statutory provisions that protect consumers while preserving access to mortgage credit that consumers want and need.

The Georgia Fair Lending Act (“GAFLA”) was put forward by consumer advocates and activist policymakers in Georgia as “the toughest predatory lending law in the nation.” Indeed,

this very toughness, especially as relates to assignee liability, may have been the law's undoing. As market participants studied GAFLA in advance of its effective date of October 1, 2002, it became evident that the law imposed absolute, unlimited liability on all purchasers, assignees or holders of "high-cost home loans" for the violation of *any* law, regardless of who committed the violation in connection with the origination of the loan. In effect, the secondary market shut down in Georgia, as secondary mortgage market participants observed:

- GAFLA imposed unlimited liability on anyone who made or took assignment of a home loan, including treble damages and attorneys' fees;
- No policies or procedures nor any amount of due diligence would limit an assignee's liability (unlike HOEPA and TILA). In effect, GAFLA established strict liability upon any assignee;
- The definition of "high cost home loan" was difficult to understand and apply, such that compliance-oriented lenders could not determine with any certainty whether a particular loan was in this undesirable class; and
- If *any* violation of law could result in unlimited liability upon an assignee, then no amount of compliance or due diligence could insulate a market participant from liability.

The "unintended consequences" of the original GAFLA are well known. Government-sponsored enterprises (GSE's) declined to purchase Georgia home loans (and not just high-cost home loans) originated after GAFLA, the rating agencies determined that they could not rate securitization transactions that contained post-GAFLA home loans, and investors ceased purchasing Georgia home loans. Ironically, because GAFLA's assignee liability provisions

covered all home loans and all assignees, even non-profit and government agency-sponsored lending activities were curtailed in Georgia.

What happened next is instructive now. The Georgia General Assembly began work on an amendatory bill upon convening in January, 2003. The bill that emerged and became law in early March, 2003 (SB53/HCSFA), preserved the general assignee liability provisions in GAFLA but:

- Permitted an assignee or purchaser to prove that it exercised reasonable due diligence intended to prevent the purchaser or assignee from purchasing or taking assignment of high cost home loans. This is known, as it has been replicated in numerous other state “predatory lending” laws, as a diligence-based safe harbor;
- Limited affirmative causes of action against assignees or holders to individual actions, with damages capped at the remaining balance of the loan plus reasonable attorneys’ fees;
- Preserved borrower actions against assignees or holders to enjoin foreclosure or obtain possession or assert defenses of recoupment or setoff; and
- Clarified that violations giving rise to assignee liability under GAFLA were for violations of that Act and not any law that could apply to a mortgage transaction.

As far as we know, the mortgage market in Georgia quickly returned to vitality. Since then, the Georgia General Assembly has addressed further issues in residential mortgage lending by enacting, *inter alia*, perhaps the strongest mortgage fraud law in the nation and strengthening the regulation of non-bank mortgage lenders and mortgage brokers.

What did we learn in Georgia and what have we observed in other states about market reactions to state laws? First, simply stated, it is possible for legislators to go too far. By now, in this Subcommittee, you are aware of the percentage of the overall residential mortgage market that relies on the efficient sale of mortgage loans to investors in order to provide homeowners with loan funds. Part of what lawmakers must contend with is that assignee liability itself is an arcane legal doctrine, an area where specific words and word formulas in statutes really matter. It is not surprising that a number of the proving grounds for new laws aimed at predatory lending did not get it quite right in these “experiments.” In fact, several other states experienced adverse market reactions to new anti-predatory lending laws, including New Mexico, New Jersey and Indiana. In each of these instances, the state legislatures went back and amended troublesome provisions. We can and should learn from our experiences in these states.

Before the Georgia experience, state legislatures who adopted anti-predatory lending laws either remained silent on assignee liability (e.g., North Carolina, New York) or simply relied on existing federal law to establish the standards (e.g., Florida). Since then, a variety of state law approaches to the extent of and limitations on assignee liability in anti-predatory lending laws has emerged. *These laws impose liability on assignees or holders of high-cost home loans, but not on all residential mortgage loans.* Thus, these laws are aimed at nonprime mortgage lending and not at all mortgage loans. The more common provisions include:

- Absolute liability on assignees or transferees, with policy-based and diligence-based safe harbors, limitations on class actions and limits on individual damage recoveries,

patterned after GAFLA as amended (Arkansas, Illinois, Indiana, Massachusetts, New Jersey, New Mexico and Rhode Island);

- Limitations on liability of holders-in-due-course (California) or of GSE's (Indiana, District of Columbia and Wisconsin); and
- Reliance on HOEPA, because the state laws track HOEPA (Ohio, Texas, Colorado and Maryland).

Is there a preferred approach to establishing assignee liability in a comprehensive federal law aimed at nonprime lending? Would this help alleviate the growing loss of homeownership due to increased defaults and foreclosures? Yes and no. Importantly, any federal law that begins with amendments to existing HOEPA likely will be freighted with HOEPA's effects. Hardly anyone, if anyone at all in the secondary market, funds or purchases HOEPA loans in secondary market transactions today. So, if Congress elects to amend HOEPA to cover more loans by expanding the loan types subject to the law or by lowering APR or "points and fees" thresholds or triggers, those loans in all likelihood will not be marketable in secondary market transactions. If Congress elects to expand HOEPA, it follows that Congress should amend the assignee liability provisions of that law. Using the states as an example, balanced, non-disruptive provisions that still provide consumers with meaningful recourse could include: (1) diligence-based safe harbors, which would encourage all secondary market participants to conduct adequate due diligence to confirm the types of loans being purchased and exclude loans with abusive or other unlawful features; (2) limitations on class actions, so that even if an "innocent" loan purchaser or investor inadvertently purchased an unlawful or abusive loan, the inadvertent violation would not result in unlimited monetary liability of secondary market investors; and (3)

similarly, meaningful individual damage limitations, based on loan balances, payments made and/or other ascertainable dollar amounts.

Congress also would be well advised to observe carefully recent actions of federal and state regulators to curb mortgage lending abuses. These actions, intended to reduce the flow of capital to loan originators who do not pay close enough attention to the needs and capacities of individual borrowers, already having a pronounced impact on the offering of loans that may not be affordable. These actions include the promulgation of the Interagency Guidance on Nontraditional Mortgage Product Risks, which the financial institutions regulators finalized last fall. Through a unique partnership, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) soon after adopted the Guidance and recommend its passage by state financial regulators. To date, nearly thirty-five states have adopted the Guidance. In addition, the same federal regulators have issued a proposed Statement on Subprime Mortgage Lending, which is broader than the Guidance. The CSBS/AARMR coalition is expected to adopt this statement when it is finalized by the federal banking regulators. In conclusion, these initiatives are moving the mortgage market as a whole away from the lending terms and practices that contributed to current widespread numbers of defaults and foreclosures.

Borrowers who unwittingly obtained or had pressed upon them subprime mortgage loans that they did not understand and could not afford deserve opportunities to refinance out of those loans, as alternatives to foreclosure. Federal legislative activity that impairs the ability of nonprime borrowers to obtain new and potentially more favorable loans, as loans such as 2/28's

and 3/27's mature and become payable in ever-increasing numbers, is not appropriate for these times. The solution could make the problem worse.

Again, thank you for having me here today. I am happy to answer any questions.

