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ENDING MORTGAGE ABUSE: SAFEGUARDING HOMEBUYERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT

OF THE

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

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

EXPLORING HOW HOMEBUYERS AND HOMEOWNERS CAN BE SAFEGUARDED FROM PREDATORY AND ABUSIVE MORTGAGE PRODUCTS AND PRACTICES

TUESDAY, JUNE 26, 2007

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ENDING MORTGAGE ABUSE: SAFEGUARDING HOMEBUYERS

TUESDAY, JUNE 26, 2007

U.S. SENATE,
SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 2:45 p.m., in room SD–538, Dirksen Senate Office Building, Senator Charles E. Schumer (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN CHARLES E. SCHUMER

Chairman SCHUMER. The hearing will come to order, and I want to thank our witnesses and apologize for being late. I want to welcome everyone to this critical hearing on "Ending Mortgage Abuse: Safeguarding Homebuyers," and I want to thank our witnesses, a broad-based group, who are appearing before this Subcommittee today.

Many of the members of this subcommittee, including myself, know firsthand about rising home foreclosures that are devastating communities in our home States, and the big question is why. Is it really "the economy, Stupid"? Is it as simple as a lack of borrower education? Is it a sharp rise in family financial emergencies? Or is it downright bad lending practices? I hope we will get to the heart of this question today so we can figure out how to best solve it.

There are a lot of different interest represented in this room today to ensure we get all perspectives. But at least we can all begin by agreeing that sustainable homeownership is the key to having a strong financial future in this country. Buying a home is the largest purchase most families will ever make, and it is a path to wealth and asset accumulation for families and their future generations. It is also critical to building flourishing communities.

Yet our mutual respect for the basic principle of homeownership has not been enough to prevent a widespread effort to exploit the most vulnerable segments of our population by tricking them into signing on to loans that they can ill afford, making it impossible for many to achieve the American dream.

The subprime storm has left virtually no corner of this country untouched. You cannot go a day without reading or hearing about families in places like New York or Ohio or Pennsylvania that are stuck in risky loans they cannot afford and desperate for a way out

that allows them to preserve their home. The problem is bad and getting worse.

This map shows the areas with the greatest increases in reported foreclosures over the 2 years. Depressed regions, like parts of the Middle West—as you can see, the darker it is, the greater the percent. Depressed economic regions, like parts of the Middle West that have experienced significant job losses in recent years, have also been prime targets for deceptive lending practices. And even in growing States—look at Colorado, look at Georgia—unsuitable loans abound. According to Realty Track, nearly 3,000 foreclosure actions were reported, and my colleague and former Chairman of this Subcommittee Wayne Allard's State of Colorado last month alone had 3,000 foreclosures.

Before our eyes, whole communities are being set up to fail when we should be arming them with the tools to succeed. It is bad enough that these families will have to lose their main source of financial stability, not to mention creditworthiness, but if these foreclosures are concentrated in a small number of communities, the effects will be devastating. Studies have shown that even one foreclosure could lower the value of nearby homes by almost 1.5 percent. That is about $3,000 in lost home value per neighbor, or $150,000 of lost neighborhood value for just one foreclosure. That is an amazing statistic. If 2 million homes foreclose nationwide, our communities would lose $300 billion in neighborhood wealth and $6 billion in local taxes that go to fund schools and roads.

So the question is: Why is this happening? I think, in my view, the fundamental reason is simple. The catalysts behind this impending avalanche of foreclosures are risky subprime mortgage loans that thousands of middle- and lower-income Americans were basically tricked into borrowing, even though the loans themselves are designed to fail them. These so-called liar loans are often wrapped in complex rate terms, high fees, and shocking rate increases that in the near term leave the borrower unable to afford rising mortgage payments.

I will ask all of you panelists why these loans have not been underwritten at the fully indexed rate. It is utterly amazing that they are underwritten at the low teaser rate, and then people just are unable to pay them. Many industry participants argue that these loans themselves are not to blame. It is not the product, they say; it is the economy. But one look at this payment chart for the most popular subprime loan in recent years, the 228 adjustable rate mortgage, and the answer is clear. The loans are traps.

Now, in this example, the borrower starts off paying $1,331 a month. That is 44 percent of his monthly paycheck. And because subprime borrowers do not have to escrow, this payment does not include the estimated $200 monthly payments for taxes and insurance. Now, after just 30 months, the teaser fixed rate expires, and the borrower's monthly payment jumps over $400, as you can see here. After 30 months, it is $1,737. Now it is 58 percent of income. Then when you go to 36 months, it is $1,950. That is 65 percent of income. And in 42 months, it is 72 percent of income. That is because the mortgage rate goes up, the teaser rate is low, and you end up paying a whole lot.

Now, I know a man from my hometown in New York named Frank Ruggiero. He has now become famous because he became our witness here. Let me tell you what happened to Frank.

He had a home. He did not need another home. Someone kept calling him on the telephone. He had diabetes and he needed dialysis, and his medical plan did not cover it. Someone kept calling him on the telephone saying, "Refinance your mortgage and I will provide you an extra $50,000 in cash," which Frank definitely needed.

They refinanced his home. Oh, and the mortgage broker told him—he asked him, "What will the interest rate be?" And he said—I think it was like 13—we will have the numbers here maybe. But he told him, "It will only be $100 more than your present mortgage rate." That was true for the first several months.

And what happened with Frank was this: Of the $48,000 in additional debt on his home, guess how much Frank received? This is pathetic. $5,728. All the rest went to closing costs. The broker received $9,300 from the proceeds, and an additional fee of $11,900 from the lender—we want to hear lenders shouldn't be responsible? $11,900 from the lender as a yield spread premium because he duped Mr. Ruggiero with such a profitable loan.

And then Ruggiero, after his payments went up, just like it did on that chart, rather dramatically, he is now—so he got an extra $5,000, and he is about to lose his home. Queens Legal Aid is trying to stop it from happening.

He was perfectly fine before. And this person called him on the phone and called him on the phone and called him on the phone, and he finally said yes. He was a bus driver for the city of New York. He was not a great financial expert. He could not follow all this, but he is a typical American.

That has to stop, and if I have anything to do with it, we will stop it. We will stop it. We will not just blame the market or blame this or blame that. We will do something to stop it.

So the economy was not the problem here. "It is the product, Stupid." No one should be tricked into signing on to a loan that is almost certain to fail them. The very existence of these loans is not a sign of the market working. The fact that these loans are underwritten almost exclusively to borrowers that cannot afford them is not a market failure.

By some estimates, 80 percent of subprime loans are these exploding ARMs, and a very high percentage do not go to finance new homes. We are all told, well, do these subprime mortgages because it is the first step for people financing new homes. I think 11 percent of subprime ARMs go to people financing a new home. The rest go to either people refinancing, like Frank, or financing a second home.

What we want to examine today is why this product even came to be and in such volume. Why are nearly three-quarters of subprime loans being originated by independent brokers or nonbank affiliates with no Federal supervision or finance companies with only indirect Federal supervision?

Look at this chart. Independent brokers make up about half of the subprime lending market. That is the person who went to Frank. Another 25 percent are indirectly regulated and 23 percent are federally regulated. And when you look at what has happened,

there is a correlation. The federally regulated loans are in much, much better shape than the non-federally regulated.

Why are these bad loans being sold primarily to families that already own a home? According to the chief national bank examiner for the Office of the Comptroller of the Currency, as I said, 11 percent of subprime loans went to first-time buyers last year.

The bottom line is that, in my opinion, it should be illegal for lenders to qualify a borrower for a loan that is anything less than its fully indexed rate. The industry must determine a borrower's ability to pay. Subprime borrowers should also be required to escrow for taxes and insurance, like all prime loan borrowers. Including the taxes and insurance would make it impossible for most to get approved for these high-rate mortgages. Thus, the reason the industry excludes them in many, many cases. Lack of escrows will only result in borrowers returning to lenders in serious trouble or default when tax and insurance payments are due.

I have heard one horror story after another where brokers go into communities, attend church services, not only offer to provide the loan, not only guarantee the loan, but offer to find the realtor, the appraiser, the lawyer. It is an unregulated world that is on the loose without adequate supervision, and we need to change it.

So one of the things I have focused on with my colleagues, Senator Brown, who is here, and Senator Casey, also a Member of this Committee, is creating a national regulatory structure for mortgage brokers and other originators in addition to pushing the regulators to conduct more oversight using HEPA and other relevant laws. In April, we introduced a strong bill, S. 1299, to offer a fix to make it harder for irresponsible brokers and non-bank lenders to sell mortgages that are designed to fail the homeowner and result in foreclosure. My goal is to strengthen standards for subprime mortgages by regulating the mortgage brokers and all originators under TILA by establishing on behalf of consumers a fiduciary duty and other standards of care.

In addition, our bill outlines standards for brokers and originators to assess a borrower's ability to repay a mortgage, requires taxes and insurance be escrowed on all subprime loans, and it holds lenders accountable for brokers and appraisers. The bill will also focus on appraisers, a group that has been talked about much less. The bill would protect appraisers who have often been pressured into becoming silent partners in many of these scams, providing inflated appraisals at the originator's behest.

It is clear that the subprime market has been the Wild West of the mortgage industry for far too long. We need a sheriff in town.

I want to thank all of you for being here, thank my colleagues, and call on Mr. Crapo for an opening statement, then my colleagues who wish to give opening statements should be prepared to do so as well.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much. Mr. Chairman, I appreciate the opportunity to work with you on this important subcommittee, and I appreciate this hearing today in an effort to focus on ending mortgage abuse and safeguarding homebuyers. I, too, look forward to working with you and my other colleagues as we

monitor the performance of the mortgage market and determine what, if anything, Congress should do.

Our focus needs to be on finding the right balance. We have already had hearings in our full Committee on this issue in general, and the same types of horror stories as you have pointed out in the example from New York, Mr. Chairman, were brought up there. And I do not believe there is anybody in America who would or, frankly, who could justify the kinds of practices that have been described in these two hearings, and certainly those types of abuses need to be stopped.

The question that we need to focus on is: How do we need to adjust the system? And what type of balance do we need to reach? Actions that we take which would restrict credit would very probably avoid the abuses that we have heard about in the hearing so far today and in previous hearings. Actions which go too far could restrict credit to those who actually would benefit from having credit or perhaps would have benefited from having a different level or different type of credit arrangement. And I think we have got to reach that balance where we make sure that one of the strengths that helps people to move into homeownership—namely, the availability of credit in this country—is not harmed in our effort to avoid the serious abuses about which you talked, Mr. Chairman.

It is important to note that, in addition to the regular meetings and forums with mortgage and market participants, our Federal regulatory agencies have undertaken a number of important initiatives already in response to this issue in recent months to try to help address problems in the subprime mortgage market. These activities range from a recent joint statement encouraging banks to work constructively with borrowers who find themselves in difficulty making their mortgage payments, to their ongoing activities to finalize the proposed joint statement on subprime mortgage lending, which addresses risks relating to certain adjustable mortgages of the kind, I believe, that you are referring to, Mr. Chairman.

Moreover, the Federal Reserve Board has initiated a review of the mortgage disclosures required under the Truth in Lending Act, as well as action at a recent public hearing to determine whether specific lending practices are unfair or deceptive and should be, therefore, prohibited under HEPA authority.

I am going to be very interested as we go through this hearing and other hearings to get answers to these kinds of basic questions as to:

One, what kind of market discipline needs to be in place? And is there market discipline in place today that is helping to address the problem?

Number two, what type of regulatory regimes should be in place to avoid the abuses that we all want to avoid, while making sure that we still maintain a healthy and robust system of credit for homeownership in this country?

Three, do we need to have more legislative authority from Congress or do our regulatory agencies and housing markets have existing authority under existing law to take the actions necessary to assure that the mortgage abuse is avoided and eliminated?

I guess, again, the question I want to answer in the end is the one I began with, and that is, where is the right level, where should the pendulum end up as we try to adjust the system in such a way that we do not have to talk about the kinds of stories that have been brought up in the hearings that this Committee has held so far in which it appears clear to everyone that people were put into loans that were designed to fail from the outset and which were designed to result in foreclosure, but to yield profits up front to some of those who were marketing the loans.

Some have said in other hearings that there is no long-term incentive in the market for that kind of practice and that the market itself will correct it. Others have said that for certain participants in the market, there is indeed an incentive for those kinds of practices and that there needs to be a regulatory regime to assure that it does not continue.

It is the answers to those kinds of questions that I think are critical to achieve in this hearing, and I will be looking for answers to those kinds of questions from our witnesses.

I want to thank our witnesses for coming here today and also for your involvement in this important part of America. Homeownership is really a big part of the American dream, and we want to make sure that everyone in America has the availability of credit to get their hand on that rung of the American dream as best they can. We want to make sure that that rung, when they reach for it, is real and that the opportunities that they believe they are being offered are real and that they are not being moved into a situation which will in the end result in the kind of financial tragedies that will further deprive them of opportunities to achieve homeownership.

Thank you, Mr. Chairman.

Chairman SCHUMER. Thank you, Senator Crapo.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thank you for calling this afternoon's hearing. I want to thank our witnesses, who bring a variety of views on how to best protect borrowers from abusive mortgage practices.

Our witnesses have been asked by the Chairman to be brief, so I will be as well. We face a crisis in Ohio. We have the highest inventory of foreclosed property in the country, and the problem is not behind us. One zip code in Cleveland, 44105, led the Nation over the last 3 months in foreclosure filings. This neighborhood, known as "Slavic Village," was once a thriving working-class community, home to generations of Americans of Czech and Polish descent. This spring, it was home to nearly 800 foreclosure filings, and as Chairman Schumer pointed out, every filing in the neighborhood depresses the value of everyone else's home.

I must say I take no comfort in the observation of the Mortgage Bankers Association that the subprime mortgage problem is not all that bad if you exclude Ohio, Michigan, and Indiana. I doubt the people of Slavic Village do either.

Ohio's economy is not performing as well as those of other States, but the unemployment rate in Ohio has actually dropped over the

past 2 years, from just over 6 percent to 5.7 percent this May. So that alone does not explain the explosion of foreclosure filings in my State.

As the chart over there indicates, over the past 2 years foreclosure filings have tripled in the cities and the suburbs of Cincinnati in the southwest, Columbus in central Ohio, Dayton in the southwest, Toledo in the northwest, and in Cleveland in the northeast—the length and breadth of my State.

Like the falling statewide unemployment rate over the past 2 years, regional unemployment patterns also suggest it is not all about the economy. Union and Delaware counties, for example, generally relatively more affluent communities just north of Columbus, have unemployment rates today of 3.9 percent, and yet foreclosure filings have tripled in those two counties over the past 2 years. Something more than a bad economy is driving this foreclosure epidemic. The industry must own up to its responsibility. I just do not buy the theory that we should let things sort themselves out in the marketplace.

Thousands of real people whose life savings can be tied up in their homes are being robbed by unscrupulous appraisers and brokers and lenders. The fact that the weapon of choice is a pen makes it no less reprehensible. A stick-up on the street and you might be out a week's pay. A stick-up at the broker's office and you might be out a life's work.

We need to put a stop to it. We need the people in this room to help rather than shift the blame, both for your customers and for the many honest people you represent.

Thank you, Mr. Chairman.

Chairman SCHUMER. Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman. I also want to echo my comrades on this Committee and welcome you to testify here this afternoon. I look forward to your comments.

I revert back to the—some would call it the "good old days," but just the old days when, where I come from, a rural State, Montana, the farmer would come in to get his loan and would literally have hat in hand trying to get the dollars to be able, you know, to operate his business or buy a new piece of equipment or potentially purchase a piece of land.

Somewhere over those last few decades, things have changed a lot. It seems to me that now it is far easier to get the money and it is far easier to get into difficulty as far as the loan process goes. Whether it is in subprime lending or with credit cards, it makes little difference to me. I think we are putting folks in a bad situation. I do not know if it is bad lending practices. I do not know if it is the economy. I do not know if it is consumers striking out and putting more pressure on the banks, although I kind of doubt on the latter.

But, I guess, you know, Senator Crapo brought up some good points in that—you know, where do we achieve the balance—the balance of making capital available but yet without hanging out young families or, as Senator Schumer pointed out, older folks who are in need of money because of medical problems, or other prob-

lems? It does not make sense to me, though, as a Senator from the State of Montana, that banks or lending institutions, at least the ones that want to be around for a while, are doing themselves any favor by forcing people into foreclosures and potentially bankruptcy.

And so as we move forward here, I would hope that we get some good answers to these questions so that we can move forward policies that make sense for middle America, for those folks who want to be able to own a home and live the American dream in a reasonable sense of the word and so we are not driving young families into bankruptcy and foreclosure.

So, with that, Mr. Chairman, I do also want to thank you for the hearing and welcome everybody here, and I look forward to your testimony. Thank you.

Chairman SCHUMER. Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you very much for this hearing, and I know we want to get to our witnesses.

Just very briefly, I think what was already said we can reiterate largely, but I do want to focus on a couple of data points which I am sure have been recited already, but they bear repeating.

I am hearing the same thing that you have heard from States like Ohio and New York and the State of Montana or the State of Idaho, where people have had it up to here with this problem. And, if anything, it is getting worse. The data shows that the rate of new foreclosures on subprime adjustable rate mortgages jumped 20 percent in the first quarter of 2007. Also, when you look at early payment defaults or delinquency rates, whatever data point you are talking about, it has gotten a lot worse. And I know there is a lot of finger pointing, and Washington is a town where there is a lot of the blame game going on. But what needs to happen as a result of this hearing and as a result of what we learn from this hearing is a set of solutions.

I want to highlight the legislation Senator Schumer introduced along with Senator Brown and I, the Borrowers' Protection Act—some basic things we should not have to legislate about, they should be done already:

Establish a fiduciary duty for mortgage brokers and other nonbank mortgage originators. We have been very specific about brokers and originators, but maybe we should not have been so specific. Maybe we should have broadened that to other players in the lending field.

Faith and fair dealing standard. Why do we even have to have that in place? They should be doing that anyway.

Requiring originators to underwrite loans at the fully indexed rate; escrowing accounts, prohibiting steering. Go down the list.

This kind of activity is an insult to the country, and it is about time that we cracked down on it. And I do not care who is standing in our way. It is about time we got serious about this. When you have people with a lot of money and a lot of power that are preying upon people that do not have the time or do not have the expertise to know what deal they are getting into. It can happen to anyone. It can happen to a wealthy person. It can happen to a very well-

educated and so-called sophisticated person, but especially someone who does not spend every day in the market, so to speak, and is not a banker or a lender.

So I think we should be aggressive and unforgiving of those who prey upon the individuals who have been adversely impacted by this.

So, Mr. Chairman, I am glad you have brought us together for this, and I am glad that my colleagues are here. But we need to pass this legislation, and we need to get serious so that map that you just saw of the State of Ohio, not to mention the other States, is not replicated across the country.

Thank you very much.

Chairman SCHUMER. Thank you, Senator Casey.

And now let me introduce our witnesses. I will introduce them in the order they will speak, which is from my left to my right, except they did not put them in order on this sheet, so I am going to be shuffling around here.

David Berenbaum serves as the National Community Reinvestment Coalition's Executive Vice President. The NCRC is a national trade association representing more than 600 community-based organizations that work to increase fair—that work to be fair. Oh, here it is—fair and equal access to credit, capital, and banking services to traditionally underserved populations.