**Written Statement of Larry B. Litton, Jr.,
President and Chief Executive Officer
Litton Loan Servicing LP**

**Before the Financial Institutions and Consumer Credit Subcommittee of the
House Committee on Financial Services**

May 8, 2007

Good morning Chairwoman Maloney, and members of the Subcommittee. My name is Larry B. Litton, Jr., and I am the President and Chief Executive Officer of Litton Loan Servicing. I appreciate the opportunity to bring the perspective of the servicing agent to this important discussion of "The Role of the Secondary Market in Subprime Mortgage Lending." Litton was founded in 1988 by my father, Larry Litton, Sr., in the midst of a similar real estate and mortgage default crisis that was concentrated in Texas in the late 1980s. My father's vision was to create a new kind of mortgage servicing company that focused substantial efforts on providing high levels of customer care with an emphasis on curing delinquent loans. Over the years we've developed a host of flexible options that we offer to consumers who have experienced financial hardships. Our vision was that investors would find value in our ability to cure loans, and this vision led to the growth of our business.

In 1996, Litton was acquired by Credit-Based Asset Servicing and Securitization (C-BASS). C-BASS is an investor in closed mortgage loans, and an active issuer and purchaser of mortgage-backed securities. Because C-BASS holds the credit risk on a significant percentage of the loans serviced by Litton, Litton's main focus is protecting C-BASS's core investment, not functioning as a "fee-for-service" company. Litton's key interest is in reducing losses rather than keeping costs down or generating revenue through fees. This structure ensures that the interests of the consumer, servicer, and investor remain aligned.

Today, Litton services 400,000 loans totaling \$60 Billion in principal balance. We are regarded as an industry leader in servicing subprime and Alt-A loans. I believe that in general, the entire mortgage industry is committed to finding ways to enable families to maintain homeownership. The development of the subprime secondary market, the expansion of subprime product innovations, and the growth of mortgage securitization have all increased the availability of home loans to all borrowers, boosting the country's homeownership rate to its highest levels ever during the last 30 years. Responsible, fair, and appropriate extension of credit is key to providing the opportunity to every American to own a home, and even as we face a widespread foreclosure and delinquency crisis, it is important that we preserve access to credit for all borrowers, and provide second chances where appropriate to borrowers who may have had a credit problem in the past.

Mortgage servicers are accountable to two key constituents – consumers and investors. We are in a unique position, and interact at the crossroads where the capital and secondary markets intersect with consumer's interests. The interests of investors and consumers are both aligned to help the borrower keep his or her house. Foreclosures lead to credit losses for investors – the average foreclosure costs investors fifty cents on the dollar. When foreclosures occur, investors lose, consumers lose, and communities lose. It is worth noting that in 2006, Litton saved over 70,000 homeowners from foreclosure and we estimate that in 2007 we will help keep over 95,000 customers in their homes.

Let's discuss solutions. Rising mortgage payments, reduced credit availability, and the decline in home prices have created financial hardship for a growing number of homeowners. Litton employs a number of proactive strategies to assist borrowers facing financial difficulties, while managing to meet our responsibilities under the law and our contracts with our investors.

Some of our strategies include early and active contact with borrowers facing pending rate and payment resets, delinquency or default: modification of existing loans to provide long-term affordability; broadening relationships with third party organizations to assist in

communication efforts with borrowers; making available credit counseling services, and implementing alternatives to foreclosure when that option is unavoidable.

We strongly believe that providing loan modification options to consumers is the number one tool we have available to deal with the impending issue of ARM resets. Litton has made use of modifications for years, and over the last few years, we have modified in excess of 10,000 loans with great success. These modifications provide payment relief for the consumer by restructuring loan terms based on the consumer's demonstrated willingness and ability to pay. When done properly, modifications (through payment deferrals, extensions of maturity date, waiving or capping arrearage, and interest rate reductions) provide the consumer with payment relief while reducing credit losses to the investors. The goal of any loan modification program should be to provide borrowers with the opportunity to make good on their financial obligation, and to create long-term affordability.

Others in the industry are employing "extension" strategies which may look like a modification but aren't. These extensions defer dollars owed without fundamentally changing the terms of loan, and they generally do not have a payment relief feature. Over time, investors could actually see increased losses associated with these extensions due to potentially high re-default levels. In fact, there is a precedent – several years ago, the manufactured housing industry used extensions as a way to cure delinquent loans. The net effect was that losses were merely deferred, and investors and homeowners were both big losers.

I must emphasize that the current wave of defaults we are seeing today has little to do with ARM resets. This initial default wave is a result of early payment defaults associated with the 2005 and 2006 originations and we believe it is merely the tip of the iceberg. These early payment defaults are generally the result of lax underwriting standards, improper documentation, or borrower fraud. The real impact of ARM resets will be seen in increasing defaults later this year and into 2008 as many borrowers experience payment increases associated with the upcoming rate increases on their ARM loans.

To get in front of the next wave, servicers need more flexibility to modify loans that are current, but are at risk of going into default. Too often, servicers trying to act in the best interest of both the homeowner and the bondholder are hamstrung by legal, accounting, and tax rules that prevent us from working with borrowers as thoroughly as we need to. In particular, I would highlight to the committee the accounting issues related to modifying loans in structured transactions, particularly FASB 140. Current understanding of accounting rules force servicers to be overly conservative when exploring options to help borrowers facing financial difficulties. Unless a loan in a structured transaction is in default, or imminent default as determined by the servicer, it cannot be modified. A servicer who attempts to modify a loan that is "current" cannot do so without facing significant accounting implications. This is a problem when borrowers are making payments on teaser rates, but will not be able to afford the rate reset on an ARM loan. Given that more than half of the loans originated in 2006 were ultimately sold to investors as mortgage-backed securities, the need for flexibility for servicers to attempt to maximize the value of the underlying loans in a securitization is more important than ever.

We do not advocate an across-the-board, "modify everybody" approach. This would be devastating to those investors who have purchased mortgage-backed securities and would cause a dramatic reduction in credit provided to the housing market. The fact is that most consumers have the ability to pay, and are in fact, making payments, and most will continue to be able to do so, even in the face of resetting rates. It is important to remember that as Americans, we believe that personal responsibility is an important part of the social contract, and repayment of debt is an important piece of that contract. All citizens have a responsibility to pay debts they owe. However, lives and communities are harmed by foreclosures. Consumers who cannot pay deserve a fair review of their loans and their ability to pay, simply because foreclosure is almost never the best answer. We believe that modifications have to be made one loan at a time, as each borrower, his loan, and his financial circumstances are different.

I would fear any holistic strategy aimed at blindly “fixing” every subprime loan. Such a strategy would lead to an accelerated flight of capital out of the mortgage markets, and that in turn would hurt homeownership opportunities for those that need help the most. Litton and C-BASS do not originate loans; however, we do believe that regulation of mortgage brokers, who have no fiduciary obligation to either the borrower or the lender, would go a long way to help reduce predatory lending, misrepresentation of loan terms to trusting borrowers, and/or misrepresentation of borrower financial ability to lenders.

Another issue that we believe should be seriously considered is requiring subprime borrowers to establish an escrow account. Historically, escrow accounts have not been required for these borrowers when they enter into a loan agreement. For borrowers struggling to remain current in their mortgage payments, the burden of a once a year tax and insurance payment can cause additional difficulty. We believe that going forward, escrow accounts should be required in order to ensure that the borrower remains able to afford the payments for the life of the loan.