Anthony Yezer is a professor and member of the Department of Economics at the George Washington University, where he directs the Center for Economic Research. He teaches courses in regional economics, urban economics, and the economics of crime. His research interests have included the measurement and determinants of credit risk in lending, the effects of regulation on credit supply, and fair lending.

Denise Leonard is President and CEO of Constitution Financial Group, a Massachusetts-based financial company specializing in Fannie Mae, Freddie Mac, and HUD mortgages. Ms. Leonard also serves as President of the Massachusetts Mortgage Association and is a Vice Chair of the Government Affairs Committee of the National Association of Mortgage Brokers.

John Robbins is the Chairman-elect of the Mortgage Bankers Association and is currently serving his fifth term on the Board of Directors for that organization. He is also CEO and a co-founder of the American Mortgage Network, a wholesale mortgage bank based in San Diego and now a wholly owned subsidiary of the Wachovia Bank.

Wade Henderson is the President and CEO of the Leadership Conference on Civil Rights, the Nation's oldest and most diverse coalition of civil rights groups that includes over 180 organizations. In addition, he currently sits on the Board of Directors of the Center for Responsible Lending. Prior to his role with the Leadership Conference, Mr. Henderson served as the Washington Bureau Director of the NAACP and Associate Director of the Washington office of the ACLU.

Alan Hummel is Senior Vice President and Chief Appraiser for Forsythe Appraisals based in St. Paul, Minnesota, one of the largest property valuation firms in the country. Mr. Hummel has also

served as the National President of the Appraisal Institute, and as a member of their Executive Committee and Board of Directors.

Pat Combs serves as President of the National Association of Realtors. NAR is America's largest professional association representing more than 1.3 million members of the residential and commercial real estate industry. Ms. Combs further serves as Vice President of Coldwell Banker-AJS-Schmidt, the second largest real estate company in Michigan.

And last, but not least, is Michael Calhoun, President and Chief Operating Officer of the Center for Responsible Lending, a nonprofit research and policy group committed to protecting homeownership by working to eliminate abusive financial practices. CRL has led efforts through research and policy advocacy to combat predatory lending and has worked for regulatory changes to require responsible practices among lenders nationwide. CRL is an affiliate of Self-Help, a nonprofit that both makes direct loans to homeowners and is also active in the secondary mortgage market. Self-Help has directly loaned over $228 million to 3,300 borrowers, and its secondary market activities has enabled $4.3 billion in financing for almost 50,000 homeowners.

We thank every one of you for being here. In the interest of time, we ask people to make 3-minute statements. That is too short, I think, so if everyone could limit themselves to 5 minutes, that would be great. And then we will get into the questions.

Mr. Berenbaum.

STATEMENT OF DAVID BERENBAUM, EXECUTIVE VICE PRESIDENT, NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. BERENBAUM. Thank you, Chairman Schumer, and I would like to express my appreciation to all the Members of the Subcommittee—Senators Crapo, Brown, Tester, and Casey. And, in particular, I would like to congratulate the sponsors of Senate bill 1299.

The National Community Reinvestment Coalition's members, unfortunately—over 600 members in all 50 States—disproportionately are in many of the hot-spot areas where foreclosure and discrimination unfortunately are widespread in the marketplace right now. Rather than rely on my remarks, I would like to build my initial statement on some of the comments that you have made in your introductory statements.

I think it is very telling that the market has been directing much of our policy right now. Wall Street dictated that, in fact, the flow of funds to the subprime market must cease because we are facing risk, and all of a sudden we are facing a meltdown in the securitization markets for subprime.

Just last weekend, Bear Stearns announced that they will be infusing $320 billion into an effort to save a particular securitization pool. I find it ironic that when a simple proposal to allocate $300 million to help consumers around this country, that is labeled a "bailout," when, in fact, the market is protecting itself already.

That has been the problem. For the past 5 years, community groups, consumer protection groups, fair lending groups, and all of our members in the National Community Reinvestment Coalition have been sounding an alarm about poor underwriting—under-

writing that not only endangered communities, their tax bases, their municipal governments, their ability to, in fact, have sound services and celebrate homeownership, but was going to impact on the safety and soundness of our banking institutions themselves. Those cries for action fell on deaf ears, and here we are today.

There are many reasons for why we are where we are at. Including in our testimony are studies looking at disparities in lending, both controlling for credit and examining HMDA data, looking at the impact of prime versus non-prime lending. Community groups and CRA advocates celebrate prime lending. Do not believe any other statement that to realize homeownership we have supported non-prime or, in fact, non-traditional products. That is a myth and untrue.

A 46-percent rate of discrimination by mortgage brokers in 10 cities that NCRC tested around the country. Within that data, brokers stating, "Don't worry. We have appraisers who will work with us to meet marks." Widespread pressure brought on responsible appraisers who are part of the checks and balances in our system.

In fact, we have a regulatory failure here on a level that is, frankly, putting the economy at risk, and it is not simply a non-prime issue. As interest rates start to go up, it will reach the prime marketplace as well.

S. 1299 will address many of the issues of concern. It is reasonable to ask lenders to play a role in watching, policing the activities of brokers who they work with in their wholesale channels and to ensure arm's-length roles for, in fact, the appraisal industry.

It is unfortunate today that appraisal management companies are opening up reports from appraisers and changing those documents. That is a clear violation of the law, but becoming a widespread practice. We need to implement laws that will ensure that services do not rush borrowers to foreclosure.

In other testimony, we have spoken to law firms that are profiting from the foreclosure process and not affording consumers who have the ability to pay or arrange a forbearance or who should be afforded an opportunity for a new loan if they are inappropriately placed in a non-traditional product the ability to do that type of workout.

We do celebrate what all of the people at this table, all the trades have done, and the regulators have done. The real question is: Why is it so late in the process? And what can we do to ensure that best practices and principles become the law for the future?

Thank you.

Chairman SCHUMER. Mr. Yezer.

STATEMENT OF ANTHONY M. YEZER, PROFESSOR, DEPARTMENT OF ECONOMICS, GEORGE WASHINGTON UNIVERSITY

Mr. YEZER. Mr. Chairman, Members of the Committee, thank you for having me. My written testimony is before you. I am going to direct my remarks to a few highlights.

Chairman SCHUMER. By the way, without objection, all of the witnesses' entire statements will be read into the record. I apologize for not doing that at the beginning.

Mr. YEZER. First, the Chairman discussed instances of predatory lending. The vast majority of subprime lending is not of that char-

acter. I could certainly address predatory lending otherwise. I do not think that there is much that Mr. Bernanke regulates that I would classify as predatory. I have had some very dismal experience with predatory lending in my own family. Actually, it resulted in a death. And so I am very sensitive to it. But I am basically talking about subprime lending, and, of course, that is the large bulk of lending that has resulted in a substantial rise in defaults and foreclosure.

So let me pose some questions that you should ask yourself just before you even think about solving that problem.

How did we get to where we are today? Why do we have this situation now? Why didn't we have it in 1995? In 1985? In 1975? Why are we having it now?

An interesting question. The Chairman speculated on this. Well, guess what we did? We beat the lenders over the head, the depositories over the head, to serve the underserved. They went out and acquired subprime lenders. They hardly knew how to manage them. And we vastly increased the supply of subprime credit as a function of Government policy, and lots of us predicted this was going to result in a problem. This also resulted in knocking the props out from under FHA, so FHA's share fell from—what, 12 to 6 or 5? FHA, of course, being a primary policy that protects the uninformed homebuyer.

OK, so that is how we got to where we are. Now, what is the beginning of a solution? Well, No. 1, maybe you ought to back off some of the regulations that created the problem. No. 2, what is a really bad solution? A new regulation that would cutoff mortgage credit supplies at a critical time in housing markets. You cutoff credit supply to housing markets, and you are cutting the demand for housing at a time when prices are falling. It does not get worse than that. Really scary.

What should precede a new solution? The answer is careful benefit/cost analysis to assure that regulations and policies generate benefits that greatly exceed the cost. You can pass a regulation to generate the benefit. But what about the cost? I mean, if 90 or 95 percent of these subprime folks are, in fact, repaying successfully, then you want to cut them off, too? I don't know about that. I mean, you have a situation where a spouse discovers the other spouse in bed with somebody else. What do we they do immediately? Of course, they get together at the breakfast table and say, "OK, we have got a good credit rating, so let's do a large cash-out refinancing and use the proceeds to fund the lawyers for the divorce." Right? That is what they do? No, of course not. One of the spouses goes out and maxes out all the credit cards, ruins their credit history, and the only way they can do a cash-out refinancing is in the subprime market. Otherwise, there is a forced sale of the house, and the kids are all disrupted.

This is a real issue. Lose your job, your spouse, or your health, and you are rapidly thrown into the subprime market because the prime market does not want to deal with you.

OK. A couple more background points on the current situation. Why do we observe high default rates? Guess what? We have got people lending to the people with FICO scores of 600 or less. People with FICO scores of 600 or less default. That is what they do. That

is what FICO tells us they do. Totally predictable. Why has it been sort of delayed? Because you can refinance people out of defaults as long as house prices are rising fast enough. This is all well understood.

Is a particular loan product, the option ARM with a prepayment shock, responsible for the problem? No. It is the low FICO scores.

Look, there is a paper by Pennington-Cross and Ho in which they basically do a proper prepayment and default analysis of option ARMs, and guess what? There is a big prepayment spike at 24 months. The people know what is coming, and they prepay out of the option ARM at 24 months. There is not a big default spike. OK?

Now, yes, some people get in trouble, but some people have a great experience with the option ARM and are using it really successfully. Possibly you do not want to ban something that a lot of people are using successfully.

The last point is underwriting. I don't think any of the lenders that Bernanke regulates failed to have good underwriters. Yes, predators do not have good underwriters, but you are not going to get at them by beating on Bernanke.

Thank you.

Chairman SCHUMER. Ms. Leonard.

STATEMENT OF DENISE LEONARD, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CONSTITUTION FINANCIAL GROUP, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Ms. LEONARD. Good afternoon, Chairman Schumer, Ranking Member Crapo, and Members of the Subcommittee. My name is Denise Leonard. I am Chairman and CEO of Constitution Financial Group in Massachusetts. I am here today testifying on behalf of the National Association of Mortgage Brokers. I have been a mortgage broker and a mortgage lender for 17-1/2 years. Like most mortgage brokers, I am a small business owner with four employees.

I appreciate the opportunity to testify today before the Subcommittee on the need to combat predatory lending practices while mandating a strong and competitive housing market. We commend Chairman Schumer's "all mortgage originator" approach; however, we believe the value of such an approach lies in the uniformity of treatment between competing distribution channels.

To give consumers real protection and not the illusion of protection, any proposed legislation should apply uniformly and in the same manner to all loan originators—brokers, bankers, and lenders. Whether a mortgage originator is large, small, State-regulated, or federally regulated, consumers deserve the same level of protection no matter which distribution channel they use.

We have built the most competitive and innovative mortgage marketplace in the world, and the dynamics of that marketplace have changed dramatically. As recently reported in 2006, Wall Street had over a 60-percent share in the mortgage market. Because of this, there are no longer clear lines that divide different distribution channels. Today mortgage originators routinely act in multiple capacities—as lenders, correspondents, brokers—and con-

sumers cannot tell the difference. Bankers' and brokers' offices look alike. Most States don't require signages that say I don't have to say I am a mortgage banker, I am a mortgage broker. Bankers and brokers don't take deposits, and most States do not require originators to disclose the nature of their relationship to the customer.

Today we urge you to consider offering consumers real protection by requiring all mortgage originators to meet minimum standards of education, testing, and criminal background checks. Creating a fee-based national registry that is run by a Federal agency like FTC or HUD which includes all originators, including those working for State and federally chartered banks, lenders, and their subsidiaries. We do not want to have a safe haven for these bad actors to be able to continue to do business. *Watters v. Wachovia* has now left a hole in consumer protection standards that really needs to be addressed. Mandating that HUD adopt a uniform disclosure that outlines the role of the mortgage originator and his or her relationship to the consumer. Since 1998 we have urged HUD to adopt a uniform disclosure, outlining for consumers the role the mortgage originator is willing to take.

Many things have happened in the marketplace. Many things are to blame. We would like to see—you know, one foreclosure is one too many, as far as we are concerned, and on behalf of NAMB, I am here today to say that we stand ready to be your partner in designing and implementing these important consumer protections.

Thank you.

Chairman SCHUMER. Thank you.

Mr. Robbins.

STATEMENT OF JOHN M. ROBBINS, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. ROBBINS. Thank you. MBA shares the commitment of this Committee to assuring protections for consumers against abusive lending. The challenge for policymakers is to balance the need to assure consumer protections against the need to assure the availability of credit. Good lenders do not trick borrowers. Good lenders qualify borrowers on their ability to repay that debt.

Every foreclosure is a personal tragedy in which no one wins. Out of 75 million homeowners, approximately 370,000 have a subprime ARM and are in trouble. Far fewer of that number will ultimately face foreclosure. Therefore, any solutions should be narrowly tailored to address the problems and not adversely affect the larger mortgage market.

The problems associated with the subprime market were driven by a number of factors: overcapacity of capital, a drop in home price appreciation, and an increase in unemployment in specific regions of the country. A current report by the JEC confirms this view. Make no mistake, though. Bad loans were made.

The problems of the market are being addressed by Chairman Dodd through the leadership of market participants as well as by Federal regulators who are tightening regulatory requirements. MBA is proud of its participation in the Dodd summit and is achieving results for homeowners by implementing the principles that resulted from that summit.

While we agree with the broad intent of S. 1299, the outcome it would mandate will unnecessarily diminish the availability and affordability of mortgage credit. Specifically, the subjective standards in S. 1299 would impose significant liability risks. The bill's underwriting criteria will force lenders to eliminate or disadvantage many mortgage financing options that have helped contribute to the near record level of homeownership in this country.

S. 1299 also makes a lender liable for acts of an independent mortgage broker over which the mortgage lender has no control and which likely occurred before the lender even purchased the mortgage. MBA believes that, in addition to assuring the availability of mortgage credit, there are three things that the Government can do to help protect consumers: first, make financial education a priority in this Nation; second, simplify and make more transparent the mortgage process and the functions and fees of key professionals; third, achieve a strong and a balanced uniform national standard for mortgage lending with increased consumer protections and more accountability for mortgage professionals, including much better licensing requirements and establishment of a national registry to help protect against bad actors moving from place to place.

Sound national regulatory standards for mortgage professionals are essential steps to establishing stronger mortgage lending protections for borrowers.

Thank you.

Chairman SCHUMER. Mr. Henderson.

STATEMENT OF WADE HENDERSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, LEADERSHIP CONFERENCE ON CIVIL RIGHTS

Mr. HENDERSON. Thank you, Chairman Schumer, Ranking Member Crapo, and Members of the Subcommittee. I am Wade Henderson, President of the Leadership Conference on Civil Rights. I am also the Joseph Rauh Professor of Public Interest Law at the University of the District of Columbia Law School, and I am honored to testify in today's hearing on protecting homeowners and eliminating abusive and predatory mortgage lending practices.

Now, like all of us, I am troubled that today's hearing is necessary. For many years, the civil rights community and consumer groups have argued that the modern mortgage lending system is broken, that traditional lenders have abandoned their fiduciary responsibility to many of the communities they serve, that greater enforcement of existing consumer protections was needed, and, finally, that the subprime mortgage lending system, which should work in a complementary way with traditional lenders, has in some instances become the primary source of mortgage lending and promoted unsound and abusive loans.

The impact of these interrelated problems on both borrowers and our entire economy is now being felt. My remarks today will focus on the national crisis in subprime mortgage lending foreclosures.

Now, you know, look, we strongly believe that responsible subprime lending does serve a valuable and necessary role in creating opportunities for people who might otherwise never own a home or who wish to use their homes as collateral for important

economic needs. The basic problem we face today, though, is that the responsible part of responsible subprime lending has given way to a high-risk profit motive that jeopardizes the future of some of the most vulnerable members of our communities and our constituencies.

In recent years, we have witnessed an explosion in the abuse of legitimate but risky mortgage products, such as the so-called 228 loan, and rapid abandonment of the use of sensible lending practices. As we are now learning, when unsafe or predatory loans are made on a widespread basis in a volatile housing market where supply far exceeds demand, yet where prices have been driven up to unsustainable levels through widespread speculation and fraudulent appraisal practices, you have a meltdown just waiting to happen.

Now, of course, we still have yet to determine the full impact of the current crisis. So far, one thing is clear: the number of foreclosures on subprime mortgages has been rising fast and will almost certainly keep rising. The Center for Responsible Lending, a member of the Leadership Conference which we will hear from today, suggests that perhaps as many as 2.4 million subprime mortgages could fail in the next several years. If that happened, we indeed have not just a crisis but an absolute disaster.

The Leadership Conference is particularly concerned about rising foreclosures among African Americans, Latinos, and low-income households. As Chief Justice John Marshall once said, "The power to lend is the power to destroy." So minority and low-income communities have long been targeted by a wide range of predatory lending practices that strip borrowers of what little wealth they have, prevent them from getting more affordable credit in the future, making them especially vulnerable to the wave of unsound mortgage lending practices in recent years.

I will not go through the specific disparities between African Americans, Latinos, and white borrowers. I think my colleague Mr. Calhoun will emphasize that. But I think it is very clear there is clearly a racial disparity, one that seems to suggest individuals are being steered into subprime loans who happen to be African American and Latino. And while we remember here that not all subprime loans are predatory, it is evident that race or ethnicity of borrower—factors that should never play a role in lending decisions—frequently determine the cost of a mortgage loan. And as foreclosures continue to increase, minority communities are likely to be hit especially hard as a result.

Now, how the growth of subprime foreclosures will affect the economy at large is still difficult to predict. But as indicated by Bear Stearns' announcement last Friday that, using its own money, it was bailing out a $3.2 billion hedge fund that was failing due to subprime mortgage collapse, an announcement that sent shock waves of concern through the financial world, we are beginning to see some very troubling signs.

It is tempting to point fingers and lay blame to a now disastrous situation. Depending upon whom you ask, mortgage lenders blame brokers, brokers blame appraisers, appraisers blame realtors, realtors blame developers, and borrowers blame all of the above. But, of course, it does not help that our society is virtually hooked on

easy access to credit and that people hoped, basic laws of economics notwithstanding, that the good times of the housing boom would last forever.

Ultimately, we believe that the blame should not be laid on any one group or sector, but on the fact that the entire subprime mortgage lending system, as we currently know it, is broken. The legal and regulatory structure that governs mortgage lending has simply failed to adapt to the widespread changes that have taken place in the subprime market in recent years.

Now, I am encouraged that many stakeholders——

Chairman SCHUMER. Please conclude your remarks.

Mr. HENDERSON. I will wrap up—have begun to do voluntary efforts, but let me make one last point, and that is particularly clear.

We at the Leadership Conference are encouraging lenders to take another very important voluntary step, and that is, an immediate, though temporary, moratorium on all foreclosures on subprime mortgages that include payment shock provisions. That would allow lenders to work with deserving homeowners to help them keep their homes by putting them on more sensible loans.

Now, obviously some borrowers use subprime loans hoping to simply get rich during the real estate boom, but a moratorium, a temporary moratorium, is vital to finding and helping borrowers who truly deserve relief.

My last point, Senator Schumer, is that we support the bill, S. 1299. We think it is an important step. We in the civil rights community are proud to be associated with its introduction.

Chairman SCHUMER. I am glad I did not cut you off.

[Laughter.]

Mr. HENDERSON. Thank you.

Chairman SCHUMER. Mr. Hummel.

STATEMENT OF ALAN E. HUMMEL, SENIOR VICE PRESIDENT AND CHIEF APPRAISER, FORSYTHE APPRAISALS, LLC, ON BEHALF OF THE APPRAISAL INSTITUTE

Mr. HUMMEL. Mr. Chairman and Subcommittee Members, America's professional appraisers thank you for addressing the problems in the mortgage industry. The current mortgage crisis with property flipping, fraud, foreclosures, inappropriate pressure, and bad consumer advice is sending shock waves through our communities and our economy. This issue demands bold action.

Because honest appraisals and fair dealings are essential for the legitimate mortgage process, effective reform demands that pressure on appraisers to report predetermined values must stop. Much of the problem comes from the way that the real estate financing industry is structured. It is a house divided. Well-regulated financial institutions perform pretty well. Unregulated mortgage originators do not.

Playing by the rules, legitimate sectors in the mortgage industry compete with the free booters cutting corners. Despite decades of effort, pressure on appraisers has doubled since 2005. Too often, appraisers feel pressure to doctor their valuations so that deals can go through.

I have been pressured. I have said no to this pressure. I have lost jobs because I have said no. I have not been paid for assignments

that I completed because I did not complete the reports to the client's direction. I have been threatened to be blacklisted if I did not remove certain information from appraisal reports that I felt was necessary to produce credible, important facts for secure and fair lending decisions to be made.

Recently, a broker client e-mailed me and complained that I had mentioned a rotting porch in a particular property that I appraised. The house had numerous problems, and they had focused on the fact that within the appraisal report, we had taken a picture of where we had actually stepped through the floor of this porch. We took a picture of the hole, showing the rotting that was going on in this house. The e-mail says, "Don't you know Appraisals 101? Don't you know that if you put that in the appraisal report, I can't make the loan I want to make? How are you going to fix this for me?"

His solution was simple: Put a rug over the hole in the floor. Don't talk about it.

I was being pressed literally to sweep a serious problem under the rug. As an appraiser, I cannot do that.

Sometimes coercion is hard to document. Just a hint in a conversation. Other times it descends into threats that "You will never work in this town again."

The time has come for a comprehensive approach of lender accountability to stop mortgage abuse. S. 1299 addresses many of the appraiser independence issues that we face. These reforms, along with other actions, include the Federal Reserve implementing an anti-coercion provision in its definition of "abusive lending practices," States developing appraiser independence rules modeled on those of the Federal banking regulators, strict enforcement of present rules, and better education of consumers, lenders, and others. These measures together can set the industry straight.

Senators, an independent appraisal is crucial to maintaining the integrity of the mortgage loan process. I urge you enact laws so we can do our jobs, not to sweep problems under the rug.

Thank you for the opportunity to speak to you today about this important issue, and I am happy to answer any questions that you might have.

Senator CASEY [presiding]. Ms. Combs.

STATEMENT OF PAT V. COMBS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Ms. COMBS. Well, thank you very much, Members of the Subcommittee. I appreciate being here today to testify. My name is Pat Combs, and I am Vice President of Coldwell Banker-AJS-Schmidt in Grand Rapids, Michigan, and the 2007 President of the National Association of Realtors.

Realtors work with mortgage lenders every day. Most are responsible mortgage professionals who have helped millions of consumers achieve homeownership. However, some lenders have taken advantage of borrowers with impaired credit, charging high fees, steering them into more expensive loans, and offering interest rates that increase dramatically after the first few years of the loan.

As a result, many of these consumers are losing their homes. As we sit here today, my home State of Michigan has one of the high-

est foreclosure rates in America. I work directly with buyers and sellers in Grand Rapids every day, and I can tell you from personal experience that when people lose homes to foreclosure, our communities, the housing market, and our economy all suffer.

Abusive lending is a national problem, and it requires solutions that strengthen homebuyer protections. Realtors ask Congress to consider the following recommendations:

First, we ask that you refer to NAR's responsible lending principles as you consider anti-predatory lending legislation. In short, we believe mortgage originators should: verify the borrower's ability to repay the loan based on all terms; underwrite loans based on verified income and assets with fewer exceptions; offer a choice of mortgages with interest rates and other fees that reflect the borrower's credit risk; eliminate prepayment penalties or make them as minimal as possible; ensure appraisals are based on sound, independent valuations; and inform borrowers of how a property is valued and provide a copy of each estimate or opinion. We also suggest strengthening penalties for abusive acts. Realtors adhere to a strict code of ethics that ensures all parties to the transaction are treated fairly. We believe lenders should be held to a similar standard.

Second, we ask you to help advance legislative, regulatory, and private sector foreclosure avoidance and mitigation efforts.

Third, we ask you to consider increasing funding for programs that provide financial assistance, counseling, and consumer education.

NAR has worked with our partners at the Center for Responsible Lending and NeighborWorks to produce our brochures on predatory lending and foreclosure, and I have attached some of these to all of the testimony. We would be happy to make these available to all of your constituents.

Realtors help families to achieve the dream of homeownership. We support responsible lending based on sound, independent appraisals, with increased consumer protections to ensure that the dream our members help fulfill does not turn into a family's worst nightmare.

As the leading advocates for homebuyers, homeowners, and homesellers, we stand ready to work with you on this important issue. Thank you.

Senator SCHUMER [presiding]. Thank you, Ms. Combs.

Mr. Calhoun.

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Chairman Schumer, Ranking Member Crapo, Members of the Committee, you have all heard much about the crisis in the mortgage market this year. Borrowers have been sold exploding ARM mortgages, lenders have collapsed, and the negative impact has hurt many American communities and the economy as a whole.

The Center for Responsible Lending conducts extensive research in this market. Last year, our research found that abuses in the subprime market were widespread, homeowners had been placed in

unsustainable home loans, and millions of families were at risk of losing their homes.

In preparation for this hearing, we examined data from ten recent securitizations of subprime mortgages, loans originated after the current crisis began. Unfortunately, we found that these same mortgage abuses continue. Specifically, we found that these recent loans had the following features and characteristics:

First, the exploding ARM loans continue to dominate. Nearly three-fourths of these recent loans were adjustable rate mortgages where initial monthly payments increased by 30 to 40 percent, even when market rate interest rates do not increase. In addition, these loans were typically underwritten only to the initial teaser rate. Almost 40 percent of these recent loans were stated income, low-doc loans, where the borrower's income is not documented, even though most of these borrowers have paychecks and W–2s.

Seventy percent of these loans had prepayment penalties that locked borrowers into bad loans and are used with kickbacks to mortgage brokers.

Finally, very few of these loans—only about a quarter—have escrow for taxes and insurance, which makes the monthly payments appear lower, but results in financial stress when the bills come due.

These practices continue because the market structure has not changed. First, these practices are not just profitable; they are lucrative for many mortgage originators. Most of these mortgages are sold to borrowers by mortgage brokers, and the number is actually in the subprime prime market about 70 percent. The chart that was shown earlier, a significant number of mortgages, subprime mortgages originated by national banks still come through the broker channel, and so that is how you get to the 70-percent figure.

These brokers are paid bonuses for putting borrowers in higher-interest-rate mortgages than the borrower qualifies for. Brokers are paid at the loan closing and have little interest in whether the loan is sustainable in the long term. Indeed, when a borrower is forced to repeatedly refinance an exploding ARM mortgage, this flipping of the mortgage produces additional revenue for the mortgage broker.

Second, there is an absence of substantive protections for American homeowners. Mortgages are families' most important but among the least protected transactions. We at the Center for Responsible Lending commend Senators Schumer, Brown, and Casey for their action in introducing the Borrowers' Protection Act of 2007 to correct this. We are also hopeful that the Federal Reserve will act soon using its existing authority and mandate to stop abusive mortgages.

I want to address very quickly a couple of comments that have been made. First, the subprime market is working well for most borrowers. The MBA's own mortgage figures showed that 10 percent of all subprime ARM mortgages nationwide are presently seriously delinquent. An additional 5 percent of those mortgages are now in foreclosure. That is right now in 1 year. If 15 percent of the mortgages are either in foreclosure or serious trouble at any time, that adds up to a lot of families who get harmed over any number of years.

Our studies showed that as many as one in five of these borrowers will lose their home, not just enter foreclosure but lose their homes. These cannot be explained by the traditional disability, divorce, or job loss. Those have not doubled in recent years, even though foreclosures have. It cannot be explained by the unemployment figures. If you look at the seven highest unemployment figures of States across the country, four of them have above the national average for foreclosures, three of them have below the national average for foreclosures.

But if you look at the fact that borrowers are getting exploding ARMs underwritten to the teaser rate, using up to 55 percent of their gross, not their take-home pay, with no documentation of their income, no escrow, and often inflated appraisals, it would be a shock if we were not having a foreclosure crisis.

In summary, we are seeing the same abusive practices because the incentives and regulatory framework have not changed. This market presently works only in the same sense as the student loan market was working with widespread kickbacks and steering that was profitable for some colleges and disastrous for many students.

States have shown that you can enact strong protections for consumers and that the subprime market will continue to thrive. The subprime volumes have quadrupled in the last 6 years despite increased regulation. We at the Center for Responsible Lending strongly support the subprime market and its continued growth, but it needs to become a product that enriches families, increases homeownership, rather than negatively hurts so many American families.

Thank you.

Chairman SCHUMER. Thank you, Mr. Calhoun, and I want to thank our broad range of witnesses. We will try to go two rounds in the questioning if we can. We hope to close by 4:30. We will try to limit questions to 5 minutes as best we can.

My first question is to both Ms. Leonard and Mr. Robbins. In Frank Ruggiero's case, where the broker made so much more money than Frank actually got on the loan, where he was not informed of the dramatic increase in the mortgage rate, so he lost—you know, in the mortgage payment.

Do you believe there should be some regulation of the mortgage broker and of the mortgage lender in those situations, or none at all? Ms. Leonard.

Ms. LEONARD. Well, I am confused as to how he would not have known what the fees were involved, because as a broker, I would have to disclose all of that yield spread premium on the good-faith estimate and on the HUD.

Chairman SCHUMER. I think what happened here, because I know this case well, is there were a whole lot of papers with a whole lot of fine print. He could not understand it all, and he was just told, "Don't worry. It is only going to be"—"your payment is going to be $1,400 a month." And this is what we are getting at here. The——

Ms. LEONARD. I think it—I am sorry.

Chairman SCHUMER. The bottom line is people are defenseless here, and you can—you know, it is almost like caveat emptor, and there is disclosure in a way that is beyond the reach, not just of

a few people but of many, many, many, many people. And the only way to deal with it is some form of responsibility. And your organization seems to feel that—I mean, it will not hurt the responsible people who are doing a good and fair job. It will just regulate the bad ones who give the whole industry a bad name. So why would you be against this kind of regulation?

Ms. LEONARD. In terms of a fiduciary responsibility?

Chairman SCHUMER. Yes, in terms of—I was asking a broader question. In terms of some regulation of the mortgage broker by the Federal Government, because right now it is very limited and up to States, and States do not do it.

Ms. LEONARD. Well, I think a Federal requirement would preempt what——

Chairman SCHUMER. Exactly. I am just asking would your organization be willing to support such a requirement. Some kind of requirement.

Ms. LEONARD. It depends on what that requirement——

Chairman SCHUMER. So you would not rule it out?

Ms. LEONARD. It depends on what it would be.

Chairman SCHUMER. OK, good.

Mr. Robbins, same thing. The lender in this situation, it seems to me, should have some knowledge of what is happening here, and if the mortgagee is unwilling to pay, if the borrower is unwilling to pay, unable to pay, they ought to be looking over the shoulder. I mean, frankly, when these loans get way up into the secondary market, two things happen. First, they cannot keep track of them all. But, second, they end up paying a price. Ask Bear Stearns. But the broker in Frank's case and the lender in Frank's case are off scot free making record profits while he is gone.

So why shouldn't there be some form of regulation, some responsibility, and now to Mr. Robbins, of the lender—the lender of first resort. That seems to me the best way to check these bad practices with very little harm done to legitimate lenders. And I think a lot of us think—not everybody here—that the reason people do not want regulation is because these practices that I outlined here are much more widespread than, say, Mr. Yezer would have us believe. Mr. Robbins.

Mr. ROBBINS. Well, No. 1, we think that the mortgage process needs to be revamped. No. 1, it is far too easy to hide fees, commissions, and interest rates, what you are actually paying, in the morass of forms that have been developed over the years to protect consumers. In fact, they do not protect consumers at all, Senator. I mean, bad players literally hide in this morass of legal paperwork. That is one of the reasons the mortgage bankers have adopted Project Clarity, which very simply states exactly what your loan is, what the terms are——

Chairman SCHUMER. But right now, with very little penalty, if the broker did not abide by that or just pushed the papers and the lender made the loan, they could all walk away scot free, even if it did not meet the standards you are voluntarily setting up in your organization.

Mr. ROBBINS. We absolutely support fair dealing standards.

Chairman SCHUMER. Why wouldn't you support making the lender responsible to make sure that at least the loan is suitable. It

seems to me a fundamental—banks have to do it. Brokers have to do it. Why shouldn't you folks have to do it?

Mr. ROBBINS. Good lenders——

Chairman SCHUMER. No. We want to deal with the bad lenders, and we think there are a lot of them.

Mr. ROBBINS. Well, I mean, good lenders, No. 1, do not trick borrowers. Good lenders underwrite loans——

Chairman SCHUMER. Agreed. Agreed.

Mr. ROBBINS [continuing]. Based upon the ability——

Chairman SCHUMER. We are not trying to legislate for the good lenders. We are trying to legislate for the bad lenders, but it also will not hurt the good lenders.

Mr. ROBBINS. Well, I think if I read your bill correctly, you are saying establish something that already exists with a good lender, which is a responsibility or a fair dealing responsibility, and——

Chairman SCHUMER. Or a suitability standard.

Mr. ROBBINS. I mean, I can tell you that good lenders today manage mortgage brokers——

Chairman SCHUMER. So can I just get this—so you would not oppose the kind of standards in our bill?

Mr. ROBBINS. No.

Chairman SCHUMER. Good. Glad to hear it. Next question—well, I am over my time. I will wait until the second round.

Mr. Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. I suppose that—perhaps, Mr. Robbins, this question is best for you, or Ms. Leonard. But according to a Bloomberg article on June 13th, the closing or sale of more than 50 mortgage companies and stricter credit rules will reduce subprime lending to $350 billion this year, a 47-percent drop from the $665 billion that the industry lent in 2005, and that is according to a Washington Mutual analysis. Are you familiar with that? And do you believe that that kind of a reduction in subprime lending is occurring?

Mr. ROBBINS. Yes.

Ms. LEONARD. I am not familiar with it, but I do believe yes.

Senator CRAPO. And what do you attribute that reduction in subprime lending to?

Mr. ROBBINS. Principally to the fact that the market has really already moved to punish lenders that became too aggressive in their products and programs. I mean, there are two lenders that have currently failed that accounted for close to about a 50-percent market share of, you know, essentially bad loans that should not have been made, and I am talking specifically about the 100-percent no-income, no-asset subprime loan, let alone the other 48 and the market share that they contributed.

So the market has already moved to punish the players pretty substantially. It wiped out their shareholders on that product. That 100-percent loan is not available in the marketplace. But, in fact, the pendulum has swung much further to a point where it has also affected—it is affecting underwriting and underwriting products and programs in the primary markets as well.

Senator CRAPO. Ms. Leonard, would you agree with that?

Ms. LEONARD. I agree with that, and what it has done—and the fear is, as you stated earlier, if the pendulum swings too far in the

opposite direction, that the very people that we need to help who are facing, you know, possible increases in their loan adjustments, those products and programs will no longer be available to be able to do that.

While we agree that, you know, the stricter guidelines should be there and there has been a huge market correction that has taken place, it is trying to keep that balance, as you said.

Senator CRAPO. All right. Thank you. So I guess in the market so far, it seems to me that a 47-percent reduction in lending is a huge adjustment. And if I am understanding you correctly, the dangerous products, the ones which were being oversold, are largely in that category of those that have been squeezed out by these market adjustments?

Ms. LEONARD. Yes.

Mr. ROBBINS. Yes.

Senator CRAPO. Ms. Combs, I would like to ask you sort of a follow-up question on that. In the same Bloomberg article that I referred to earlier, it states that subprime mortgage lenders have tightened the credit guidelines so much that they are squeezing about 500,000 first-time buyers out of the market, and that is according to the National Association of Home Builders. Does that track with your experience or your understanding?

Ms. COMBS. I had not seen the report. I do not know that. I am finding that a lot of our first-time homebuyers are reaching toward FHA, and we are hoping that we can pull that FHA modernization bill out and get that rolling, because I think that is going to be a real positive thing to use as we move forward without some of the subprime products that are out there. So we are hoping that that is going to really energize that first-time home market.

Senator CRAPO. Thank you, and I agree with you on that FHA reform. I think that is going to be a critical part of the focus that we need to pay attention to here.

I have got only a minute left, and I just wanted to toss out—and I think maybe Mr. Calhoun and Mr. Yezer and Mr. Robbins and Ms. Leonard or others may want to jump in on this. I seem to get a lot of different competing information about how many foreclosures are actually happening. Mr. Calhoun, you indicated 5 percent with 10 percent in danger. I am looking at another article coming out of the Financial Times that indicates that very few of the delinquent mortgages in the subprime will ever actually see foreclosure. And I have heard that kind of information coming from other sources.

Would anybody here like to just jump in and tell me—I know Mr. Calhoun basically already has registered his opinion that he thinks that it is much higher than is being alluded to. I am curious as to whether any others on the panel think the numbers of foreclosures that we are hearing about are low or high or about what we expect in the market or what have. Mr. Berenbaum.

Mr. BERENBAUM. Senator Crapo, if I may jump in, there is another troubling concern that the media is beginning to report on and some studies are about to come out on and, that is, consumers are beginning to rely on consumer credit, and, frankly, prioritizing paying some of their gas expenses and other expenses over their mortgages.

Senator CRAPO. In order to keep their mortgage alive?

Mr. BERENBAUM. Well, in order to struggle to keep everything juggling in the air right now. And this gets to the role of the economy and also some of these more non-traditional mortgages. The situation is compounding, and I am afraid the numbers, regardless of what happens with interest rates, we have a few, a year or two ahead with these adjustments that are going to be very difficult.

Senator CRAPO. Well, my time is up, but I am going to get another round. I see three or four of you that may want to jump in on this. I am going to come back to this when it is my turn next, so just get ready.

Chairman SCHUMER. Thank you.

Senator Casey.

Senator CASEY. Thank you very much, Mr. Chairman. I did want to note for the record, which I should have noted in my opening, just from data from Pennsylvania, subprime adjustable rate mortgage foreclosures, the first quarter 2005 versus the first quarter 2007, nationally 1.44 percentage—I am talking about 1.44 to 3.13, but in Pennsylvania, 1.59 to 2.6. So virtually almost a doubling in that time period.