The idea of a foreclosure moratorium is a bad idea for the industry, and the economy as a whole. Moratoriums and bailouts tend to encourage bad behavior, and may provide an incentive for borrowers to default on their loan obligations without penalty. Unfortunately, servicers are not always successful in their attempts to avoid foreclosure, and foreclosures are a necessary process in order for investors and lenders to recover the money they are owed. A moratorium forces us to believe that all borrowers facing financial difficulties are exactly the same, when in reality each loan, each borrower’s financial situation, even each community is different. Servicers need to be able to evaluate each individual situation, the circumstances currently facing the borrower, and the borrower’s willingness and ability to repay the debt. Denying investors the ability to recover invested capital will accelerate a flight of capital out of these markets. Rather than a full moratorium, we would suggest encouraging servicers to adopt a two-week delay – which we have already implemented at Litton - in the process for every

borrower referred to foreclosure. This solution achieves the same goal of a moratorium by slowing the process down without significantly driving expenses up, which in turn keeps losses down. That two-week period gives the servicer additional time to communicate available options to the borrower, while giving the borrower additional time to explore their options as well as find help available through neighborhood and national advocacy groups.

Another obstacle facing servicers comes from the Rating Agencies. Servicer ratings and required language in the Pooling and Servicing Agreements related to Mortgage-Backed Securities transactions restrict some servicers more than others when it comes to ability to modify loans. It is in the best interest of consumers if all servicers have the flexibility to modify loans, when warranted. A level playing field is in the best interest of consumers – because when a servicer's options are restricted, more foreclosures are the ultimate result.

With respect to mortgage-backed securities, it is unlikely that any participant in the process would want to encourage the origination of loans where there is little to no expectation of payment. The success of mortgage-backed securities is dependent on the expectation that homeowners would generally want to find a way to make their monthly payments, and keep their loans current. These payments are what ultimately form the cash flow paid to bondholders and it is generally in everyone's best interest that foreclosure be avoided as often as possible. Everyone loses – the borrower, the investor, and the servicer – when foreclosure is the only option. Every participant in the process is interested in reducing defaults and lowering delinquencies.

In any discussion of a legislative solution to the subprime crisis, it is important to note that securitization has allowed homebuyers an unprecedented access to credit, increasing homeownership rates throughout the United States. Securitization allows this increase in lending to be achieved without an excessive concentration of risk in any one area of the economy. Short and long-term market disruptions can be absorbed without major impact to the larger economy. Any potential legislative responses to the current concerns regarding

increasing delinquency rates should be evaluated carefully to ensure that they are not overly restrictive to those entities working diligently to help borrowers keep their homes, nor overly restrictive to consumers who need access to fair and appropriate mortgage credit in order to purchase or refinance their homes, or to the investors who bought the mortgage-backed securities in good faith.

Finally, it is important to understand that variations in local economies create pockets where some communities are hit harder by the current subprime crisis. It is in these areas that Litton believes that community organizations can deliver help and solutions more rapidly and more effectively than government involvement. Legal restrictions in the way servicers are required to communicate with borrowers can create problems that may only be solved through the intervention of local, grassroots advocacy organizations. Borrowers facing financial difficulties – and the possibility of losing their homes – are more often than not confused, frightened, and unaware that there are options available to them. Because servicers are required to inform customers that any communication is an “attempt to collect their debt,” customers who need help most are often reluctant to contact their servicer directly for fear that an admission of financial hardship is a fast track to foreclosure. Litton conducts aggressive outreach to borrowers in communities experiencing high delinquencies, however, in many cases, customers are more comfortable speaking to their neighborhood organization than directly to us. We are in favor of not only providing funding and support to these types of organizations, but in creating relationships between the organizations and the servicers to assist in efforts to reach homeowners who want to make a sincere effort to save their homes. We don't care how borrowers get in contact with us – as long as they do. We can't help borrowers until we can communicate with them. We also believe that these relationships are a two-way street. Consumer groups need to behave responsibly and recognize that not all corporate entities are “bad,” and not all consumers need, or deserve, a loan modification.

In summary, Litton is in favor of the following initiatives to address the issues in the subprime market: servicers engaging in early and frequent contact with borrowers who, in their estimation, face a high likelihood of default based on their loan product; servicers actively engaging in appropriate loan modifications if the borrower's financial situation warrants such a modification and there is a willingness on the borrower's end to satisfy their debt, and the modification is appropriate in that it creates long-term affordability; requiring escrow for tax and insurance payments, and giving servicers more flexibility under current accounting standards, to modify loans within securitizations before they default. Litton is opposed to a nationwide foreclosure moratorium, and would prefer a recommended two-week delay before any foreclosure action proceeds in order to allow borrowers more time to explore the options available to them. Litton is also a strong believer in working with third-party and community organizations in order to provide counseling and communication channels to reach out to borrowers who may be too scared to contact their lender or servicer directly. Support of these types of relationships at the federal, state, and local level would go a long way to mitigating the impending increase in delinquencies and foreclosures.

I would like to thank the Chairwoman and the members of the Subcommittee for the opportunity to share Litton's perspectives on the subprime mortgage market and I would be happy to answer any questions you may have.

McDermott Will & Emery

**Statement of Howard F. Mulligan
Partner, McDermott Will & Emery**

**Before the
Committee on Financial Services
United States House of Representatives**

May 8, 2007

Thank you and good morning. My name is Howard Mulligan. I am a partner in the New York office of the international law firm of McDermott Will & Emery. For the last fourteen years, I have been engaged in representing issuers, underwriters, servicers, bond insurers and rating agencies in securitization and other structured finance transactions, including the securitization of home mortgages. I am pleased to be here to testify, based on my experience, with regard to issues related to the role of the secondary market in sub-prime mortgage lending. I commend the Committee on Financial Services for calling these hearings.

Overview

Home ownership is widely viewed as a salient feature of the American cultural landscape. Federal law reflects the importance of home ownership in the United States by encouraging and assisting deserving families in endeavoring to purchase a home. The capital markets have also contributed substantially to expanding the availability and reducing the cost of mortgage credit by coupling investors and home buying families through the process of mortgage securitization. Home mortgage credit is more widely available today and at a relatively lower cost than ever before, due in no small part to securitization and secondary mortgage market activity.

Approximately \$10.2 trillion of family mortgage debt was outstanding at the end of 2006. In the past few years, the mortgage-backed securities market has emerged to be the largest of all the fixed income markets. At approximately 70 percent overall, home ownership is close to, if not having surpassed, its highest level in history. It is clear to any astute market observer that the liquidity provided by securitization and the secondary market has facilitated these positive developments.

Mortgage securitization is the process of packaging and bundling mortgagees' monthly principal and interest payments of home mortgage loans and using these payments to back mortgage-backed securities, which are sold to institutional investors, such as pension funds, insurance companies and mutual funds in either private placements or public transactions. Mortgage securitizations are structured and implemented in accordance with the requirements and expectations of national rating agencies.

In a myriad of ways, securitization transactions have made mortgage loans more available and affordable to American consumers.

First, securitization taps on a wide and deep reservoir of capital sources to fund the mortgage lending market. Institutional investors both inside and outside the United States generally do not want to hold individual mortgage loans in their investment portfolios because of the risk attributable to an unrated ordinary consumer. However, because of the risk mitigants and rating enhancers inherent in the scaffolding of structured finance transactions, these well heeled institutional investors are active buyers of mortgage-backed securities, making their funds available to American families buying homes. The ability of mortgage lenders to sell mortgages in the secondary market promptly, efficiently and with substantial certainty increases funds available to lend and significantly reduces consumer borrowing costs.