The first question I wanted to ask was to—actually, two, I think Mr. Henderson and Mr. Calhoun. Both of you referred to racial disparities, and I noted that in some of the material that we have. I think it bears repeating or emphasis.

FDIC Vice Chairman Marty Gruenberg noted in a speech last year, and I quote, "Significant racial and ethnic differences in the incidence of higher-priced lending remained unexplained"—unexplained—"even after accounting for other information reported in the HMDA data. The Federal Reserve study found that borrower-related factors accounted for roughly one-fifth of the disparity."

So I think the record is pretty clear that there are some—and you could even highlight that more with numbers. The bias in subprime lending, the most recent HMDA data show that nearly 55 percent of African American homebuyers and 46 percent of Hispanic homebuyers received high-cost mortgages. By comparison, only 17 percent of non-Hispanic whites got high-cost loans. So for African Americans, it is 55 percent, Hispanics 46 percent, for everybody else 17 percent.

I wonder if either or both of you could comment on that data.

Mr. HENDERSON. Well, Senator, I think that the HMDA data that you have recited is data that we would rely on and certainly it seems to confirm the very suspicions that we share with you with respect to the racial disparities in high-cost loans.

The additional evidence that we have suggests that African Americans were 3.2 times and Latinos 2.7 times more likely to receive subprime purchase loans than white borrowers, and for refi's, African Americans were 2.3 times and Latinos 1.6 times more likely to receive subprime loans.

The evidence that we have seen clearly suggests that there is a racial disparity that is not entirely explained by virtue of the status, the economic status of the borrowers. We have seen too many instances where borrowers with prime credit end up being steered into high-cost loans when, in fact, they could qualify for prime loans, not subprime loans, and should be encouraged to do so.

But I think what you have seen is the absence of, in some instances, credible banking institutions in various communities and the overreliance on subprime loans because of their easy access and their willingness to fill the void that banking interests have created and their failure to respond.

So we think the system is interrelated. We agree that subprime lending has a useful purpose, but not as the prime source of lending when other institutions have abrogated their fiduciary responsibility in the communities that they serve.

And in response to Mr. Crapo, I think if one looks at what happened in Pennsylvania, the statistics that you cited, or go to statistics about foreclosures in Newark, New Jersey, or Cleveland, Ohio, or Detroit, Michigan, you are seeing a profound impact—a profound impact—on communities that are just beginning to, you know, recover from economic downturns that they experienced while other parts of the country were growing.

And so we are relying not simply on statistical information. We are relying on surveys of individual families and borrowers and seeing the devastation in the communities in which these foreclosures are beginning to mount. It is a deeply troubling situation that cannot be resolved entirely by the good-faith, voluntary efforts of many of the people here on the panel. You need something far stronger and a more effective coordinated response.

Mr. CALHOUN. If I could add something real quick——

Senator CASEY. Let me add something, Mr. Calhoun. I have only got about 30 more seconds, but I will come back in the next round. You referred in your testimony—I was trying to locate it in the written testimony. I did not, and it may be in there and I probably missed it. But on bonuses, can you recite that again, that information you presented on bonuses? What do you get a bonus for in the instances you are talking about?

Mr. CALHOUN. Mortgage lenders have so-called rate charts that show required interest rates for any type of loan and any borrower credit score history. And they also have on those same charts figures that show how much the broker gets paid if the loan has a higher interest rate than the rate that the borrower qualifies for. And for a given loan, like the example that Chairman Schumer gave, those percentages can be 1 to 2 or even more percent of the total loan amount. So you are talking about, for example, in your case the broker got, I believe, a yield spread premium of almost close to $10,000, and that is in addition to what the borrower paid the broker up front for its services in helping them through the mortgage market.

Senator CASEY. Thank you. I am over time. I will come back.

Chairman SCHUMER. I will follow up if I might take the liberty of the Chair and ask Ms. Leonard: Do you believe that practice should be allowed, that the higher the interest rate that the mortgage brokers gets, the bigger bonus they should get? Do you think that should ever be allowed?

Ms. LEONARD. Well, if you are talking about the yield spread premium and how we get paid, in order to—I cannot go ahead and put a borrower into a higher-rate loan and make more money on the back end without having their debt-to-income go up as a result. So I cannot automatically just—because I could get more money, be-

cause I could put them in a higher rate, doesn't necessarily say that I would be able to. If I did that, then they would no longer qualify or I wouldn't be able to get them approved.

Chairman SCHUMER. Well, I will take this out of my time, and the second round will go longer. HUD did a study that showed borrowers pay about $7.5 billion in excess yield spread premiums to mortgage brokers. YSPs, as they are known, are fees hidden from the consumer, and they are supposed to be used to defray closing costs, and HUD indicates borrowers are overpaying by 50 percent.

Ms. LEONARD. But they are not hidden from the consumers because we have to disclose them. We always have. We disclose them on our——

Chairman SCHUMER. You disclose them in writing in a big document?

Ms. LEONARD. Yes. It is disclosed on the good-faith estimate. It has to be disclosed on the HUD. And as Mr. Robbins said in his opening statement, there should be transparency for all functions——

Chairman SCHUMER. To those of you dealing with the individuals, Mr. Calhoun, do the people ever know of this fee?

Mr. CALHOUN. Most borrowers do not even understand they have just paid this.

Chairman SCHUMER. How can it be justified? Isn't it an incentive to give—40 percent of these subprime borrowers qualify for prime loans. Isn't it an incentive to rip people off? And why should we justify it?

Ms. LEONARD. No, it is not, because if I can qualify them for a prime loan and make the same yield spread, I am going to do that. I am going to——

Chairman SCHUMER. Why? You make a bigger bonus if you qualify them for a higher spread.

Ms. LEONARD. No, I do not. Not in my market.

Chairman SCHUMER. OK. But if somebody did, that shouldn't be allowed, right?

Ms. LEONARD. If they——

Chairman SCHUMER. If somebody made—if the broker made more money by qualifying people for a higher interest rate loan, even though they would qualify for a lower interest rate loan, should they be able to make a bonus? Not whether it does happen or not, but hypothetically, should that be allowed to happen?

Ms. LEONARD. Yes, because it is not a bonus. It is a profit anyway.

Chairman SCHUMER. OK.

Ms. LEONARD. But the banks get to make it——

Mr. YEZER. Can I comment a second?

Ms. LEONARD. Yes, please.

Mr. YEZER. You understand that there are some cases in which what a broker does is trivial and the person is qualified. Usually when you are dealing with someone who has a lot of financial acumen, in some cases brokers have to work with households for a year or more in order to get them qualified because these are—they have to actually help them to cure their own credit history. If you want them to work with these people to actually qualify——

Chairman SCHUMER. I did not ask that question, Mr. Yezer. You are not even answering the question.

Mr. YEZER [continuing]. Then they need to be compensated.

Chairman SCHUMER. I want to ask you the question.

Ms. LEONARD. Can I——

Chairman SCHUMER. If somebody qualifies for a lower interest rate—OK?—and they get——

Ms. LEONARD. But they automatically——

Chairman SCHUMER [continuing]. A higher interest rate in their loan——

Ms. LEONARD. Right.

Chairman SCHUMER [continuing]. Should the broker get an added bonus because they got a higher interest rate. Yes or no, Mr. Yezer, hypothetically.

Mr. YEZER. The major lenders run borrowers through a scheme——

Chairman SCHUMER. I did not ask that.

Mr. YEZER [continuing]. Which qualifies them at——

Chairman SCHUMER. Can you give me a yes or no answer? Can you give me a yes or no answer?

Mr. YEZER. Actually, I am sorry. If a person——

Chairman SCHUMER. A hypothetical. Borrower A qualifies for a prime mortgage, OK?

Mr. YEZER. Yes.

Chairman SCHUMER. The broker signs him up or her up for a subprime mortgage at a higher rate, even though they qualify for a prime mortgage, should the broker get an added financial bonus for doing that? Yes or no.

Mr. YEZER. The answer is no, and——

Chairman SCHUMER. Thank you.

Mr. YEZER [continuing]. The major lenders run them through a screen so they cannot do it. They know this trick.

Ms. LEONARD. But they don't, and you don't understand the process.

Chairman SCHUMER. Ms. Leonard and Mr. Yezer, you are on a different planet than Mr. Berenbaum, Mr. Calhoun, Mr. Hummel, and probably Ms. Combs and Mr. Henderson, because everyone knows this happens regularly——

Ms. LEONARD. But if you would let me explain——

Chairman SCHUMER [continuing]. And we are trying to prohibit it.

Ms. LEONARD. On a prime loan, if I put you in a 6.5-percent rate with a yield spread of 1 percent on the back and you could qualify for 6.75 on the back, I am going to make more money on that prime loan versus a subprime loan.

Chairman SCHUMER. OK. Maybe in your business that is true, Ms. Leonard, but we have found instance after instance where, with other brokers, they make more money by getting them the 6.75.

Mr. ROBBINS. Can I offer——

Chairman SCHUMER. Mr. Robbins.

Mr. ROBBINS. I am a wholesale lender who works with mortgage brokers.

Chairman SCHUMER. Yes.

Mr. ROBBINS. And the vast majority of the brokers that we deal with do not abuse yield spread premium.

Chairman SCHUMER. Correct.

Mr. ROBBINS. Are yield spread premiums abused? Absolutely.

Chairman SCHUMER. Right. Thank you.

Mr. ROBBINS. Do borrowers understand that what they are paying in a yield spread premium? The vast majority of the time, no, they do not.

Chairman SCHUMER. How many of you—raise your hands—would agree that there are occasions—we can argue about how many—where it is abused? Raise your hands. How many of you agree that we should prohibit it?

Mr. ROBBINS. Let me explain why——

Chairman SCHUMER. Go ahead.

Mr. ROBBINS [continuing]. Why yield spread premium is a good thing if it is disclosed properly: because in some cases it saves borrowers cash. And where a borrower, as an example, buying a new house is moving in, wants to do landscaping and other things——

Chairman SCHUMER. Lower downpayment.

Mr. ROBBINS [continuing]. They will choose to take a higher interest rate because they qualify for it and save the two or three or four or five thousands dollars that they would pay in cash and use that to furnish the home.

Chairman SCHUMER. Understood.

Mr. ROBBINS. So there is a tradeoff, and a yield spread premium is a good thing, used properly. Used improperly, it is a bad thing.

Chairman SCHUMER. No question. But it can be used as an incentive to put people at a higher mortgage rate when they necessarily would not want to be or have to——

Mr. ROBBINS. It could be, yes.

Chairman SCHUMER. Especially when it is abused and not disclosed, especially when it is a first-time homebuyer, especially when it is someone who is not well educated in the ways of finance.

Ms. LEONARD. But the only time it is not disclosed is when the banks are getting it is SRP. We have to disclose——

Mr. ROBBINS. No, wait a minute. You know, it——

Chairman SCHUMER. Mr. Calhoun, do you know of instances where it has not been disclosed and the borrower did not know?

Mr. CALHOUN. There is not under present law an enforceable right for the borrower to get that information.

Chairman SCHUMER. Correct.

Mr. CALHOUN. HUD has said that it should be disclosed, but the borrower who does not get it disclosed has no right to take any action.

Chairman SCHUMER. Right. Do you agree with that, Ms. Leonard? I am not saying what happens in your company. I am saying there is no right—that it is often not disclosed, and there is no penalty when it is not, and then the poor borrower is stuck. And that is what we are trying to change here, and you are arguing we should not, basically, because you are saying we should not regulate anything.

Ms. LEONARD. I guess because——

Mr. BERENBAUM. Senator Schumer, if I may just add in——

Chairman SCHUMER. Please.

Mr. BERENBAUM [continuing]. This gets back to the *Watters v. Wachovia* issue, to have one meaningful standard that reaches all originators, whether they are a broker or a banker.

Chairman SCHUMER. Right.

Sorry. Mr. Menendez. And I have a lot of other questions, but I will defer to Mr. Crapo before I do my next round.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you for pacifying the panel before I got to them.

[Laughter.]

Chairman SCHUMER. Part of my job.

Senator MENENDEZ. A moment of levity.

Let me thank the Chairman for his leadership on this, and I would ask unanimous consent that my full statement be included in the record.

Chairman SCHUMER. Without objection.

Senator MENENDEZ. I am really disappointed that we are back here, and in my mind not all that much has changed. You know, we still see a tsunami of foreclosures across the country, and I am afraid another storm is about to hit as the adjustable rate mortgages, the mixed tranche sets and resets. And it seems to me that each participant in the life of the loan has to step up to the plate and take some real responsibility and action.

I am personally tired of hearing that the marketplace is going to take care of all this on its own. It does not seem to be moving in that direction. If we want to quiet the storm, it seems to me that brokers, lenders, realtors, appraisers, credit agencies, investing firms, and regulators need to take a step forward.

And so in that context, as well as that, I am seriously concerned about the realities of the racial and ethnic disparities that exist here that cannot be substantiated simply by income. If it could be substantiated simply by income, one would understand. But it cannot and, therefore, that is a real concern that I have. It seems to me that there are certain blatant racial and ethnic biases in the process, and turning what is for most people the majority of household wealth which comes from homeownership equity, turning that dream into a nightmare.

Let me just ask, Mr. Robbins, I see the subprime market dominated by adjustable rate mortgages, and the majority of those are hybrid ARMs. And we see those ARMs and mortgage brokers and lenders use the initial low teaser interest rate to entice very often debt-strapped families into the loans. When the rate adjusts higher, homeowners are faced with the choice of another expense of an equity-stripping refinance, struggling to pay an unaffordable loan or foreclosure.

So do you support underwriting loans to the fully indexed rates?

Mr. ROBBINS. It depends on how you qualify a fully indexed rate. At a rate that it could achieve 7 or 8 years afterward, no. At a rate that—a non-teaser rate, at the rate that it should be at, the start rate of the loan, the fully indexed start rate, absolutely. I think most good lenders do that already.

Senator MENENDEZ. OK. And in your testimony, you say that unemployment was and continues to be the main factor in the rise of delinquencies and foreclosures across the Nation, not mortgage

products. But do you see any connection between the way we underwrite hybrid ARMs and the subprime crisis we are in?

Mr. ROBBINS. We have not seen in the database that we currently have, which is 43 million loans, or about 86 percent of all loans serviced, a tie directly to mortgage product. Now, foreclosures, we think foreclosures may likely continue to rise before they get better. Ultimately, is there—as I had said, will some result as a result of bad lending and back product? Yes. We believe that there were loans that should not have been made. And I was very clear about that. I was very clear about saying that subprime 100-percent, no-income, no-asset loan was a loan that made no sense.

Senator MENENDEZ. Because I see there are a whole bunch of scholars and experts, most recently in the New York Times, who have said that another tsunami is on the way because during the next 5 years, over $1 trillion in adjustable rate mortgages will reset. And so I look at that and I say to myself we are still looking at a very significant——

Mr. ROBBINS. Well, adjustable rate mortgages, you know, I mean, properly utilized, have sustained homeownership for the last 25, 30 years in this country. Adjustable rate mortgages——

Senator MENENDEZ. And I think that is what we are trying to get at, whether in all cases they are properly utilized.

Let me go to something, Ms. Leonard, that the Chairman was pursuing in a different context. Do you think that mortgage brokers have a legal duty to act in the best interests of the borrower?

Ms. LEONARD. I think I have a duty to act in good faith and fair dealing with——

Senator MENENDEZ. I did not ask you that. Do you believe that you have a legal duty to act in the best interests of the borrower?

Ms. LEONARD. I think that I do that anyway. It does not need to be regulated.

Senator MENENDEZ. Well, do you believe that you have the obligation to use your most reasonable efforts to get the customers the best loan they can?

Ms. LEONARD. Well, I do not have access to all of the loan programs and products, so within what I do, within the investors that I have relationships with, I try to do the best job for my borrower and put them into the best loan available to them through me.

Senator MENENDEZ. Well, I am trying to get a sense of whether you believe on behalf of your association that you have a legal responsibility to use the most reasonable efforts to get your customer the best loan they can? It is a rather straightforward question.

Ms. LEONARD. We do.

Senator MENENDEZ. Is that a yes or a no?

Ms. LEONARD. Yes.

Senator MENENDEZ. You do, OK. Because I would hope that mortgage borrowers, people who arrange financing in what is often the family's largest financial interest and assets, would not owe less of a duty to a borrower than a real estate agents or attorneys owe their clients at the end of the day.

Mr. Chairman, I have other questions, but I will wait until the next round.

Chairman SCHUMER. Thank you. I just am going to read something into the record. I will have to be on my way. Mr. Casey will chair. But I wanted to read this in just to talk about, as Ms. Leonard seems to be the one person at this table who does not believe we ought to have some kind of regulation, maybe Mr. Yezer as well.

This is an affidavit from somebody named Mark Baumchil, who worked for Ameriquest Mortgage Company. You have heard of that company, Ms. Leonard?

Ms. LEONARD. Yes.

Chairman SCHUMER. It is a pretty big one.

Ms. LEONARD. Yes.

Chairman SCHUMER. OK. Here is his affidavit. I am just going to read points of it and then ask unanimous consent that it be put in the record.

"When I started my employment with Ameriquest, I received training demonstrating and encouraging high-pressure sales tactics. Such training included watching a series of videos relating to mortgage sales tactics featuring Dale Vermillion. Account executives were also shown scenes from 'Boiler Room,' a movie about unethical and illegal high-pressure sales practices."

Then he says, "They were using it as a model, not as something to avoid."

Here are some of the things he says. "Ameriquest taught me and encouraged me to inflate the stated value of the customer's property for the purpose of qualifying them for a refinanced loan. Ameriquest trained and encouraged account executives, through scripts and otherwise, to encourage borrowers to take out cash from their mortgage loans for such things as home repairs and vacations in order to increase the loan amount."

"It was a common and open practice at Ameriquest for account executives to forge and alter borrower information or loan documents. For instance, I saw account executives openly engage in such conduct as altering borrowers' W-2 forms, pay stubs, photocopying borrowers' signatures, and copying them onto other unsigned documents and other similar conduct." Et cetera, et cetera. It is a long affidavit.

Chairman SCHUMER. Should the people who did this at Ameriquest have some kind of regulation, or should we just leave it up to them to do a good job, Ms. Leonard?

Ms. LEONARD. They should be held accountable for their actions.

Chairman SCHUMER. How should we do that?

Ms. LEONARD. By bringing action against them for what they did.

Chairman SCHUMER. Do you think there should be some kind of governmental regulation? Let's say they are judgment proof.

Ms. LEONARD. Well, how could they be judgment proof, because there is already regulation——

Chairman SCHUMER. They might be bankrupt.

Ms. LEONARD. They are lenders.

Chairman SCHUMER. They might be bankrupt.

Ms. LEONARD. Remember, they are a lender, so——

Chairman SCHUMER. They do not have the kinds of regulations we are talking about here.

Ms. LEONARD. Why don't they?

Chairman SCHUMER. Because they are not on the books. Should they? If there are no regulations—let's just posit there are.

Ms. LEONARD. It should be fair for—it should be level for everyone.