Second, mortgage backed issuances provide a way for mortgage originators to sell the loans that they originate which, in turn, creates capital for the extension of new loans. Before securitization became prevalent, banks funded mortgage loans through their customers' deposits, and mortgage credit was determined, in most instances, by the volume of bank deposits. Today, because of the outlet of securitization and the flexibility that such transactions provide, banks, mortgage companies, financial service companies and other lenders have the option of selling loans into the secondary market, rather than retaining such loans on their books for their entire term.

Third, securitization not only mitigates, but specifically tailors, the risk of investing in mortgages. The professionals that structure mortgage backed transactions have formulated innovative methods (including derivative enhancements and other synthetic techniques) of segmenting the risks associated with investing in mortgages and creating securities that allow investors to assume the precise level of risk (and corresponding coupon) to which individual investors are comfortable.

Fourth, in disbursing mortgage related securities across a wide array of purchasers, including purchasers outside of the United States, the widespread securitization of residential mortgage loans has decreased the risk of regional mortgage holdings in local banks. Because mortgage backed issuances are less concentrated, the risk of borrower default has been allocated more efficiently and, as a result, is less dependent on, and correlated to, individual localized real estate markets.

State Initiatives Regarding the Sub-Prime Market

Securitization helps provide capital for both "prime" mortgages (to mortgagees with relatively good credit) and "sub-prime" mortgages (to mortgagees with weaker credit). The sub-prime lending market offers borrowers who fail to qualify for prime rate mortgages the chance to fulfill the proverbial American dream, providing the loan necessary (albeit at a higher rate and often subject to more restrictive covenants) to own a home.

The sub-prime lending market can, however, be a perilous venue for the vulnerable borrower. In this side alley for the structured finance market, a person with poor credit, few

options, and perhaps little financial wisdom might easily find himself the victim of so called predatory lenders eager to take advantage.

Beginning with North Carolina in 1999, many states began passing so called anti-predatory lending legislation, purportedly designed to strengthen and fill in the perceived gaps left by federal law. At least 47 state and local jurisdictions now regulate sub-prime lending. Despite the genuine best intentions of the state legislatures, however, the laws affecting the lending industry have, in most cases, hurt the very borrowers they were intended to protect. These unintended consequences are illustrated in a number of ways.

First, many of these state initiatives have arguably overreached to the degree that the lending industry cannot operate effectively. These ostensible "protections" often restrict operations and escalate costs for potential lenders, which in turn raises costs for borrowers or even drives impacted or potentially impacted lenders away from the market altogether.

Second, those states that have anti-predatory lending laws use a myriad of different schemes. In order to maintain a national or even regional practice, lenders must gain expertise in the laws of several states. Operating in different jurisdictions requires lenders to make varying, subjective, and often conflicting, judgments for each jurisdiction. The differing state laws add risk (often change of law risk, which cannot be quantified or structured around without great difficulty) and cost to the lenders' activities, and the lenders then pass these costs on to the borrower.

Third, and perhaps most significantly for the mortgage securitization market, several of the state statutes have arguably had a chilling effect on securitization by imposing assignee liability (extending liability to secondary market loan purchasers). Assignee liability allows a borrower to bring a civil action against not only the lender but also the innocent assignee that purchased the loan in the security market. The specter of assignee liability is intended to encourage secondary market loan purchasers to "police" the secondary market by exercising extensive diligence with a view toward avoiding purchasing bad loans. Unfortunately, the Home Ownership and Equity Protection Act of 1994 ("HOPEA") and many of the state schemes have established opaque and subjective triggers for assignee liability. Some state laws have imposed liability on assignees based on the conduct of parties that they could not control or subjective determinations of whether the loans were in the "best interests" of individual borrowers. Other state statutes have imposed assignee liability based on vague standards of "suitability." Each of these approaches makes the participation of secondary market investors almost impossible, to the extent that these downstream investors were held liable for subsequent potentially arbitrary and capricious determinations that the origination of certain mortgage loans were not in the "best interests of", or were "unsuitable", or "inappropriate" for particular borrowers. The resulting uncertainty and extra costs engendered by assignee liability statutes have operated to negate many of the benefits of the mortgage securitization market, thereby restricting the financing and growth of the lending industry to the detriment of consumers.

The experience of various states in enacting, and then subsequently amending, anti-predatory lending legislation has been telling. In 1992, Georgia enacted legislation which was so expansive and stringent in imposing assignee liability that many lenders refused to purchase any Georgia loans and major rating agencies announced that they could not rate any structured

finance transaction containing a single loan subject to the Georgia statute. As a result of the reaction of the secondary market and the impact on mortgage originations, Georgia was compelled to amend its aggressive predatory lending statute to remove several of its most onerous provisions. The pattern has been repeated in other jurisdictions that have enacted burdensome anti-predatory lending legislation, such as Rhode Island, New Jersey and Ohio, which have been forced by the reaction of the secondary market to amend the most overreaching and manipulative provisions of their sub-prime initiatives.

The Mortgage Market is Predicated on Legal Certainty

The fundamental goal of a securitization issuance is to impose certainty so that originators can access the capital markets at a less expensive rate and the intent of the transaction is that this capital efficiency can ultimately redound to the benefit of the consumer. In any mortgage backed transaction, investors need to know that (i) the risks they take at the time they make their investments will not be altered by changing the terms of the underlying contracts that back the issuance and (ii) they will not have to bear liability based on the conduct of parties that they do not control or subjective determinations of whether loans were in the “best interest” of individual borrowers. The terms of most securitizations do provide, however, flexibility for servicers to accommodate particular cases of borrower distress. Risk is typically modeled at the time of issuance based on probabilities of default and severities of loss of the underlying mortgages, based on historical data and loan terms remaining as they existed upon the closing of the transaction. The analysis does not include change-of-law risk, which is extremely difficult to effectively calculate and thereby model, but is generally viewed by rating agencies as remote. Consequently, structured finance professionals have not developed techniques of “structuring around” change of law risk. Increasing change-of-law risk will inhibit the flow of funds as investors will not be able to quantify and mitigate the risks they are accepting at the time that they decide to enter the transaction.

In the securitization arena, the banks, finance companies and other institutions responsible for receiving monthly mortgage payments from borrowers and passing them through to investors are called mortgage servicers. In recent months, these mortgage servicers have been tirelessly working with borrowers who are in arrears on their loans to help avoid foreclosures. Such efforts by servicers have been abetted by the flexibility inherent in the typical transaction documents in securitizations, particularly the servicing agreements, which provide servicers with the latitude to modify loan terms and extend deadlines to help distressed borrowers avoid default and keep their homes.

Investors cannot advance funds flexibly and efficiently into a mortgage finance system characterized by a patchwork of different state and local laws which dictate different standards of conduct and liability. A liquid and efficient national mortgage market at its current scale in the United States depends to a substantial extent on relative uniformity of risk and certainty that merely purchasing mortgage loans will not give rise to unmanageable liability or significant loss of investment.

In that regard, the bipartisan Responsible Lending Act (HR 1295) introduced on March 15, 2005 (the “Responsible Lending Act”), provides a valuable model in alleviating uncertainty in the secondary mortgage market. Among other ways of promoting uniformity in the

secondary market, the bill calls for the establishment of federal preemption of all state laws and would provide the mortgage lending industry with a single national standard with which to comply rather than the current complex milieu of state and local laws that have engendered confusion and a lack of certainty in the secondary mortgage market.