Chairman SCHUMER. Should they have some kind of regulation, this company? Let's assume they have none now.

Ms. LEONARD. If they had none, yes.

Chairman SCHUMER. Thank you. OK.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. When I was ending my questions, I had raised the question of why we have such a disparity in terms of projections about the level of foreclosures that are currently happening and that are expected to happen in the future. And I noted that I think there were a couple who wanted to jump in on that.

Mr. Yezer, did you want to respond to that?

Mr. YEZER. Yes. For something like that, again, when I talk about benefit/cost analysis by professional economists, you have excellent staff at the Board of Governors who could get such an estimate for you. They have access to proprietary data sets that would get you a pretty good number and an unbiased number. So I would actually recommend consulting someone like that.

Senator CRAPO. All right. Anybody else? Yes, Mr. Calhoun.

Mr. CALHOUN. Yes, Senator. I do not think that the numbers are so far apart. I think that there is a lot of confusing of apples and oranges. And one number that you hear—and it is the one that has been talked a lot about today by the MBA—is the snapshot. How many loans are in trouble right now as we sit here? And if you look at their testimony on pages 6 and 8, they acknowledge that 10 percent of subprime ARMs are presently seriously delinquent and another 5 percent are in foreclosure right now. But more loans will be—those loans will go through the foreclosure process. In our analysis, we assume, like they do, and other experts, that about half of them will cure. But when you follow loans through the life of the loan, which is what we did, you find out that over the life of the loan, you add up all those snapshots, and it means the numbers out there range—for example, I think Lehman Brothers is higher than our numbers. Moody's says 16 percent of these folks are going to lose their homes. We say 20. Lehman has said as many as 30. But it is a whole bunch of these folks at a level not seen since the oil field crisis and even beyond.

Mr. BERENBAUM. There is also another issue with regard to depreciation in housing and then the overvaluation initially of the housing in the mortgage marketplace, which many homeowners now are trapped in their housing and do not have access to equity or are overleveraged. And that reaches into the middle class as well.

Mr. CALHOUN. And if I can just add one other point that has been asked, do loan features make a difference? We have done research where we have held borrower credit scores and other characteristics constant and found that these abusive features dramatically increase the probability of foreclosure. For example, you can look at the MBA's number, the foreclosure—the seriously delinquent rate, using their numbers as of today in their testimony

today, for the subprime ARMs it is nearly double what it is for the subprime fixed-rate mortgages. It does matter what kind of loan you get.

Senator CRAPO. Mr. Robbins, did you want to respond?

Mr. ROBBINS. Yes, I do. No. 1, the subprime loans will always have a substantially higher delinquency ratio than a prime one. We all know that going in.

We know that the highest level of ones in foreclosure was about 10 percent in the year 2000, in the fourth quarter of the year 2000—pardon me, 2001.

We know that, as I had said, approximately 320,000 loans—and it is a snapshot, a point-in-time number, and that will be larger over a period of time. The 2.4 million loans that you hear, you know, is thrown out as a projection, and yet using Center for Responsible Lending's number, this is a cumulative number that has transpired since 1998.

And so if you add what actually has been foreclosed upon from that point to this, and then say what is going to happen in the future, we would agree with that number. But it is a cumulative number over a long period of time. It is not what is going to hit us as a tidal wave in the next couple of years. There are 6.5 million subprime loans in this country, total. OK? Out of those 6.5 million subprime loans, 20 percent would be what? A million three, 1.3 million?

We also know that about 50 percent of all subprime loans get cured or do not complete the foreclosure process. And so if you say, OK, of all subprime loans in this country, 20 percent will go into foreclosure—he said be foreclosed against. What he is saying is that 40 percent of that number, 6.5 million, would go into foreclosure with that number to be foreclosed against. And short some economic catastrophe, when we know that today 83 percent of the people are paying—making their payment on time, we don't see that number as a credible number of a long period of time. We think it is less than that by a substantial margin.

Mr. HENDERSON. But even if Mr. Robbins is correct about the numbers, even if he is entirely correct about the numbers, the selective impact of these foreclosures on communities in which individuals, companies have created loans that—or marketed loans that have significant flaws has been devastating.

Again, I cite Newark as an example. I cite Cleveland. I cite Pennsylvania. I cite New York. I think there are examples in the market of a differential impact in some communities that, in effect, reflects a level of impact far beyond what Mr. Robbins has suggested.

A blip in the market obviously is seen as a relatively minor incident for those who are examining the entirety of the market. But for individuals who are caught up in the morass of foreclosure, it is devastating. And when you have a concentrated group of those individuals in selected communities, the impact can be quite significant. And if you take the argument as well that unemployment is contributing to this problem, look at communities that are going through transition, either because the forces of globalization have affected industries in those towns or you have had significant unemployment increases. And I think you have a recipe for real disaster.

Mr. ROBBINS. Well, we know that 750,000 jobs were lost in manufacturing in the Rust Belt States, the five States that we cite in there, since the year 2000. So that is going to have a disparate effect on those communities. That is why in the State of Ohio the prime rate foreclosure rate is 3 times higher than the national average.

Mr. CALHOUN. I think a really critical point, though, is that the numbers we are talking about understate the threat to American homeowners. When all of us here talk about foreclosure rates, we are talking about what is the risk that the borrower will lose their home in this particular loan. Well, subprime loans turn over very quickly. The average life is 30 months or less. So all of us here are talking about somewhere between 1 in 10 and 1 in 5 of those families losing their homes in that average 30-month period. Most of those borrowers at the end of 30 months do not win the lottery and pay off their subprime loan. A significant portion of them go into a new subprime loan where they are once again at risk of losing their home.

If you spread this out over 10 years, well north of 1 in 3 families who are in the subprime market for 10 years will lose their home—not go into foreclosure, but lose their home, over 10 years in the subprime market.

Mr. YEZER. Let me just——

Chairman SCHUMER. Mr. Yezer, Senator Crapo is going to do a follow-up. I just want to thank the panel. I must go to another place.

I also want to make one other—because it was a great discussion. I am glad we had it this way with the back and forth, and I hope it continues when my colleague Senator Casey will take over the chair.

The one other thanks I wanted to make is, this is the last hearing for somebody who has served this Committee and me and the people of New York and America extremely well, and that is Carmencita Whonder, my banking person, who is going on to other things. So I wanted to thank her for her service on the record from all of us. So thank you.

[Applause.]

Chairman SCHUMER. The record will show loud applause.

[Laughter.]

Senator CRAPO. Mr. Chairman, could we also have unanimous consent to keep the record open after the hearing for further questions?

Chairman SCHUMER. Yes, and that has been done, and we will submit written questions. We all have some. Thanks.

Senator CRAPO. Thank you. And I asked the Chairman for permission, before he leaves, to just have one follow-up, even though my time has been far exceeded.

Mr. Calhoun, I wanted to be sure I was understanding you right. Are you telling me that in the subprime market 1 in 3 persons who obtains a subprime loan will lose their home?

Mr. CALHOUN. If they are in the subprime market over a 10-year period. And then during that time, a typical subprime borrower would refinance as many as three times during that 10-year period.

Senator CRAPO. But at some time, if they stay in for more than 10 years, at some time they will lose their home. How many people actually do that? What percentage?

Mr. CALHOUN. The number——

Senator CRAPO. You are not saying that one-third of all subprime loans are resulting in successful foreclosure?

Mr. CALHOUN. To be clear, our projections based on—we use Moody's housing appreciation projections. We project that 1 out of 5 subprime borrowers will lose their home—not just go into foreclosure, but lose their home in their current loan. Fitch projected that that would be 12 to 16 percent, because they use more optimistic housing projection numbers. We use Moody's numbers. Lehman Brothers projected it would be even higher than what we projected.

But if you look at a borrower, which many subprime borrowers do, and if you talk to the brokers here, I think they will confirm this, many subprime borrowers refinance from one subprime loan to another, and all of these foreclosure rates we have been talking about today are how many are going to lose it in that current loan, which is typically a very short-lived loan. I do not think there is any dispute on this panel about how——

Senator CRAPO. You are not saying they refinance. You are saying they lose their home.

Mr. CALHOUN. Yes.

Senator CRAPO. Mr. Robbins.

Mr. ROBBINS. Well, No. 1, we know historically that if a borrower stays in the home 18 months, their chance of being a very successful homeowner is increased dramatically.

No. 2, approximately 50 percent—and this is, again, according to some of our major servicers, and I want to reiterate that we represent 43 out of 50 million homeowners in the United States, so 86 percent have been producing these numbers for 30 years. That about 50 percent of subprime borrowers in a couple major portfolios refinance into prime loans. And of the remaining 50 percent, 25 percent refinance into a subprime fixed, and the other 25 percent refinance into another subprime, in this case a 228 or a 327, when the reset date occurs.

And so we think from what we see in those specific cases, what history has taught us about loan modifications, which can be used in about 80 percent of the cases where a borrower will work with us and respond. With the industry we think that the numbers being utilized and thrown out today are sensationalized to a great degree.

Senator CRAPO. Well, I see my time is far gone. I appreciate the indulgence of my colleagues. Thank you.

Senator Casey [presiding]. Thank you, Senator.

Mr. Robbins, I want to get back to you. I know you have been the subject of a number of questions and it has been an interesting exchange.

You have been to my office and to others over the last couple of weeks going back, in my case several weeks. I want to direct this to you. You have a job to do here today and you are representing your point of view.

But I do want to, first of all, point out on page 12 and 13 of your testimony. You cite three things that should happen here. No. 1, borrower education. No. 2, that the MBA believes simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market and such improvements are long overdue. That is No. 2. No. 3 is uniform lending standards.

So we are talking about borrower education, all necessary consumer information. And No. 3, uniform lending standards. They are the recommendations.

I have to say, after listening to the testimony today, after listening to the questions that were asked, after discussions with you and a lot of other people over these many weeks now, I have to say these three recommendations fall, I think, far short of what needs to get done. Because when I look at these, and I want to give you a chance to comment, when I look at these, when I—first of all, borrower education, I think that is really, really trying to shift the blame here, frankly, to borrowers who are not informed enough. But we can debate that a long time. I just think you are wrong on that.

But the other two, necessary consumer information and uniform lending standards, I think that is exactly what we—not just contemplated in the legislation that I am a cosponsor, but I think it is very specific. We talk about establishing a fiduciary duty for mortgage brokers and other non-bank mortgage originators.

Two, create a faith and fair dealing standard for all originators. Three, requiring originators to underwrite loans to the fully index rate. And applying, in essence, throughout this legislation, truth in lending requirements.

Now I do not think there is any difference, and in fact I think this gets to it much moreso than your recommendations do. Because if you are going to talk about all necessary consumer information and giving as much information as possible about uniform lending standards, what else are we talking about here?

Mr. ROBBINS. Well, let me expand on the three areas, because it was originally said OK, what will it take to help reduce the predatory lending done in the United States? And the Mortgage Bankers Association came up with three areas that would help dramatically. The first is consumer education. And it really is more than—it is fundamentally getting to the heart, including education if you remember our conversation in your office, about educating youth in this country. We need a financial literacy court to be taught in high schools in this country.

And it is not that any single one of these is the right answer. It is a collection of all of them.

Senator CASEY. Well, let me just interrupt for 1 second. I think we can get a lot of agreement on that. But I do not think that is the cure. You are going to identify three cures to the subprime lending——

Mr. ROBBINS. But each of them by themselves——

Senator CASEY [continuing]. Fiasco or crisis——

Mr. ROBBINS [continuing]. Is not the answer.

Senator CASEY. I think that in the top three.

Mr. ROBBINS. I think it is one of the areas that we could help is making, when creating smarter consumers, the same ones that are subject to those credit cards and that rash of consumer information when they come out of high school and creating better consumers, so that they can shop mortgages.

No. 2, it has to do with truth in lending. What you talk about is changing the process so that the process is crystal clear to borrowers. You know, our responsibility is certainly to educate them on the product that they are choosing. But what they need to do is make sure they understand that product, they understand what the payments are, they understand what the risk and rewards of that product are so they make an education decision on that product.

The current system does not allow that to occur because it disguises all that information. And ultimately the chairman of Fannie Mae said the same thing. He said he recently bought a house, signed his name 45 times, and found four forms he could not understand in the process.

Last, we said the uniform national standard created—that affects all lenders the same nationwide. But part of that process was the licensing of mortgage brokers and bringing them into a regulatory constraint of some time so that—we thought that that also, testing the same things that we have heard from them today, would help the process substantially.

Senator CASEY. And I do not want to abuse my privilege as the temporary chair, but I will get a little more time. Senator Mendendez deserves time and kudos for patience.

Mr. Henderson, I want to have you weigh in on this but again, there is a question that we can deal with today or you can submit more testimony, written testimony for the record. But what is wrong with a fiduciary duty for mortgage brokers? What is wrong with faith and fair dealing for all originators? What is wrong with fully indexing the rates?

Mr. ROBBINS. I do not think you heard me disagree with any of those.

Senator CASEY. I mean, I think they are pretty basic and they are usually part of every faith and fair dealing and real estate transaction right now with banks.

Mr. ROBBINS. Our industry agrees with faith and fair dealing. Our industry, I mean, again, depending on a fully index rate, it depends on how you define a fully index rate.

Senator CASEY. Are you saying you endorse part of this bill?

Mr. ROBBINS. I am saying there are parts of this that I like very much.

Senator CASEY. That is good. I am glad we can establish common ground on that.

Mr. ROBBINS. No, absolutely.

Senator CASEY. I want to let him get to this. I will try to get next to you.

Mr. HENDERSON. Look Senator, we would support the three recommendations that Mr. Robbins has discussed. But they are not responsive to the problem of the crisis in subprime lending. So let us put that aside.

Mr. Robbins never mentioned, for example, the elimination of prepayment penalties.

Mr. ROBBINS. I would like to talk about it.

Mr. HENDERSON. That really load some of these loans with penalties that borrowers are simply unaware of and simply cannot afford to pay. He did not talk about, for example, eliminating the yield spread premium with respect to bonuses that mortgage brokers may get. While he supports licensing and some element of regulation, you did mention that, it was not part of the three essential elements that he listed as his recommendations which we think are especially important.

And in response to Senator Menendez's question about whether mortgage brokers should have a fiduciary responsibility to provide the best loan, the most suitable loan for the borrower that they represent, the acknowledgment of an ethical duty that, indeed, one or two brokers may follow is different from a standard that is universally applied to an entire industry.

In our view, there is something more that is needed beyond the kind of voluntary compliance that we have talked about here today. We are not interested in trying to over regulate the market. We do not believe that the market works best under the heavy thumb of regulation. But what we are seeing here today certainly is the opposite of the notion of some regulatory interference in the market. We have seen an absence of regulatory involvement, an abdication of the spirit if not the letter of the way in which these laws are to work together in an integrated fashion to ensure a fair marketplace.

I agree with Chairman Schumer. There is a touch of caveat emptor, let the buyer beware, in terms of how this process works. And it is simply not working well. And the crisis we are seeing today is an example of that.

That is one of the reasons that we have urged for a very modest temporary moratorium, a voluntary moratorium, on the part of the lenders who are holding the bulk of these subprime loans that are scheduled to be triggered in a way that will be harmful. We think taking a deep breath, allowing some effort to coordinate the voluntary efforts that individual lenders have taken, is an important step.

We have not argued the need for regulation immediately to examine this issue. But the failure of the industry collectively to come to terms with the nature of this crisis leaves us no choice but to recommend some level of intervention beyond what we have seen. That is one of the reasons we think your bill is such an important tool and we hope that Congress moves immediately to try to enact it. But we are also hoping that the industry itself will come to terms with the fact that it needs to do more than the kind of voluntary efforts which have been undertaken, which are not really responsive to the entity of the problem.

Mr. ROBBINS. If I could offer one comment——

Senator CASEY. I have to gavel myself to a close. I want to let Senator Menendez—I will come back, because I have got more.

Senator MENENDEZ. Thank you, Mr. Chairman.

I just want to pursue three different things as quickly as possible. You know, when I left off with Mr. Robbins, we were talking

about the Times article and the experts that said that another tsunami is on the way because over the next 5 years $1 trillion in adjustable rate mortgages will reset. At least as to that claim, that there is going to be $1 trillion in adjustable rate mortgage that reset, is there a dispute about that?

No. OK.

Now, Mr. Calhoun, I understand that that potentially can result in about 2 million families losing their homes. Is that a projection that is reasonable? Is it within the ambit? How would you describe it?

Mr. CALHOUN. Again, to be very specific about that, as Mr. Robbins said, there are about 6.5 billion subprime loans out there right now. Our projection is that one in five of those the borrower will lose their home before that loan is refinanced or paid off.

Senator MENENDEZ. And that would mean roughly how many people or families?

Mr. CALHOUN. That would be 1.3 or 1.5 million presently in the subprime market.

And then, the numbers are not clear as to—there is not good data as to how many of those borrowers refinance into new subprime loans. He gave an example of some very limited data that was only for lenders and it did not include brokered loans, which tend to refinance more often.

But if you assume that 40 percent of these borrowers, this is what we did in our study. If you assume 40 percent of the borrowers graduate to a better prime loan or fixed rate at the end, rather than refinance into another subprime loan, you end up with over one in three of these borrowers losing their homes before they escape the subprime market.

And I do not think we can—if there are two points that we come out of here with, one is again, following up with Mr. Henderson's comments, literally a generation of wealth accumulation in the minority communities, African American and Hispanic communities, are at threat here. This is the greatest threat in a generation to that equity that has been built up over a lifetime.

The second is we have firm evidence that this market has not and will not fix itself. And I will give you three quick examples. One is one of the largest subprime lenders had a policy for many years of not paying yield spread premiums. And in fact, on its website, actively telling borrowers that yield spread premiums created a conflict of interest for the broker to increase their interest rate. So you should never pay them.

That lender found that the brokers simply would not send him any loans. They would take them elsewhere and they had to reverse its policy.

Another lender, who is now out of business, that we met with a year ago, acknowledged that these exploding ARMs were unsustainable and they were hard to justify in the market. But it also had come to the conclusion that if it stopped taking those exploding ARMs from brokers, the loans would go elsewhere and its business would fall in half.

And last, as we heard so vividly earlier today about appraisals, again and again appraisers who play by the rules and try and resist the intense pressure to jimmy the numbers up are competi-

tively disadvantaged. They lose business. Those who try and play by the ethical rules in today's market are disadvantaged and are hurt, just like consumers are, because there are no standards.

It is like a football game. If you do not prohibit holding, you are going to have a lot of holding.

Senator MENENDEZ. And if I may interrupt, because you are taking most of my time.

Mr. CALHOUN. I apologize.

Senator MENENDEZ. But I appreciate your answer very much. And that brings me to the question I want to go to Mr. Robbins on. Because there is a universe that clearly either loses their home or goes back again into the subprime market for an extension of what they hope will be an extension on their dream, it is particularly important to look at the nature of the subprime market, particularly the adjustable rate mortgages that I want to go back to. Because on page five of your testimony, you talk about the causes of foreclosure.

Mr. ROBBINS. Correct.

Senator MENENDEZ. And you stress economic factors. And you cite data from Freddie Mac's Workout Prospector as the source of the information, from what I can see of your footnote.