The Imposition Assignee Liability would Impair the Secondary Mortgage Market

Imposing unquantifiable assignee liability on the secondary market for abuses committed by mortgage originators would severely affect investors' willingness to assume mortgage risk for which they might become liable through no fault of their own. This would generate more rather than fewer innocent victims of predatory lending activities and ultimately reduce the availability of capital to the mortgage market. Rather than making secondary market participants the monitors or enforcers for the actions of originators, assignee liability would simply drive investors away from the sub-prime market entirely, severely reducing capital available for sub-prime lending and regressively raising costs for the working families least able to afford home ownership.

Investors and other market participants are ill suited to surveil and monitor laws that apply to originators, nor is that the proper role of the secondary market. By way of analogy, it is noteworthy that the federal securities laws never presumed to impose liability on purchasers of stock for corporate misconduct or malfeasance.

An interesting starting point for reform that is worthy of consideration is the assignee safe harbor provision embedded in the Responsible Lending Act. By operation of the bill, assignees could create a safe harbour against both defensive and affirmative assignee liability claims if the assignee: (i) has policies against purchasing higher-cost mortgages or mortgages that contain lending violations; (ii) requires by contract that the seller represent that it would not make or buy loans with lending violations; and (iii) exercises reasonable due diligence in reviewing purchased loans. Unless the borrower can prove that the assignee had knowledge of a lending violation, damages are limited to actual financial losses and attorney's fees. These provisions, combined with the preemption of the varying state laws by a national standard, provide a clear and effective background upon which the secondary mortgage market can operate. Whether such a safe harbor mechanism would be palatable to the secondary market is still open to debate and subject to further analysis but, in providing at least some degree of predictability, it may at least amount to a step in the right direction.

Mandated Forbearance would be Punitive and Inflexible

The securitization market thrives on certainty and loathes uncertainty. Federal laws with a view toward modifying the terms of mortgages post issuance would unfairly penalize innocent classes of investors who purchased mortgage backed securities predicated on the assumption that the terms set forth in the loan documentation would be applied and interpreted according to the original terms of the documents. Those terms reflect a negotiated and time tested allocation of mortgage credit risk among transaction participants. Most non-prime securitization transactions include provisions that permit some flexibility to modify loans where a default has occurred or is reasonably foreseeable, and customary economic incentives have evolved to ensure loan servicers use that flexibility. Altering reasonable expectations of investors regarding the

operation of contracts associated with their investment would dramatically reduce the supply of capital to the mortgage market. In addition, such a federal initiative may also cause uncertainty on the part of the law firms that render the various legal opinions that buttress structured finance transactions.

The documents that govern securitization transactions contain “waterfall provisions” which set forth a priority of payments structure applicable to each (usually monthly) payment date. These waterfall provisions are formulated in such a way that what benefits one class will often harm another. For example, the timing of principal payments, if accelerated, may be beneficial to certain principal-only classes and harmful to other classes, such as interest-only classes. Investors who assumed that any losses would be allocated according to the terms of the transaction documents most likely will have hedge costs and possibly tax consequence if those losses were instead dealt with another way by the operation of officious and unpredictable legislation. There are also potentially negative consequences to waiving defaults or altering standardized collection procedure and experience has clearly indicated that lending regulation aimed solely at reducing the incidence of defaults has had a detrimental impact on secondary market participants. For example, if servicers are unconditionally required to grant waivers of contract terms to mortgage holders, it may provide incentives for others that are not in genuine distress to claim similar benefits. Imposing unforeseeable costs on the market would undermine the certainty required by investors and make future investments in mortgages both less available and more costly to obtain. Moreover, imposing uniform “one size fits all” mandates regarding the proper course of forbearance very often might have negative consequences for the unique challenges and exigencies of an individual borrower.

Suggestions

I concur with many of the suggestions put forward by the American Securitization Forum and the Securities Industry and Financial Markets Association in prior testimony before this Committee. Among these suggestion are as follows:

Assiduous Enforcement of Existing Law

Rather than enacting a plethora of new laws to respond to the current turbulence in the sub-prime market, federal, state, and local agencies should vigorously oversee and enforce existing law and regulation in the origination process, which often is the point where mortgage fraud and abuse take place. There is also a need for consistent and comprehensive enforcement of laws applicable to mortgage brokers, appraisers, engineers, consultants and others involved in loan origination.

Consumer Education and Disclosure

Instead of burdensome laws that impose unnecessary risks on secondary market participants, the more advisable path is to provide fulsome opportunities for consumer education and credit counseling to allow borrowers to select the products that are uniquely suited to their needs. Consumer education should be supplemented by uniform and meaningful mortgage disclosures that effectively inform consumers of the risks that they assume when taking out a particular mortgage loan. Not only will consumer education and disclosure uniformity assist

borrowers in making informed choices, such protections will also promote greater transparency for a liquid and flexible market that enables lenders and investors to responsibly accommodate consumer needs. In that regard, it is noteworthy that the Responsible Lending Act envisages robust counseling and effective education to borrowers so that they are better apprised of the risks of entry into the mortgage loans and to also grasp a better understanding of the totality of the transactions.

Uniform and Objective Standards Should Govern the Market

A polyglot of inconsistent state and local laws only serves to increase the costs of compliance, inhibits the purchase of mortgages on a uniform basis, generates uncertainty, artificially restricts the flow of capital and ultimately harms the very consumers these well intentioned laws were designed to protect. Congress should act to adopt uniform national lending standards applicable to mortgage originators that are clear and objective without imposing any undue restrictions on the secondary market. To best benefit non-prime borrowers, such standards must be national in scope and include broad preemption of state and local laws.

With regard to imposing uniform and objective market standards, the Responsible Lending Act may provide a useful starting point. The Responsible Lending Act establishes federal preemption of all state laws and provides for one national standard with which to comply rather than the complex mosaic of state and local laws that have increased cost and complexity.

The Market's Response Has Been Effective and Should be Allowed to Continue

Both the lending and investment markets have responded proactively to the rise in delinquencies among sub-prime borrowers over the course of the past six months and many of the practices that led to poor performance now so abundantly apparent in the originations of 2005 and 2006 have been jettisoned. A number of sub-prime lenders have withdrawn from the market entirely. Those lenders who remain have tightened their lending and underwriting standards. Investors have become more cautious about the types of securities that they buy. By application of the forces of the marketplace, prices for certain securities backed by sub-prime loans have fallen, reflecting the heightened risk associated with the increase in delinquencies. Portfolios are being scrutinized more diligently at even higher levels as the attributes of the loans that suffered early payment defaults are becoming well known. As previously discussed, mortgage servicers have been taking advantage of the flexibility inherent in typical securitization documents to assist troubled borrowers in avoiding delinquency and foreclosure.

If federal regulators were to restrict credit severely at this particular juncture they would run the risk not only of denying future borrowers credit, but making it extremely difficult for existing borrowers who are about to endure rate increases to obtain reasonable re-financings of their mortgages when their rates reset. Overly expansive legislation could exacerbate the already significant stress in the sub-prime market.

Conclusion

A uniform, national lending standard will promote competition and market efficiencies and will reduce the cost of home ownership. Implementation of such a sweeping legislative initiative would make it easier for financial institutions and their in-house counsel to navigate the

legal landscape. Among other liberating effects, lending industry professionals may clear their files of the numerous diverse and often conflicting laws (and legal opinions regarding compliance with those laws) previously necessary for a national lending practice. For many lenders operating within strict local laws, the regulatory chokehold upon their activities will be loosened.

In drafting national standards, Congress should promote risk-based pricing, avoid prohibitions or excessive restrictions on certain types of mortgage products, steer clear of any suitability standards and enhance the regulation and oversight of mortgage brokers. National standards should be clear and concise and not assign unquantifiable liability to the secondary market for originators' practices.

Ultimately, the public policy challenge for regulators, professionals in the secondary market and consumer advocates is to strike the delicate balance between counteracting abusive predatory mortgage lending practices and ensuring that borrowers who may not be able to obtain loans in the prime market do have ready access to credit.

Hope for a better future – both economic and social – could be on the horizon in both the lending industry and the economy in general in the wake of passage of a uniform national anti-predatory lending reform law based on some of the more securitization/secondary market friendly provisions set forth in the Responsible Lending Act. With stories relating to sub-prime issues now dominating the headlines of business pages, professionals in the lending industry as well as those engaged in securitization and the secondary markets await the decision of Congress, which will soon be called on to decisively seize on this exceptional opportunity to enact legislation with a view towards providing consistency, transparency and certainty in the mortgage lending marketplace, as well as ensuring consumer protection and promoting home ownership.

Predatory Lending in NY Compared to S&L Crisis, As Subprime Disparities
Worsen

Byline: Matthew Lee of Inner City Press

NEW YORK, April 11 -- Investment banks on Wall Street have been facilitators of the shady loans that have the subprime lending industry in crisis. This message was delivered Wednesday by the ex- Wall Street banker nominated as Superintendent of the New York Banking Department, Richard Neiman.

Delivering his first speech in that capacity, Mr. Neiman had comparisons to the savings and loan crisis in the 1980s, and harkened back to the 1970s for the lending discrimination called redlining, which he implied was a thing of the past. Now, he said, there is reserve redlining, in which African Americans and Latinos are targeted for high cost loans.

Eliot Spitzer, now hitting his 100th day as New York's governor, picked as his Banking Superintendent a long-time bank lawyer with Citigroup and more recently part of the Toronto Dominion conglomerate. Some community representatives who spoke to Inner City Press on condition of anonymity, because they have to deal with the Banking Department, expressed concern that despite the speech Mr. Neiman may based on his resume be too close to industry, or unwilling to consider that his previous employers have engaged in abusive lending practices. Citigroup, for example, is noteworthy for having twice settled predatory lending charges, with the Federal Trade Commission for \$240 million and with the Federal Reserve Board for \$75 million in 2004.

More recently, just-released 2006 data distinguishing which loans are over a federally-defined rate spread of three percent over the yield on Treasury securities of comparable duration on first lien loans, five percent on subordinate liens show that Citigroup in its headquarters Metropolitan Statistical Area of New York City, confined African Americans to higher-cost loans above this rate spread 4.41 times more frequently than whites. Toronto Dominion's U.S. mortgage data in 2006, while generally not subprime, reflect that African Americans were confined to higher cost loans over the rate spread 16 times more frequently than whites, and Latinos 12 times more frequently than whites.

Perhaps because of his background, or also because his nomination still awaits action by the State Senate, Mr. Neiman on Wednesday thanked the many industry representatives in NYU's Lubin Auditorium, as well as other

regulators. Federal Reserve chairman Ben Bernanke also spoke Wednesday at NYU, intoning that "market-based regulation has proven an effective supplement to (or substitute for) conventional command-and-control approaches." Consumer advocates expressed concerns that Mr. Neiman may share this distaste for "command-and-control" (that is, for active regulation) and rather may seek to rely on the "invisible hand" to solve these predatory lending problems.

NYDB staff's "Bank on NY" campaign -- but what about Bank *OF* New York? Developing

Mr. Neiman's speech on Wednesday, however, used all of the appropriate buzzwords, from loan suitability to reverse redlining to concerns about the contagion impact of foreclosures on neighborhoods' home prices. Particularly noteworthy was his reference to Wall Street investment banks as "facilitators" who bear some responsibility for the loans they enable. But even with the flight to preemption of Citibank and JPMorgan, what about facilitator Bank of New York and major securitizer and trustee Deutsche Bank, which, a Department staffer acknowledged Wednesday to Inner City Press, remains under Department's jurisdiction? Mr. Neiman said that Eliot Spitzer had convened a working group including the state's mortgage and human rights agencies as well as the Secretary of State and the Banking Department.

Not surprisingly, Mr. Neiman decried Federal preemption of his Department and state and local laws. Eliot Spitzer, as state attorney general, chafed as such preemption when courts ruled that only the Office of the Comptroller of the Currency had jurisdiction over the national banks owned by Citigroup, JPMorgan Chase, HSBC and Wells Fargo. Spitzer ended up acting on lending disparities only at Countrywide Financial, which had yet to shift its lending under the umbrella of Federal law.

For purposes of comparison, Countrywide in 2006 in New York State confined African Americans to higher-cost loans above this rate spread 1.7 times more frequently than whites. Citigroup was more disparate than Countrywide, while denying 35.5% applications of African Americans, and 33% of applications from Latinos, versus only 21.5% of application from whites.

Other banks with Community Reinvestment Act responsibilities in New York were also more disparate than Countrywide. In New York State in 2006, Countrywide confined Latinos to higher-cost loans above this rate spread 1.38 times more frequently than whites. JP Morgan Chase was more disparate, confining Latinos to higher cost loans 1.63 times more frequently than whites.

Washington Mutual was even more disparate, confining Latinos to higher cost loans 1.99 times more frequently than whites. Wells Fargo was slightly less disparate to Latinos, with a disparity of 1.3, similar to HSBCs, while being more disparate to African Americans, disparity of 2.43. Over 35% of HSBC's mortgages to African Americans in New York State in 2006 were subprime, over the rate spread. Nationwide in 2006, HSBC made 6295 super high-cost loans subject to the Home Ownership and Equity Protection Act (HOEPA) -- that is, at least eight percent over comparable Treasury securities -- more than HSBC made in 2005.

Looking even more locally, Citigroup was most disparate in the lowest-income borough its headquarters city. Citigroup in 2006 confined borrowers in Bronx County to higher cost loans 19.6 times more frequently than borrowers in Manhattan. The disparity between Manhattan and Brooklyn at Citigroup in 2006 was 14.77.

Bank of America, which like New Century, bankrupt and now under criminal investigation for the business Inner City Press is calling subprime, has thus far in response to requests refused to provide its 2006 data despite a requirement that it be available on March 31, also assists other subprime lenders in 2006, the report says, by securitizing loans for Ameriquest, which last year settled predatory lending charges with state attorneys general including in New York for \$325 million. The settlement only required reforms at Ameriquest Mortgage and two affiliates, but not its largest affiliate, Argent Mortgage, which Citigroup now has an option to buy. The 2006 data show that Argent made 117,328 mortgages, of which 107,530 or 91.65% were higher cost loans over the rate spread.

Several other large lenders, some directly under the NY Banking Department, have sought to avoid being scrutinized by refusing to provide their data in computer analyzable form. Institutions insisting on providing their data in paper or PDF form have included Delta Funding, Lehman Brothers, AIG, Fremont Investment & Loan and other large subprime lenders, as well as banks such as Whitney Bank and Fifth Third Bank and New York Community Bancorp. Mr. Neiman on Wednesday called for transparency and action. He will be judged, activists say, not on what he says, but what he does.

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IMF Warns on U.S. Subprime Lending, While Praising Its Global Spread

Byline: Matthew Russell Lee of Inner City Press at the UN

UNITED NATIONS, April 10 -- The International Monetary Fund, while singing the praises of financial globalization in a report issued today, notes dryly that "the subprime sector of the U.S. mortgage market has deteriorated more rapidly than had been expected." What the IMF misses is that the same subprime lending scheme which began in the U.S. and is now embroiled in bankruptcies and criminal charges, is being expanded worldwide by the Large, Complex Financial Institutions which the IMF loves and serves.