But our staff spoke to Freddie Mac this morning and according to them the Workout Prospector does not include any subprime loans. And so, in other words, if it does not include any subprime loans as its rationale for why, in fact, people ultimately lose their standing, it seems that the data may simply not apply to the subprime market.

In addition to that, I would point out that Michael Stanton, the Director of the Financial Services Research Program at GW University Business School, gave a presentation this past May in which he said that in 2001 to 2002 the subprime foreclosures were an economic condition story.

But he went on to say that in 2006 and 2007 and beyond it is a story of disappearing equity and rising interest rates, in contrast to the earlier period. I take that to mean that the rising home prices are no longer sufficient to bail out lenders and investors from the kinds of bad loans such as 228s that dominated the subprime market.

If that is the case, then there should be a real concern about how we look at the subprime market, particularly in the adjustable rate mortgage, particularly as it relates to the question I asked you earlier about the fully indexed rate. Because all of these are variables that are clearly going to affect a very significant universe.

Mr. ROBBINS. And I think I was clear in saying that I support underwriting at a fully indexed rate.

Senator MENENDEZ. But do you know that your data does not include the subprime mortgages?

Mr. ROBBINS. No, I was not aware that the Freddie Mac data did not include subprime loans.

Senator MENENDEZ. Well, I think that affects significantly and I think this is a real concern.

Mr. ROBBINS. But the data that I shared relative to the mortgage banking industry does include subprime loans.

Senator MENENDEZ. You make the comment, and I do not want to belabor the question, but it is under the heading subprime market troubles and perspective.

Mr. ROBBINS. Right.

Senator MENENDEZ. The data that you are using is not related to the subprime market and therefore we have got to look at mortgage products in addition to whatever economic factors. That is my point.

And last, if I may, Mr. Chairman, with your indulgence, it will be my last question. I want to turn, just briefly but importantly, to this disparity. As a Hispanic-American, I find it incredibly incredible. And I think reading this whole section is important so that we understand the paragraph. Because I think we talk about the number, but it is the juxtaposition of the numbers that is a problem.

"The several analysis of information collected under the Home Mortgage Disclosure Act has shown that African Americans and Latino borrowers received a disproportionate share of higher rate home loans—" and this is the point I want to emphasize "—even when controlling for factors such as borrower income and property location." Even when controlling for factors such as borrower income and property location.

And that most recent Home Mortgage Disclosure Act data shows that nearly, as Senator Casey said, 55 percent of African-American home loan buyers and 46 percent of Hispanic home loan buyers received high cost mortgages. And by comparison, by comparison, only 17 percent of non-Hispanic whites got these high cost loans.

So the suggestion that it is simply an income issue is false——

Mr. YEZER. Absolutely.

Senator MENENDEZ [continuing]. When you control the essence of both a combination of factors on borrower income, property location, and you see this disproportionate effect and it cannot be explained simply on income. Then I would ask Mr. Henderson, Mr. Calhoun, do you have any insights into that for the Committee?

Mr. HENDERSON. Senator Menendez, I think your question dramatically underscores one of the great difficulties that we as a Nation and we in the civil rights community have had particularly in trying to get a handle on the problem that we are addressing today and the lack of effective regulation that exists currently and our inability to rely on voluntary compliance alone to produce the kinds of results I think we as a nation would want.

I mean, I do not think anyone is taking issue in challenging the numbers that you have emphasized today. They come from the Home Mortgage Disclosure Act.

The difficulty we have had, quite frankly, is getting HMDA data released and made available so that we can address these issues in a much more aggressive and forthright manner. It really underscores what we consider to be the very modest regulatory intervention that the bill which you and the Chairman have supported, it seems to us would make with respect to the overall problem.

And what I have not heard anyone say on the panel that opposes this kind of modest intervention, why should we continue to rely on a system that does not ultimately address the kinds of disparities that go to the heart of the meaning of equal opportunity in the

21st century? If we cannot rely on the industry itself to address these issues, surely then we have to take additional steps to make the system work more effectively.

Senator MENENDEZ. Mr. Calhoun.

Mr. CALHOUN. First of all, we should not be surprised by this result. In the last few years we saw this exactly same dynamic in the automobile financing market, where lenders were—the major finance companies paid bonuses to car dealers for increasing the interest rate on consumer car loans above what the consumer qualified for. And there the data showed overwhelmingly that the borrowers who paid the biggest penalties were Hispanic and African American borrowers.

We have that same bonus system with yield spread premiums in the mortgage market. We should not be surprised that we get the same result. The result in the auto market is all the major lenders have now tapped those bonuses that they will pay to try to reduce or eliminate the discriminatory impact.

The second thing, and I will be very quick, I would refer everyone to studies of testers that Mr. Berenbaum's organization has sent out where they send out blind testing of lenders. They will send out equally matched potential borrowers. And over and over again the African American and Hispanic borrowers are quoted worse terms and given fewer options. And this is across a wide array of cities, a wide array of lenders. And they have done this testing repeatedly. And discouragingly, it continues to show those results.

But all borrowers should support and would benefit from the anti-steering provision in your bill that prohibits steering people to loans with higher rates than what they qualify for. It happens to all borrowers, Caucasian, African American, and Hispanic, but particularly to the latter two groups. But all groups would benefit from that protection.

Senator MENENDEZ. Thank you, Mr. Chairman.

Senator CASEY. Thank you, Senator Menendez.

I have two more questions. I know we are going over now. We will come to a close and then I want to give people another 30 seconds.

Two questions. One, the first one for Ms. Leonard and Mr. Robbins. This question, which is I think fundamental to borrowing in a way that is fair and equitable and in the best interests of the borrower, frankly, escrowing for taxes and insurance, which is a common practice with prime loans. Subprimes, inherently riskier, it is not happening.

A, would you agree with that part of the legislation for escrowing?

Ms. LEONARD. Yes, with high loan to value loans, yes.

Senator CASEY. Mr. Robbins?

Mr. ROBBINS. Yes.

Senator CASEY. Great.

One more question, and then I will let everyone get a last word before we—it is five o'clock right now.

Mr. Hummel, I wanted to get back to you about your testimony, which I thought was particularly striking in terms of what you

have experienced personally in the world of appraisals. You work in Minnesota?

Mr. HUMMEL. My personal practice is in Iowa and Minnesota. Our offices are in 30 States.

Senator CASEY. But whether it is Iowa or Minnesota or anywhere else, what is the typical process that would be triggered by a complaint by an appraiser who has been unduly pressured by a lender or by anyone in the process to fix an appraisal or to commit fraud, frankly? What is the typical process that would be triggered? What kind of prosecution, so to speak, can take place?

Mr. HUMMEL. The typical process right now is one of frustration because there is no process. Because the lenders have a disparate, if even existing, regulatory structure, we do not know who to contact. We may contact a banking commissioner. We may contact a regulatory agency such as OTS or FDIC if they are a federally regulated bank. Those are relatively easy in order to contact.

But it is the disparity between the States, of which there is anything from virtually registration only to a complex licensing system with very little enforcement. If a complaint is lodged, we may or may not hear anything.

That is why we are in such support of 1299, because it does set forth a Federal mandate that a system will be in place that is equal across all States for accountability.

Senator CASEY. Thank you. And I want to go right to left and just give everyone 30 seconds, lightning round. If you hear the gavel, you know you went too long. And then we will wrap up.

Mr. Calhoun.

Mr. CALHOUN. I think the lesson that comes from looking at the appraisals is that disclosure is not enough. In fact, it can be counterproductive if you do not have substantive standards.

And second, even substantive standards are not enough without accountability. In many States across this country, it is illegal to pressure an appraiser to raise the number. But there is no accountability. There is no enforcement.

That is why we, at the Center for Responsible Lending, so much applaud your efforts in this bill to place on the lender, who really is at the hub of the transaction, the responsibility to know the broker, to know the appraiser. That is the only way that this problem will ever be cleared up, is by creating incentives for the market to police itself.

And we again appreciate your efforts to bring reform to this market.

Senator CASEY. Thank you.

Ms. Combs, on any topic?

Ms. COMBS. Sure, actually this topic. I hope that we are not, at this point, closing the door after the horse ran out. And I strongly support the elimination of prepayment penalties. I think that would very, very highly help every one of those folks who are in—probably not at this point, but in the future—who are looking at the possibility of refinancing and/or foreclosure.

And also, that we support every borrower that qualifies for a prime loan to be able to get that prime loan and not having them taken off somewhere else and talked into some other type of loan.

And finally, if there would be some way that you could take a look at the Internet and some of the things, the abuses that are happening there on a lender perspective, it would really, really help those of us who are trying to do a really good job in working with buyers and sellers and helping them get a really good legitimate loan. Because I think the Internet has done something out there that has put the crazies in people's minds.

So I thank you so much for having the opportunity to be with you here today. Thank you.

Senator CASEY. Thank you. Mr. Hummel.

Mr. HUMMEL. If anybody was not convinced and they walked into this room, as to the need for this legislation, they have got to be, by listening to this discussion. I was just absolutely amazed as the discussion went where we were talking about the fact that good people do not need laws because they are doing it right anyway.

And I cannot agree with that more because I would work, and probably have worked, with just about every industry member at this table. They are good people.

And my members at the Appraisal Institute, the American Society of Appraisers, the National Association of Independent Appraisers, the Association of Farm Managers Rural Appraisers, all professional organizations, who are also regulated. I work with their members and successfully. They are not the ones that are creating the problems.

The laws need to be on the books for those individuals that are not doing what they should do, that are not just coercing appraisers or bankrupting consumers. That is what the law is intended for. That is who the law is necessary for.

And we applaud your success in bringing the legislation this far and will do whatever we can to encourage it to be passed.

Senator CASEY. Thank you. Mr. Henderson?

Mr. HENDERSON. Thank you, Senator Casey.

Look, the mortgage lending system is deeply flawed and we now have a crisis in subprime home mortgage foreclosures. The crisis is having a disproportionate impact on African American families, Latino families, low income families. And that disproportionate impact is not explained away by factors that would ordinarily justify such a problem.

Voluntary compliance is necessary but it is insufficient to address the magnitude of the problem, which we have outlined today. And I think your bill, S. 1299, is a modest intervention in the regulatory marketplace but a necessary step that would help protect borrowers from being compromised in the way that we have heard described today.

So we think that all of these steps are necessary and we think that they should be done as soon as possible. Thank you.

Senator CASEY. Thank you. Mr. Robbins?

Mr. ROBBINS. We support a lot of what 1299 has. We think prepayment penalties, used correctly, are very important. If they get the full value, consumers get a lower rate when they sign up. And they are used on fixed rate loans, as well as adjustable.

S&E liability is an important issue. 60 percent of the home loans in this country are put in mortgage-backed securities and sold around the world. You cannot hold an investor 10,000 miles away

responsible for the origination of the loan. If you do, they are just going to go to another asset, they are going to buy that, and they are not going to buy mortgage-backed securities, which will have a huge disaster and credit crunch the likes that we have never seen if you change that.

The forbearance is something that the market has the ability to do now. The market has the ability to handle these foreclosures. There is no resource constraint in the market to deal with this. If you go into a blanket foreclosure you will exacerbate significantly the number of foreclosures in this country. It will hurt people and not help them, because the clock continues to run on that. It would be a terrible, terrible idea.

And the market has adjusted substantially relative to where it was. And that, along with a uniform national standard adopted, will help significantly in the issues that we have seen and correct the predatory lending that we have seen in the country.

Thank you.

Senator CASEY. Ms. Leonard.

Ms. LEONARD. Thank you. We, too, agree with many of the features of the legislation. But what we would like to see, as well, is national registry so that there is not a safe haven, that there has to be a tracking for all of these bad actors that disallows them to move around from point A to point B and not be tracked. We hope that everyone in this industry would agree to that.

We believe in increased professional standards with criminal background checks for everyone. So that again there is a way to get out of this industry the very individuals who have harmed people along the way.

Senator CASEY. Thank you. Mr. Yezer.

Mr. YEZER. No one disagrees that this legislation would have benefits. The question is costs. I could save 45,000 American lives a year, easily. Just require people to drive in golf carts. That is 45,000 lives per year saved. That is a lot.

I am not sure that passes a benefit/cost test, though. I think you need some—I have heard a lot of ridiculous numbers and assertions here, quite frankly. I think you really need to go to the bank regulators, get professional economists to help you out with all this.

Man, the lenders are already running away from this market. In response to this, and the threat of litigation, if they run faster, you may engineer the recession of 2008. You could make the textbooks.

Senator CASEY. I am resisting the temptation to respond, but we will wrap up. Mr. Berenbaum.

Mr. BERENBAUM. Thank you very much. The membership of NCRC fully support 1299. We would like to see some additional language affording servicing protections.

We also want to commend Senator Reed for some of his efforts in his bill, and particularly the data base to monitor foreclosure trends. Selected foreclosure in low to moderate income communities is a great concern to us. Often we found in the 1980's that low to moderate income communities faced foreclosure more quickly, even though they were qualified for forbearance agreements. So the Reed idea is a very good one.

And last, I do think we need to address the issue of the securitizers. Freddie Mac has done the correct thing in stepping up

and offering new standards for subprime and 228s. Others have not followed. As well, there are tax implications on the tranches and pools. If we want to keep Americans in their homes, we need to relax those standards so that we can keep those Americans there for the securitized portfolios.

Senator CASEY. Thank you. This hearing is adjourned.

[Whereupon, at 5:11 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHARLES SCHUMER

I want to welcome everyone to this critical hearing on "Ending Mortgage Abuse: Safeguarding Homebuyers" and thank the witnesses who are appearing before the Subcommittee today. Many of the member of this Committee, including myself, know first hand about the rising home foreclosures that are devastating communities in our home states. The big question is why? Is it really "the economy, stupid"? Is it as simple as lack of borrower education? Is it a sharp rise in family financial emergencies? Or is it downright bad lending practices?

I hope we will get to the heart of this question today, so that we can figure out how best to solve it.

There are a lot of different interests represented in this room today to ensure we get all perspectives.

But at least we can begin by all agreeing that sustainable home ownership is the key to having a strong financial future in this country. Buying a home is the largest purchase most families will ever make and it is the path to wealth and asset accumulation for families and their future generations. It is also critical to building flourishing communities in which homeowners and small businesses are willing to invest in their local economies, create new jobs, and contribute to the country's economic growth.

Yet, our mutual respect for this basic principal has not been enough to prevent a widespread effort to exploit the most vulnerable segments of our population by tricking them into signing on to loans they can ill-afford—making it virtually impossible for many to truly achieve the American Dream.

African-Americans, Hispanics, single mothers, and the elderly are targeted everyday in predatory lending schemes and deceptive loan practices—enticed into mortgages with low "teaser" rates that will only reset to future payments that the borrowers cannot mathematically afford. For example, a study by HUD and the U.S. Treasury found that sub-prime loans were issued 5 times more frequently to black neighborhood households as they were to white neighborhood households. And 39 percent of homeowners living in upper-income black neighborhoods have sub-prime refinancing—twice the rate of homeowners living in *lower-income white* neighborhoods.

This sub-prime storm has left virtually no corner of this country untouched. You can't go a day without reading or hearing about the families in New York, in Ohio, in Pennsylvania that are stuck in risky loans that they can't afford, and desperate for a way out that allows them to preserve their home. The problem is bad and getting worse. This map shows the areas of the country with the greatest increases in reported foreclosures over the past two years.

[Point to the national heat map]

Depressed economic regions, like parts of the Midwest that have experienced significant job losses in recent years, have also been prime targets for deceptive lending practices. And even in growing states like Colorado and Georgia, unsuitable loans abound. According to RealtyTrac, nearly 3,000 foreclosure actions were reported in my colleague and former Chairman of this Subcommittee Wayne Allard's state of Colorado last month alone.

Before our eyes whole communities are being set up to fail when we should be arming them with tools to succeed. The risk of a foreclosure boom in these communities is real. In a widely publicized report, the Center for Responsible Lending estimated that 2.2 million sub-prime loans made in recent years have already failed or will end in foreclosure, costing homeowners as much as $164 billion, primarily in lost home equity.

It is bad enough that these families that have to foreclose will lose their main source of financial stability, not to mention their credit-worthiness, but if these foreclosures are concentrated in a few communities, the effects would be devastating. Studies have shown that even one foreclosure could lower the value of nearby homes by almost 1.5%. That is about $3,000 in lost home value per neighbor, or $150,000 of lost neighborhood value for just one foreclosure. It two million homes foreclose nationwide, our communities would lose $300 billion in neighborhood wealth and $6 billion in local taxes that go to fund schools, roads, etc.

So . . . the question is why is this happening? There is a lot of blame going around, but I think the fundamental reason is very simple.

The catalyst behind this impending avalanche of foreclosures are risky subprime mortgage loans that thousands of middle and lower income Americans were tricked into borrowing, even though the loans themselves are designed to fail them.

The so-called "liar loans" are often wrapped in complex rate terms, high fees, and shocking rate increases that in the near-term leave the borrower unable to afford rising mortgage payments.

I ask all of you panelists why have these loans not been underwritten at the fully indexed rate?

Many in the industry participants argue that that these loans themselves are not to blame—it's not the product, they say, it's the economy . . . and that is why we are seeing record delinquencies and foreclosures.

But one look at this payment chart for the most popular subprime loan in recent years—a "2/28 Adjustable Rate Mortgage"—and the answer is clear. These loans are traps.

In this example, the borrower starts off paying $1300 a month, which is 44% of his monthly paycheck of $3,000. And because subprime borrowers don't have to escrow—this payment doesn't even include the estimated $200 monthly payment for taxes and insurance.

After just 30 months, the initial teaser fixed rate expires, and the borrower's monthly payment jumps over $400.

Then, at 36 months, it resets again, to nearly 50% higher than her initial monthly payment. In 42 months, assuming the underlying interest rate rises 1.5 percentage points, the borrower is paying $2200 a month—or 72% of their income—to service this mortgage.

In order to prevent payment shocks and stave off foreclosure, this borrower needs to get a 63% pay raise before his mortgage starts resetting—or win the lottery. And the worst part about it, is that the broker knows this from DAY ONE.

They know full well that the likelihood of the homeowner defaulting on their loan is high, but they don't care because they've already made their money.

I know a man from my hometown by the name of Frank Ruggiero, who was talked into signing on to such a loan. Unfortunately due to his weekly dialysis treatments he could not be here today to share his story first hand.

In Mr. Ruggiero's case, he was recently tricked by an aggressive broker who told him to refinance his mortgage of $368,000 with a new mortgage of $416,000. Of the $48,000 additional debt on Mr. Ruggiero's home, he received only $5,728, and the balance went to closing costs. Out of this deal, the broker alone received $9,300 from the proceeds and received an additional fee of $11,900 from the lender as "yield spread premium" because he duped Mr. Ruggiero with such a profitable loan.

Mr. Ruggiero is one of millions of borrowers that are getting duped into loans that are designed to fail the borrower and benefit the broker.

The economy is not the problem here. It's the product, stupid. No one should be tricked into signing onto a loan that is purposely designed to fail them. The very existence of these loans is not a sign of the market working. The fact that these loans are underwritten almost exclusively to borrowers that can't afford them is a market failure. By some estimates, 80% of subprime loans are these "exploding" ARMS.