Citigroup, for example, brags of aggressively expanding its subprime CitiFinancial business to more emerging markets countries. General Electric's GE Money unit doesn't brag, it just expands, offering high-rate lending in every continent. The American Insurance Group, which bought a subprime lender along with American General, seeks to spread the subprime model throughout its global franchise. HSBC, even while announcing earnings warning about its U.S. business, has exported the questionable Household International business model to Eastern Europe, Latin America and elsewhere.

One of the IMF's conclusions is that "Policy makers need to make sure that ongoing oversight of internationalized financial institutions is effectively coordinated cross-border." But on the issue of subprime lending, the U.S. Federal Reserve while approving yet another Citigroup acquisition has ruled that "claims about lending activities in India... are either outside the jurisdiction of the Board" or "contain no allegations of illegality or action that would affect the safety and soundness of the institutions involved in the proposal, and are outside the limited statutory factors that the Board is authorized to consider when reviewing an application under the [Bank Holding Company] Act." 87 Federal Reserve Bulletin 9, n.61 and next FRB approval.



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MAY 8, 2007**

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The National Association of REALTORS® (NAR) is pleased to submit our views to the House Financial Services Subcommittee on Financial Institutions and Consumer Credit for the hearing entitled, “The Role of the Secondary Market in Subprime Mortgage Lending.” We commend Chairman Maloney, Representative Gillmor and members of the subcommittee for holding this hearing on the important issue of the secondary market for subprime residential mortgages and public policy recommendations to curtail abusive lending. Securitization plays an important role in ensuring liquidity to our nation’s housing finance system and keeping the secondary market strong and sound is in everyone’s interest.

Securitization plays an important role in ensuring liquidity to our nation’s housing finance system. Securitization activities by both the newer private secondary market players and the more mature government sponsored enterprises have allowed the majority of Americans to become homeowners. Both sectors have the accompanying responsibility of ensuring that its efforts are designed to also keep these families in their homes. Keeping the secondary market strong, sound and acting in the best interests of those it seeks to serve is in everyone’s interest.

The National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association representing more than 1.3 million members and five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

REALTORS® Want to Prevent Irresponsible and Abusive Lending

Irresponsible and abusive lending practices are a major problem for our nation’s communities. While responsible subprime lenders have played an important role in helping millions of consumers achieve homeownership, abusive lending occurs much too often in subprime markets. Unfortunately, some lenders have abused their role and taken advantage of vulnerable borrowers by charging extremely high interest rates and loan fees unrelated to risk, using aggressive sales tactics to steer consumers into unnecessarily expensive or inappropriate loan products, and advertising “teaser” interest rates (like the 2/28 or 3/27 adjustable rate mortgage) that steeply increase after the first few years of the loan. The consequence of abuses in the subprime market is higher rates of foreclosures leading to the loss of families’ homes and savings and increased vacancy rates which, in turn, can cause all homes in a neighborhood to lose value.

Real estate professionals have a strong stake in preventing abusive lending because:

- Abusive lending erodes confidence in the Nation’s housing system.
- Legislative and regulatory responses to lending abuses that go too far can inadvertently limit the availability of reasonable credit for prime as well as subprime borrowers in a credit-driven economy.

- To the extent responses to abusive lending constrain the ability of the secondary mortgage market to provide liquidity for home finance, consumers will find it more difficult and expensive to buy a home.
- Citizens of communities, including real estate professionals, are harmed whenever abusive lending strips equity from homeowners, especially when irresponsible lenders concentrate their activities in certain neighborhoods and create a downward cycle of economic deterioration.

NAR Supports 8 Key Responsible Lending Principles

NAR supports (a) keeping fair and affordable mortgage products available for borrowers with imperfect credit; and (b) eliminating abusive and problematic mortgages that are made without sufficient regard to whether the borrower can afford the loan and that can lead too often to foreclosure. Specifically, NAR supports a detailed list of improvements to the Home Ownership and Equity Protection Act of 1994(HOEPA) which were included in our submitted statement for the March 27, 2007 House Financial Services Subcommittee on Financial Institutions and Consumer Credit for the hearing entitled, “The New Regulatory Guidance on Subprime Hybrid Mortgages: Regulators and Response.”

However, with 2.2 million American households projected to lose their homes and as much as \$164 billion due to foreclosures in the subprime mortgage market,¹ the public policy debate has grown far beyond how to fix HOEPA, and instead is focused on how to keep people in their homes and how to prevent this subprime “mess” from happening again.

NAR supports the general principle that all mortgage originators should act in “good faith and with fair dealings” in a transaction and treat all parties honestly. NAR’s Code of Ethics already imposes a similar obligation on REALTORS[®], who are required to treat everyone in the transaction honestly. NAR encourages legislators to use such a standard of care as a guiding principle when drafting anti-predatory lending legislation rather than using the phrase to create a new federal duty that would be too general and, therefore, too difficult to enforce.

1. Affordability. NAR supports strong underwriting standards that require all mortgage originators to verify the borrower’s ability to repay the loan based on all its terms, including taxes and insurance, without having to refinance or sell the home.² Lenders should consider all relevant facts, including the borrower’s income, credit history, future income potential, and other life circumstances. Lenders should not makes loans to borrowers that make loss of the home through sale or foreclosure likely if the borrower is unable to refinance the mortgage or sell.

¹ Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners, Center for Responsible Lending (December 2006).

² The limited exceptions to this general principle would include prime borrowers with sufficient verifiable assets to handle a balloon mortgage or a significant jump in mortgage payment.

- Underwriting Subprime Loans with “Teaser Rates.” Some subprime loans are structured with a significant jump in monthly payments often resulting in “payment shock” for the borrower. While these mortgages may be a reasonable choice for subprime borrowers who can afford them, a majority of subprime borrowers do not have the resources to deal with or an understanding of the unique terms and conditions of these risky mortgage products that can result in a significant “payment shock.” Therefore, lenders (including mortgage brokers) should exercise more caution when underwriting such loans to subprime borrowers to make sure the borrower is able to afford the mortgage. Examples of these risky mortgage products include loans with a short-term interest “teaser” rate for the first two or three years (known as 2/28s and 3/27s), loans with an initial interest-only period, and mortgages that negatively amortize.³

NAR will carefully monitor the debate on underwriting standards for subprime loans and will support policies consistent with the goal of assuring that, taking into account all relevant circumstances, borrowers, who have demonstrated the financial capacity to meet their mortgage obligations, continue to have access to mortgage loans made by responsible lenders.

- Reasonable Debt-to-Income Ratio. NAR supports requiring lenders to make subprime loans that have a reasonable debt-to-income ratio. Borrowers should have enough residual income after making their monthly mortgage payment, including taxes and insurance, to meet their needs for food, utilities, clothing, transportation, work-related expenses, and other essentials. Requiring underwriting at a fully amortizing, fully indexed rate is meaningless if the lender uses such high debt-to-income ratios that the family doesn’t have enough income remaining to pay for other necessities.
- Escrow/Reserve for Payment of Taxes and Insurance. Lenders that make subprime mortgage loans should generally require that the monthly payment include an amount to be held by the mortgage servicer in an escrow/reserve/impound account for the payment of the borrower’s periodic payments, such as taxes and insurance. Similar to the escrow requirement exceptions for prime loans that exist in some jurisdictions, borrowers that make at least a 20 percent downpayment should have the option to budget for these payments independently.