And what I want to examine today is why this product even came to be, and in such volume. Why are nearly three-quarters of subprime loans being originated by independent brokers or non-bank affiliates with no federal supervision, or finance companies with only indirect federal supervision?

[Point to pie graph of large share of independent brokers in subprime market]

And why are these bad loans being sold primarily to families that already own home? According to the chief national bank examiner for the Office of Comptroller of the Currency, only 11 percent of subprime loans went to first-time buyers last year. The vast majority were refinancings that caused borrowers to owe more on their homes under the guise that they were saving money.

The bottom line is that it should be illegal for lenders to qualify a borrower for a loan for anything less than its fully indexed rate. The industry must determine a borrower's ability to pay.

Subprime borrowers should also be required to escrow for taxes and insurance, like virtually all prime loan borrowers. Including the taxes and insurance would make it impossible for most to get approved for these high rate mortgages, thus the reason the industry excludes them. Lack of escrows will only result in borrowers returning to lenders in serious trouble or default when tax and insurance payments are due.

We must put an end to these practices and now.

I have heard one horror story after another where brokers go into communities, attend church services and not only offer to provide the loan, not only guarantee loans, but also offer to find the realtor and the appraiser. There is an unregulated world that is on the loose without adequate supervision—and we need to change that.

One of the things I have focused on—with my colleagues Senators Brown and Casey—is creating a national regulatory structure for mortgage brokers and other

originators in addition to pushing the regulators to conduct more oversight using HOEPA and other relevant laws.

In April, we introduced a strong bill, S.1299, to offer a fix to make it harder for irresponsible brokers and nonbank lenders to sell mortgages that are designed to fail the homeowner and result in foreclosure.

My goal is to strengthen standards for subprime mortgages by regulating mortgage brokers and all originators under the Truth in Lending Act (TILA) by establishing on behalf of consumers a fiduciary duty and other standards of care. In addition, the bill outlines standards for brokers and originators to assess a borrower's ability to repay a mortgage, requires taxes and insurance to be escrowed on all subprime loans and holds lenders accountable for brokers and appraisers.

The bill will also focus on appraisers a group that has been talked about less. The bill would protect appraisers who have often been pressured into becoming the silent partners in many predatory lending scams, providing inflated appraisals at the originators' behest.

It is clear that the subprime mortgage market has been the Wild West of the mortgage industry for far too long. We need a sheriff in town. Thank you, I look forward to hearing your testimonies.

PREPARED STATEMENT OF SENATOR ROBERT MENENDEZ

Thank you, Mr. Chairman. I would like to begin by thanking Chairman Schumer and Ranking Member Crapo for holding this important hearing today on safeguarding homebuyers. Chairman Schumer, your leadership on this issue has been commendable and I look forward to continuing to work with you to address this current subprime situation.

I want to start by saying that I am disappointed to see that we are back here again and that not much has changed—*there is still a tsunami of foreclosures across the country and I am afraid another storm is about to hit as adjustable mortgage rates reset.* We cannot excuse or ignore this problem any longer—each participant in the life of a loan needs to step up to the plate and take real responsibility and action. *I am tired of hearing that the market will take care of it and tired of the finger pointing.* Every broker, lender, realtor, appraiser, credit rating agency, investing firm and regulator needs to make changes *if we have any hope of quieting this storm.*

We need to address the use of adjustable rate mortgages and seriously weigh the benefit against the cost—with over 7 percent of subprime loans with an adjustable rate mortgage in foreclosure in NJ—I think the cost is simply too great. I support Senator Schumer on this and believe we must underwrite these loans to the fully indexed rate.

We need to address the blatant racial and ethnic bias in subprime lending. Why is it that nearly 55% of African American home buyers and 46% of Hispanic home buyers receive high-cost loans—compared to 17% of non-Hispanic whites? We need to find a way to address this disparity. For the Hispanic community in particular, the majority of household wealth comes from ownership equity alone so a predatory loan can *turn the American dream of owning a home into an absolute nightmare.*

We also need to increase access to financial literacy programs and counseling services so that prospective homebuyers can make informed decisions. I say to every homebuyer: *know your mortgage.*

We need to work on creating a national standard, that does not preempt strong state laws, so that we can define and penalize predatory lenders.

And beyond the issue of predatory lending, we need to examine the effect of raising the FHA loan limit as I suspect it will create more alternatives for subprime borrowers.

We cannot sit by any longer while unsuspecting Americans watch their dream of homeownership turn into a nightmare of financial ruin.

I look forward to hearing from our witnesses and I stand ready to work with all interested parties on this important matter.

Thank you.

Testimony of the

National Community Reinvestment Coalition
David Berenbaum, Executive Vice President

Before the Senate Committee on Banking, Sub-Committee on Housing, Transportation and Community Development

Ending Mortgage Abuse: Safeguarding Homebuyers

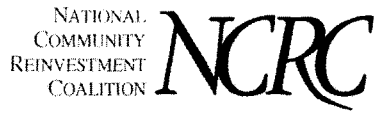
Tuesday, June 26, 2007

Introduction and Executive Summary

Chairman Schumer and Ranking Member Crapo, it is an honor to be here today as the voice for over 600 community organizations from across the country that comprises the National Community Reinvestment Coalition (NCRC). NCRC is the nation's economic justice trade association dedicated to increasing access to credit and capital for minority and working class families. NCRC and our member organizations have been at the forefront in the war against predatory lending. I testify this morning on behalf of NCRC and John Taylor, President and CEO of NCRC.

NCRC has advocated before Congress and the regulatory agencies over two decades for stronger CRA, fair lending, and anti-predatory lending laws. NCRC enforces the nation's fair lending laws as a private attorney general through complaints and lawsuits combating discrimination and redlining. NCRC has filed and settled precedent-setting cases against lenders and brokers in cases involving steering and refusal to lend to rowhomes, Indian reservations, and to other protected classes. We also operate nationally renowned programs including the Consumer Rescue Fund, a foreclosure prevention program, and the Center for Responsible Appraisals and Valuations, which features an alternative dispute mechanism for allegations of fraudulent appraisals.

We are on the precipice of a mortgage tsunami of foreclosures unless immediate intervention occurs. The industry has flooded the market with exotic mortgage lending such payment-only Adjustable Rate Mortgages (ARMs), and "hybrid" 2/28 and 3/27



ARMs. These exotic subprime mortgages overwhelm borrowers when interest rates shoot up after an introductory time period. According to the FDIC's testimony at a previous Senate hearing, interest rates are due to rise for borrowers of one million subprime loans in 2007 and another 800,000 next year.[1] As a result of the abusive lending, the nation is experiencing record foreclosure rates and more than 14% in outstanding subprime loans were delinquent by the end of 2006.[2]

Market failure is rampant and all stakeholders, industry and government alike, are collectively responsible for this failure. The lending industry has created a system in which no one is accountable when the tsunami hits borrowers. Brokers and lenders quickly sell loans into the secondary market. The secondary market has precisely diversified risk to the point where no one investor loses significant amounts, even when foreclosures spike. Too many servicers, appraisers, and foreclosure legal specialists have also figured out how to profit from abuses in the dangerous game of mortgage monopoly.

The federal government holds ultimate responsibility for allowing the mortgage market to spin out of control. The government's traditional role in a market economy is to establish rules that ensure fairness and basic protections for consumers. In the case of the lending industry, the government needs to establish requirements for financial institutions to deal fairly with consumers or face stiff financial penalties for failing to do so. Currently,

[1] "Regulators are Pressed to Take Tougher Stand on Mortgages," by Gregg Hitt and James R. Hagerty, Wall Street Journal, March 23, 2007

[2] "Subprime Defaults at Recession Level, FBR Says," Bloomberg News reproduced in the American Banker, February 5, 2007; "Regulators are Pressed to Take Tougher Stand on Mortgages," by Gregg Hitt and James R. Hagerty, Wall Street Journal, March 23, 2007.

financial institutions escape with minimal financial penalty for abusive lending practices which inflict massive financial pain and ruin for families and communities.

In this testimony, NCRC will describe in detail how unscrupulous brokers, appraisers, and financial institutions profit at the expense of families and communities. We will explain how S.1299, the Borrowers' Protection Act of 2007, will effectively address the systematic abuses committed by financial institutions at various stages in the lending process.

In addition to the provisions in S. 1299, NCRC's testimony will describe the need for additional protections such as requirements imposed upon servicers to engage in good faith dealings with borrowers. Recently, we have become focused on the issues of law firms that act as foreclosure mills, profiting from consumer hardship and rushing consumers to homelessness, even as we try to negotiate forbearance agreements for consumers who can afford to stay in their homes. This greed in the legal system as attorneys represent investors or servicers is one of the reasons that we support stronger servicing protections.

Brokers – The Point of Entry to the American Dream or Financial Ruin

Mortgage brokers are the point of entry for most families seeking to buy a home or refinance a mortgage. Brokers facilitate up to 70% of loans made in this country, and many honest brokers serve an important role in the marketplace. Unscrupulous and abusive brokers, however, set up borrowers for failure the moment they submit

applications and sign loan documents. Unfortunately, NCRC has documented through a nationwide testing project that too many brokers engage in steering and discriminatory practices.

From 2004 to 2006, NCRC conducted mystery shopping of mortgage brokers, both large and small. Posing as loan seekers, both White testers (the control group or Comparison group) and Black or Hispanic testers (the protected group) met with and called local brokers to inquire about their loan options. NCRC's fair lending testing of mortgage brokers recently uncovered a 46% rate of disparate treatment based on race and national origin.

Both groups of testers presented themselves as having plenty of equity, stable income and good credit. The protected-class testers were actually given more attractive profiles in terms of their amount of equity, credit standing and employment tenure, and should have logically received better treatment.

However, these Black and Hispanic testers only were favored in a very small minority of the cases. White testers were routinely shown higher levels of service, of encouragement and given more information about loan products. In the most egregious cases, members of the control group were given better pricing, and the tested companies represented their policies differently to the two testers.

NCRC's broker testing yielded 106 total complete, matched-pair tests. Individuals located in the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Houston, Los Angeles and Saint Louis tested brokers that were local, established businesses. In conducting the broker testing, NCRC found several companies with particularly egregious initial results. In these cases, testers were again dispatched for follow up testing to confirm and further investigate the practices of these companies. Of the 106 total tests, 84 separate companies were tested, the difference being as a result of 22 follow up tests.

A portion of the follow up tests were directed at Allied Home Mortgage Capital Corporation, against whom NCRC has filed a fair housing complaint. Additional complaints may also be filed, pending further investigation.

Our results documented the following disturbing patterns:

1. African Americans and Latino's were discouraged 25% of the time concerning their efforts to meet with a broker, while Comparison testers were discouraged only 12% of the time in their efforts to obtain credit.

2. Brokers spent more time with white shoppers then African Americans and Latinos, spending on average 39 minutes with white testers and only 27 minutes with African American and Latino testers.

3. White mortgage seekers received greater encouragement over sixty percent of the time, while African Americans and Latinos were questioned about their credit over 32% of the time. White shoppers were only questioned about credit 13% of the time.

4. White mortgage seekers had specific products discussed with them 91% of the time, while African Americans and Latinos had specific products discussed with them 76% of the time. Further, White testers received two rate quotes for every one quoted to African American and Latino testers.

5. NCRC documented pricing discrimination in 25% of the fair lending tests, and noted that fees were discussed 62% of the time with white testers but only 35% of the time with "protected testers."

6. Fixed rate loans were discussed 77% of the time with white testers but only 50% of the time with African American and Latino testers.

These results are very troubling and document the fact, controlling for credit and individual applicant qualification factors, African Americans and Latinos are being discriminated against in the marketplace and being forced to pay a "race tax" due to unequal access to credit.

Pricing Disparities Cannot Be Explained Away

NCRC's civil rights enforcement suggests that steering and discrimination are not isolated events but widespread throughout the industry. Data analysis of a national database, the Home Mortgage Disclosure Act (HMDA) indicates that predatory lending is a national epidemic.

Price discrimination is not often discussed in the context of predatory lending, but we believe that it is a central element of predatory lending. When a borrower is steered towards a loan with an Annual Percentage Rate (APR) two or three percentage points higher than the loan for which she qualifies, the borrower will pay tens of thousands or hundreds of thousand dollars more in mortgage costs due to the discrimination. This represents a substantial loss of wealth, which could have been used to send a child to college or start a small business. When several residents of a minority or working class neighborhood suffer price discrimination, the neighborhood loses millions of dollars that could have been reinvested in neighborhood businesses and other institutions to build wealth.

In 2003, NCRC released a path-breaking study, entitled the *Broken Credit System*, documenting price discrimination on a national level.[3] We found that after controlling for creditworthiness and housing characteristics, the amount of subprime refinance loans increased as the number of minorities and elderly increased in neighborhoods in ten large

[3] See NCRC's *Broken Credit System* at http://www.ncrc.org/policy/cra/documents/ncrcdiscrimstudy.pdf

metropolitan areas. In addition to the NCRC report, two studies conducted by Federal Reserve economists found that subprime lending increases in minority neighborhoods after controlling for creditworthiness and housing market conditions.[4] The Center for Responsible Lending also recently used HMDA data with pricing information to reach the same troubling conclusions that racial disparities remain after controlling for creditworthiness.[5]

NCRC has conducted several studies documenting the persistence and stubbornness of pricing disparities. For example, our *Homeownership and Wealth Impeded* report uncovers troubling evidence that racial disparities increase when income levels increase.[6] For example, subprime loans made up a high 41.9 percent of all refinance loans to low- and moderate-income (LMI) African-Americans. In contrast, subprime loans were 19.2 percent of refinance loans to LMI whites in 2004. LMI African-Americans were 2.2 times more likely than LMI whites to receive subprime loans. Even for middle- and upper-income (MUI) African-Americans, subprime loans made up a large percentage (30.2 percent) of all refinance loans. Moreover, the subprime share of loans to MUI African-Americans was 2.7 times larger than the subprime share of loans to MUI whites. The same pattern of disparities increasing with income occurred when the report

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[4] Paul S. Calem, Kevin Gillen, and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, October 30, 2002. See also Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter, *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, in Fannie Mae Foundation's Housing Policy Debate, Volume 15, Issue 3, 2004 pp. 603-622.

[5] Center for Responsible Lending, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, see http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010

[6] To access NCRC's report, *Homeownership and Wealth Building Impeded*, please go to http://www.ncrc.org/policy/analysis/policy/2006/2006-04-20_NCRC-OA-PRRACReport.pdf

examined lending to females compared to males or in immigrant neighborhoods compared to predominantly white neighborhoods.

Federal Reserve economists have found that the incidence of high-cost lending is less when banks issue loans through their branches than when banks originate loans through brokers. The Federal Reserve studies do not conclude that brokers are steering minority borrowers to high-cost loans, but the studies mention steering as a possibility. NCRC's mystery shopping suggests that steering is indeed a real possibility. Also, since more than one study has found that high-cost lending is higher for minorities after controlling for creditworthiness, the evidence to-date suggests that the burden lies on skeptics who dismiss the likelihood of steering. NCRC believes that anti-steering provision of S. 1299 is absolutely necessary to combat the steering committed by abusive brokers and lenders.

Appraisal Fraud

Predatory loans include several features such as steering that increase costs beyond the point at which borrowers can afford their loans. Another factor that drives up loan costs is appraisal fraud. Appraisal fraud is commonplace in the housing market and is the result of collusion among abusive lenders and appraisers.

Originator sanctioned appraisal inflation is the dirty little secret of the lending industry. We welcome this hearing and commend you Chairman Schumer, for looking into a

problem that nobody likes to talk about but, in many ways, has triggered the subprime time bomb.

Why is it that brokers are allowed to self select valuation professionals?

Why is it that is lenders are forced to rely on AVM's – which are highly inaccurate themselves – due to widespread mortgage fraud in the marketplace?

Why is it that, despite the protections of FIRREA and the requirements of USPAP, appraisal companies are beginning to sanction the "unlocking" of appraisal reports performed by valuation professionals and changing their content – a clear violation of the law?

Their response, when licensed appraisers began to question the legality and impact of this activity – is to threaten or hit the whistle blowers with slap suits. Just ask Pamela Crowley, a Florida appraiser and a signatory member of NCRC's Center for Responsible Appraisal & valuations who created www.mortgagefraudwatchlist.com to expose lender pressure and valuation fraud, She is being wrongfully sued by an appraisal management company for having the integrity to expose this issue. Senator Schumer, your focus on valuation issues is right on point.

When the bottom falls out, borrowers are left in upside down mortgages where they owe more than the home is worth. Many subprime and prime borrowers are finding themselves in just this situation. We must work to stop lenders, mortgage brokers, real estate agents and title companies from pressuring appraisers to inflate home prices.

NCRC has issued a number of white papers on appraisal pressure, broker discrimination, and lending disparities, including the 2005 paper, entitled *Predatory Appraisals: Stealing the American Dream*, which shed sunshine upon a number of appraisal tactics that regulators – including NYS Attorney General Andrew Cuomo - are now investigating. NCRC concluded that appraisal inflation and the breakdown of the appraisal system posed a serious impediment to responsible lending, while placing the safety and soundness of the mortgage marketplace at risk.

NCRC's CRF program is intervening in a significant number of cases where borrowers have been victimized by appraisal fraud. A sample of CRF loans revealed that about one fifth of the homes were overvalued by more than 50% of their true value, and two thirds of the homes were overvalued by 15-50% more than their true value.[7] Inflating appraisals leave borrowers with unaffordable loans that they are unable to refinance because the loan amounts are higher than the true value of their homes, especially as the housing market cools in the next few years. The results are too often theft of homeowner wealth, equity stripping, and/or foreclosure.

NCRC's CRF program and other research reveal that in order to get an inflated valuation, lenders and brokers use a number of tactics. Some apply pressure by withholding their payment, threatening to not do business with the appraiser, or even blacklisting him or her altogether unless the appraiser meets the lender's requested value. They may demand

[7] See NCRC's report, *Predatory Appraisals: Stealing the American Dream*, June 2005, http://www.ncrc.org/responsible-appraisal/pdfs/AppraisalReport.pdf

that appraisers guarantee a predetermined value, ignore deficiencies in the property or simply increase the appraisal if the lender is unsatisfied with it. Lenders also "shop around" (also known as "value shopping") by contracting several appraisers to evaluate one property and then use the highest valuation they find.

Industry surveys suggest that intimidating appraisers is widespread. In 2003, a study conducted by October Research Corporation reported that appraisers were feeling pressure by lenders to mark up property values. Of the 500 appraisers surveyed nationwide, an alarming figure of 55% said they felt pressure to overstate values of the properties they appraised. In addition, 99% of the appraisers interviewed believed that their peers give in to lender demands at some point. A more recent October Research report that was released in 2006 found that the incidence of pressuring appraisers increased to 90%.

The CRF cases and other research of widespread abuses lead NCRC and industry partners to establish a Center for Responsible Appraisals and Valuations.[8] Lenders, appraisers, and other industry partners agree to an ethical code and also agree to submit disputes regarding fraudulent appraisals for arbitration. The alternative dispute resolution of the Center promises to expeditiously settle cases of appraisal fraud and to promote industry-wide changes in practices when a critical mass of industry stakeholders participate in the Center.

[8] See http://www.responsibleappraisal.org/.