2. Limit Stated Income/Stated Assets Underwriting. Since mortgages underwritten based on “stated income” and/or “stated assets” (also known as “no income verification” or “no doc” loans) typically have higher rates, lenders making subprime loans should, as a general rule, underwrite loans based on verified income and assets. The main exception

³ Negative amortization ordinarily results if the mortgage permits a borrower to pay less than the interest on the mortgage for a limited time, in which case the difference is added to the total amount of the loan the borrower must repay.

should be for borrowers whose incomes derive from hard-to-verify sources (such as self-employed borrowers and borrowers in the “cash economy”).

3. Flexibility for Life Circumstances. NAR believes that a standard for determining a borrower’s ability to repay must be flexible to accommodate borrowers with unique circumstances, such as:

- ✓ Borrowers who have demonstrated the ability to make monthly payments, over a long term, that are higher than underwriting standards would otherwise allow. Lenders should consider, for example, the borrower’s history of making rent and student loan payments.
- ✓ Borrowers with high assets but low income who, for cash management or other financial planning reasons, elect a mortgage with a monthly payment that their current income is not sufficient to cover.
- ✓ Borrowers who anticipate a jump in income or assets due to life events such as graduation, completion of professional training, completion of payment obligations for student or car loans, another member of the household entering the work force when young children start school, or an inheritance.

4. Anti-Mortgage Flipping Policy. NAR supports an anti-mortgage-flipping rule requiring mortgage originators making or arranging for a loan that refinances an existing residential mortgage to verify that the new loan provides a significant benefit to the borrower (one test often proposed is the loan must provide a “reasonable net tangible benefit” to the borrower). The lender should consider the circumstances of the borrower, as discussed above, all terms of the new loan including taxes and insurance, the fees and other costs of refinance, prepayment penalties, and the new interest rate compared to that of the refinanced loan.

5. Bar Prepayment Penalties. Under the 2005 policy, NAR opposes prepayment penalties for all mortgages. Prepayment penalties often work to trap borrowers in loans they cannot afford by making it too expensive to refinance. If complete prohibition of prepayment penalties is not feasible, NAR supports permitting prepayment penalties for the shortest time and the lowest amount possible. For example, a borrower in a 2/28 mortgage should be able to refinance at the end of the initial two-year “teaser” rate period without having to pay a prepayment penalty.

6. Alternative Factors for Measuring Creditworthiness. Borrowers with little or no credit history, as traditionally measured, usually have lower credit scores and must pay more every month for their mortgage than those with higher scores. Even if such a borrower is able to qualify for a mortgage, it may be one that has negative amortization or provides for a significant jump in payments after an initial teaser rate period. NAR supports ongoing efforts to take into account consumer payment history not typically considered, such as rent, utility, telephone, and other regular payments and urges HUD, the regulators, the GSEs, and lenders to work to strengthen these efforts. Use of alternative credit approaches will be especially beneficial for low- and moderate-income first-time homebuyers and borrowers with problematic loans that need to refinance their mortgage to avoid foreclosure.

7. Mortgage Choice for Borrowers. NAR supports requiring mortgage originators to offer borrowers one or more mortgages with interest rates and other fees that appropriately reflect the borrower's credit risk. It remains the responsibility of borrowers to decide upon the best mortgage for their needs and circumstances, but they can only do so if they understand all the facts so they can make an informed decision. The following are suggested principles for consideration of Congress and the regulators:

- For originators who offer nontraditional mortgage products, the originator should:
 - offer all borrowers a choice of several significantly different mortgage options;
 - include at least one traditional loan product as one of the options for the borrower to consider, if the borrower qualifies for such a product offered by the originator; and
 - before application acceptance, disclose information about the maximum potential payment over the life of the loan and the date the initial payment will increase to a fully amortizing, fully indexed payment amount.
- For subprime borrowers, originators that offer FHA-insured mortgages or VA home loan guaranty mortgages should consider whether these types of mortgages should be offered as an appropriate option.
- If the originator does not offer mortgages with rates and fees appropriate for the borrower's credit risk, the originator should inform the borrower a lower interest rate may be available from another originator or that the borrower may wish to seek housing counseling, to allow the borrower an opportunity to shop elsewhere or receive counseling before proceeding. For example, a prime borrower that applies for a loan to a lender that only makes subprime loans should be advised that other options may be available.
- For loans originated by a mortgage broker, the broker should offer mortgage options that are among the lowest-cost products appropriate for the borrower.

8. Enforcement/Remedies. NAR supports enactment of strong remedies and penalties for abusive acts by mortgage originators. Among the options for consideration are:

- Criminal penalties similar to those under RESPA.
- Civil penalties similar to those under RESPA.
- Assignee liability that balances the need to protect innocent borrowers with problematic loans against the risk that increasing the liability of innocent holders of mortgages in the secondary market could reduce the availability of mortgage credit.

- Prohibition of mandatory arbitration clauses that bar victims' access to court.

Responsible Lending Principles Should Apply to Wall Street

NAR appreciates that Wall Street investors, facing the implosion of numerous subprime lenders, a surge in foreclosure filings and record delinquency rates, are now requiring better underwriting and increasing pricing for subprime loans. However, some would argue, "too little too late" or "what prevents an investor from relaxing standards once subprime headlines have passed?"

NAR recognizes the impracticality of requiring investors to look at each loan file in a securitized pool to determine whether the mortgage originator appropriately verified the borrower's ability to repay the loan based on all its terms. However, we do believe that loan purchasers have an obligation during the course of their due diligence review to ensure that the lender is making safe, sound and responsible loans, using appropriate underwriting standards and a strong internal control system.

NAR urges secondary market participants to use our 8 Key Responsible Lending Principles as guidance during the course of due diligence in the acquisition of whole loans or loan pools. We believe that effective due diligence policies applied prior to the loan purchase would curb the ability of abusive lenders to pawn problematic loans off on the secondary market.

Foreclosure Avoidance and Mitigation

NAR supports legislative, regulatory, and private-sector foreclosure avoidance and mitigation efforts. We urge lenders, especially lenders that have made loans without considering the ability of the borrower to make payments under the loan, to act promptly to help borrowers resolve the problem, including through recasting of the mortgage, forbearance, favorable refinancing, waiving of prepayment penalties, and other appropriate tools. Prompt action will almost always be in the best interests of the lender, as well.

NAR also supports increased funding for programs that provide financial assistance, counseling, and consumer education to borrowers to help them avoid foreclosure or minimize its impact. We believe that Congress and the regulators should examine alleged abuses by mortgage servicers, some of whom are engaging in predatory servicing by imposing unjustified high fees on borrowers, which can contribute to, or even cause, delinquencies and foreclosures.

Conclusion

Irresponsible and abusive lending can be a disaster not only for the borrower and his or her family, but for the community as well. Problematic loans are often made in concentrated areas and are more likely to result in foreclosures. High foreclosures of

single-family homes are a serious threat to neighborhood stability and community well-being. Foreclosures can lead to high vacancy rates which, in turn, can devastate the strength and stability of communities.

REALTORS® help families achieve the dream of homeownership. The National Association of REALTORS® supports responsible lending with increased consumer protections to ensure that the “dream” our members help fulfill does not turn into a family’s worst nightmare. NAR stands ready to work with Congress on the important issue of risky mortgage products and we are happy to make available to your constituents our “How to Avoid Predatory Lending” consumer education brochure and our “Learn How to Avoid Foreclosure and Keep Your Home” brochure that we will release next week. Thank you.