While NCRC hopes our Center can influence industry practice, we believe that appraiser abuse is widespread enough that it threatens to destabilize entire communities through inflated appraisals as well as victimizing untold numbers of individuals consumers. Appraiser abuse, as a significant contributor to the looming foreclosure crisis, must be reined in by rigorous protections established by S. 1299.

NCRC's Consumer Rescue Fund

Broker and appraisal fraud are just two of the multiple abuses encountered by NCRC's Consumer Rescue Fund (CRF). Unfortunately, we can testify in the strongest terms today that S. 1299 is urgently needed to eliminate the series of abuses experienced by victims of predatory lending assisted by the CRF.

Through the national CRF program, NCRC works with victims of predatory lending so their mortgage payment becomes more affordable and foreclosure can be avoided. We believe that the work of CRF demonstrates the enormous value of Senator Schumer's proposal to fund foreclosure prevention counseling at $300 million annually. As the Senator suggests funding counseling is extremely cost effective, with counseling costing about $1,000 while a single foreclosure costs families, financial institutions, public agencies and other stakeholders about $80,000.

NCRC's member groups and their communities are an integral part of the CRF program. The CRF identifies consumers who are in predatory mortgages and fixes the mortgages

through mediation with lenders or arranging for refinance loans.[9] Consumers contact NCRC member organizations participating in the CRF program. In a number of instances, the NCRC members in the CRF program are counseling agencies assisting consumers experiencing delinquency and default on their loans. NCRC and our members have found that families in desperate circumstances are most likely to view nonprofit community-based organizations as trusted advisors. While distressed families will hesitate to approach their lender or servicer, they have an intuitive sense that nonprofit organizations exist to lend them a helping hand.

NCRC's CRF program offers mediation services or arranges refinance loans through lending institutions participating in the program. When NCRC mediates with lenders, the lenders will often make the loans more affordable by reducing the interest rate, the margin, and sometimes forgives part of the loan. Refinancing is often employed to deal with an abusive term and condition. For example, an abusive term such as a prepayment penalty that matches or exceeds the reset time period is often dealt with through a refinance.

The CRF program will mediate loans made in any state. Refinancing services are currently available in the following 17 states: Alabama, Arizona, California, Florida,

[9] HSBC North America provides refinance loans for the CRF program and supports CRF counseling. Other sponsors of the CRF program include Select Portfolio Servicing, Inc, the Ford Foundation, Freddie Mac, The Fannie Mae Foundation, Fannie Mae, The JP Morgan Chase Foundation, and The Heron Foundation.

Georgia, Illinois, Indiana, Maryland, Massachusetts, Nevada, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, and Wisconsin.

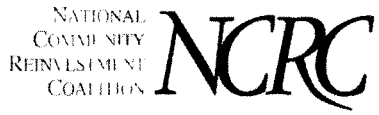
CRF's Success: At Least $500 million in Equity Saved

The CRF program has saved borrowers and their communities millions of dollars. In a sample of 112 cases, the median principal amount of the loans was approximately $157,000. The mortgage rates of the previous predatory loans ranged between 5.5% and 17%. The median prior mortgage rate was 9.38%.

Analysis of loan terms before and after refinance

	Principal Amount	Prior Mortgage Rate	New Mortgage Rate	% points difference	Old Monthly Payment	New Monthly Payment	$ Savings
Average	$156,986.2	9.58%	5.74%	3.84%	$1,198.4	$922.0	$276.5
Median	$161,280.4	9.38%	6.00%	3.38%	$1,165.8	$941.7	$224.1

The interest rates of the refinance loans were considerably lower than the rates of the previous predatory loans. The new loans had interest rates ranging between 1% and 8%. The median rate of the new refinance loans rate was 6.00%. The difference between the median rate of the previous loans (9.38%) and the new loan (6%) was 3.38 percentage points, which results in substantial amount of equity saved over the life of a loan.



CRF customers have been able to save millions of dollars of wealth by refinancing out of abusive loans. The average monthly payment was $1,198 for the abusive loans. For the new refinance loans, the average monthly payment was only $922. As a result of the refinancing, the average monthly savings was $276.50, which equates to $3,318 annually. Assuming a 30 year loan term, the total savings on an average loan would be $100,000. Given that the CRF program has assisted at least 5,000 victims through either refinancing or loan modifications, the program has saved borrowers approximately $500 million in equity.

CRF Finds that Minority and Working Class Americans Targeted with Loans Containing Multiple Abuses

A NCRC review of CRF cases indicate that abusive lenders are targeting minority and low- and moderate-income borrowers and communities with high cost and exotic mortgages.[10] About 77% of the borrowers in the CRF sample were African-American. Almost half (47%) resided in low- and moderate-income neighborhoods and 83.6% of the borrowers had incomes below $45,000. The findings that CRF customers were mostly minority and low- and moderate-income is consistent with NCRC's research and other studies documenting that a disproportionate amount of high cost lending is directed towards minority and working class communities. Traditionally underserved

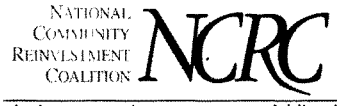
[10] For more detail about the CRF fund, see the report by NCRC and the Woodstock Institute, *Asset Preservation: Trends and Interventions in Asset Stripping Services and Products*, September 2006, at http://www.ncrc.org/policy/analysis/policy/2006/2006-09_LifetimeOfAssets_NCRC-WoodstockPaper.pdf

communities suffer from less product choice and consequently are more susceptible to abusive high cost and exotic mortgage lending.

The CRF cases also reveal that predatory loans do not usually contain just one or two abusive terms and conditions. More often, a toxic loan in the CRF program contains several abusive features including ARM loans with lax underwriting considering only the initial rates, exaggerated borrower incomes, payments that borrowers cannot afford, exorbitant fees and yield spread premiums, piggyback lending adding excessive debt, and abusive servicing.

The 27 specific abuses revealed by the CRF program include the following:

Abuses	**Description**
asset-based lending	Lenders evaluate a loan application by looking only at the quality of the security or equity, and not at the ability of the borrower to repay the loan
forced placed insurance	Servicer assigns hazard insurance to borrower, coverage is usually much more expensive
HOEPA loan	A loan with a very high interest rate and/or fees that is covered by federal consumer protections. Predators violate the legal protections of HOEPA loans.
Mandatory arbitration	Stipulation that a borrower cannot sue a lender in a court of law, but must use an arbiter
prepaid credit insurance	Insurance financed into the loan that would cover mortgage payments in a case of disability, unemployment, death. Much more expensive than paying monthly outside of loan
abuse of right to cancel	Abusive practices that make it hard for a consumer to cancel a mortgage (ie. abusing right of rescission)
abusive collection practices	Aggressive tactics of collecting late payments
default interest rate	Increasing interest rate in case of delinquency
excessive prepayment penalty	Excessive fee for paying off a mortgage before its maturity



insincere co-signers	Adding insincere co-signers to the application in order to inflate the income of the borrowers. Abusive lenders will add children and other insincere co-signers who cannot contribute to loan payments.
loans made in excess of 100% LTV	When the loan amount exceeds the fair market value of the home
negative amortization	Loan product that requires a monthly payment that does not fully amortize a mortgage loan, thereby increasing the loan's principal balance
flipping	Persuading a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced
fraud	Example: Forging signatures on loan documents
lack of TNB	Lack of tangible net benefits that justify the origination of a new, higher-balance and high-cost loan
targeting/discrimination	Cases when lenders specifically market predatory loans to customers based on race, ethnicity, or age
predatory appraisal	Overestimating the market value of the house
balloon payment	A mortgage that has level monthly payments over a stated term but which provides for a large lump-sum payment to be due at the end of an previously specified term
equity stripping	A case when a homeowner's equity is reduced due to repeatedly refinancing, high fees, and other abuses
home improvement scam	Home improvement costs financed into the mortgage usually paid by a lender to a home improvement contractor directly.
misrepresentation	Misrepresentation of loan terms to a borrower
falsified application	Falsifying loan applications (particularly income level or adding insincere co-signers, etc.)
Stated income	Not requiring full documentation of income from tax forms and paystubs. Reduced documentation or stated income loans increase the chances of fraud.
yield spread premium	Fee paid by lenders to brokers for loans carrying interest rates above a par rate
abusive servicing practices	Servicers not recording payments, force placing insurance, applying high late fees, etc.
unfair terms	High interest rates and loan terms not justifiable by risk (consumer's credit score)
fee packing	Charging undisclosed, improper, and high fees

The sum total of the abuses equals loans that are considerably beyond borrower repayment ability. A sample of 69 CRF cases included calculations of the monthly housing payment-to-income ratio (front-end ratio) and the monthly total debt-to-income ratio (back-end ratio). The front-end and back-end ratios of the predatory loans in the

CRF sample were considerably higher than common limits in standard underwriting guidelines. The median front-end ratio was 35.4%. The median back-end ratio was about 50% as shown in the graph below. Standard front-end and back-end ratios for prime loans are 28% and 36%, respectively. The considerably higher ratios of the predatory loans in the CRF sample suggest that the loans were beyond the consumers' abilities to repay, leading to financial distress and/or bankruptcy and foreclosure.

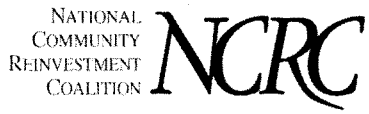
CRF Cases **Unaffordable Loans**

Debt-to-income Ratios

	Front-end Ratio	Back-end Ratio
Average	40.77%	50.28%
Median	35.43%	49.78%

Compounding the high front- and back-end ratios was the fact that most of the loans in the CRF sample did not have escrows covering property tax payments and hazard insurance. Two thirds of the borrowers in the CRF sample did not have escrow accounts. On top of housing payments and debt levels that were unsustainable, a number of the CRF borrowers experienced payment shock when they discovered that they had thousands of additional dollars in taxes and hazard insurance payments that were not covered by the loans.

The case studies in the appendix illustrate the multiple abuses on the CRF loans, and how predatory lenders and brokers take advantage of hard-working Americans who are striving mightily to achieve or preserve their American Dream of homeownership. The



case studies reveal that aggressive "push-marketing" by predators result in consumers receiving loans that are unaffordable and unsuitable, when tragically an appropriate product would have worked fine.

Recommendations

NCRC believes that the Borrower's Protection Act of 2007 is an excellent start in eradicating several of the core elements of predatory lending. We call on Senate Banking Committee to mark-up the bill quickly and we call on the U.S. Congress to pass S. 1299. Distressingly, the abuses associated with predatory lending include a number of abusive practices beyond those addressed in S. 1299. NCRC therefore urges Congress to pass a comprehensive anti-predatory lending bill, building on the foundation of S. 1299 and the strongest state laws.

Opponents and skeptics of anti-predatory laws will assert that more laws and regulations will reduce access to credit for working class and minority borrowers. But when market failure is rampant, government must step in to fix the broken marketplace. In economic jargon, the actors in a broken market do not internalize the negative externalities of their actions. In other words, the actors in the lending marketplace do not face financial penalties commensurate to the harms of predatory lending. The rapid adoption of dangerous exotic and subprime ARM loans as mainstream products indicates that the market has too few self-correcting mechanisms to curb dangerous products and practices. Strong law and regulation that effectively stop abusive practices do not reduce

responsible lending. Instead well-crafted law puts the abusive lenders out of business, benefiting responsible lenders and families alike.

The following elements of S. 1299 are essential:

Fiduciary Duty of Brokers – One essential problem in today's market is that brokers quickly release themselves of any responsibility for abusive loans after their sales and processing of borrowers' applications. Imposing a fiduciary duty on brokers will provide a powerful financial incentive to refrain from deceptive and exploitative practices.

Fair Dealing – A straightforward and powerful method for significantly reducing deceptive practices is to impose an obligation on brokers and lenders to act with reasonable diligence and to engage consumers in good faith and fair dealing. This is also an elastic concept that can effectively curb future abuses not contemplated by anti-predatory bills. While bills can and should curb specific abuses in today's marketplace, a bill cannot anticipate all deceptive practices in the future. A fair dealing requirement will deter the market from constantly changing abusive practices to escape the reach of specific statutory provisions.

Assessment of Ability to Repay – S. 1299 is absolutely correct to require underwriting based on payments for principal, interest, taxes and insurance. All too often, predatory lenders do not underwrite loans considering all of these payments. In addition, lenders

should underwrite based on the maximum possible payment during the first seven years of the loan. Abusive lenders will underwrite at the initial low rate on ARM loans, setting up borrowers for payment shock and financial distress when the loan's interest rate adjusts upwards. Finally, low- and no-documentation loans are dangerous as indicated by NCRC's CRF program and the Comptroller of the Currency in a recent speech. NCRC's supports S. 1299 requirements to use widely accepted income verification documents including pay stubs and bank statements.

Escrow Requirement for High-Cost Mortgages – NCRC documents that most of the high-cost loans in the CRF program lack escrows. Borrowers in high-cost loans often experience financial stress because they did not anticipate tax and insurance payments. The most ironclad assurance that borrowers of high-cost loans can afford tax and insurance payments is to require that lenders establish escrows for high-cost loans.

Lender Liability for Broker Misdeeds – Currently, victims of predatory lending get caught in a game in which the lender and the broker will point fingers at each and do not assume responsibility for abuses. S. 1299 appropriately imposes responsibilities on brokers. It also appropriately imposes liability on lenders who do properly oversee brokers and allow the brokers with which they do business to commit exploitative practices.

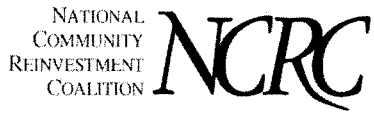
Steering Prohibited – NCRC's mystery shopping of brokers, NCRC's data analysis, and a wide body of other research suggests that steering is prevalent. The result is the loss of

substantial amounts of equity in minority and working class communities. We applaud S. 1299 emphasis on prohibiting steering. It is also important to prohibit lenders from miss-representing the credit history of the borrower or the appraised value of the property as S. 1299 does.

Protections for the Appraisal Process – Fraudulent appraisals is a fundamental problem that contributes significantly to unaffordable loans. S. 1299 rightly imposes a good faith and fair dealing requirement on appraisers and also prohibits lenders from pressuring appraisers and communicating any desired estimated value to appraisers.

Additional provisions for a comprehensive anti-predatory bill include but are not limited to:

Prepayment Penalties – One of the first NCRC CRF cases involved a prepayment penalty that almost prevented a pre-foreclosure sale. In this case, not only was the original homeowner victimized, but all the usual stakeholders in a housing transaction (the buyer and real estate agent) also suffered harm. This example illustrates the damage that onerous prepayment penalties pose to the functioning of the housing market in minority and low- and moderate-income neighborhoods. Previous bills would prohibit prepayment penalties on all loans after 3 years, but many if not most subprime loans have prepayment penalties occurring in the time period between two and three years. Congress must consider stringent limits to prepayment penalties between two and three years.



Financing Points and Fees – NCRC's CRF program reinforces the need to prohibit or limit financing points and fees so that loans do not become unaffordable. NCRC supports a prohibition on the financing of points and fees into high cost mortgages. At the very least, the predatory lending bills in previous sessions prohibited the financing of points and fees beyond 3 percent of the loan amount.

Single Premium Credit Insurance – NCRC believes that single premium credit insurance (SPCI) must be prohibited on all loans. At the very least, anti-predatory bills must ban the financing of single premium credit insurance (SPCI) and debt cancellation or suspension agreements on high cost loans and include SPCI in the definition of points and fees. These SPCI provisions should be straightforward because major subprime lenders have themselves discontinued single premium insurance products. Prohibiting these products on all loans would best protect consumers and insure that an industry best practice remains intact.

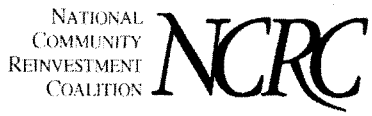
Flipping – An anti-predatory lending bill must establish a rigorous net tangible benefit standard and must avoid a series of safe harbors or exemptions that have the potential for enabling abusive refinancings. Under some previous anti-predatory lending bills, the NCRC CRF case example in California could be construed to be permissible. In this case, the refinance loan offered a tangible benefit of cash for various needs, but was clearly not a tangible net benefit to the borrower, considering that the high fees rendered

the loan beyond the borrower's repayment ability. Any flipping language in a federal bill must be air tight and supported by a strong definition of a high cost loan.

Pre-Loan Counseling – NCRC supports pre-loan counseling modeled after the successful counseling requirement in the North Carolina anti-predatory lending law. In that state, a consumer is required to receive counseling by a counseling agency approved by public housing departments before a lender can issue a high cost loan to a borrower. The added risks associated with a high-cost loan necessitates counseling so that a borrower can understand and prepare for a high-cost loan. Extra disclosures by themselves have proven to be inadequate in informing and protecting borrowers.

Mandatory Arbitration – An anti-predatory lending bill must prohibit mandatory arbitration. Major subprime lenders have given up on mandatory arbitration, meaning that a ban on mandatory arbitration should not be a contentious item in an anti-predatory bill.

Limits on Liability for Secondary Market - Currently, under federal law, a financial institution that purchases a high cost loan from a lender or broker is liable for all claims and defenses arising from violations of law. Applying liability for purchasers of loans is critical because a significant amount of abusive lending has been enabled by the secondary market. Borrowers often have no recourse if the purchasers of loans have no liability.



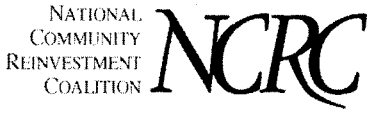
Reporting to Credit Bureaus – Previous bills required lenders making high cost mortgages to report monthly borrower payment history to credit bureaus. This is a vital protection. Several years ago, former Comptroller of the Currency, John Hawke, raised alarms concerning lenders holding customers captive by not reporting their credit history. Comptroller Hawke pointed out correctly that consumers would have no way of proving their creditworthiness for lower cost loans if the credit bureaus did not have current information of their payment history due to lenders' withholding payment information. A requirement to report to credit bureaus will protect homeowner wealth by enabling borrowers to lower their interest payments and thus build up their equity faster.

Mortgage Servicers - An anti-predatory bill must apply protections against abuse by servicers of mortgages including force placement of insurance and failure to correct errors relating to payments. Servicers must also be required to work in good faith with borrowers and nonprofit agencies representing borrowers to thoroughly and reasonably consider alternatives to foreclosure.

Foreclosure Prevention and CRA Modernization

National Foreclosure Prevention

NCRC urges policy-makers to adopt a foreclosure prevention bill that provides funding for foreclosure prevention counseling. Senator Schumer has proposed that Congress appropriate $300 million to provide funding through the Department of Housing and



Urban Development (HUD) to nonprofit counseling agencies to engage in foreclosure prevention counseling. Senators Schumer, Brown of Ohio, and Casey of Pennsylvania have also asked major financial industry trade associations to generate a $2 private sector match for every $1 appropriated by the federal government to fund foreclosure prevention efforts like NCRC's CRF program. Based on a report issued in the spring of 2007 by the Joint Economic Committee of the U.S. Congress, the Senators estimate that their public and private sector funding would assist between 300,000 to 900,000 families in danger of foreclosure.[11] Considering that about 2 million families confront ARM high-cost mortgages whose interest rates will increase this year and next, the Senators' approach is cost-effective and promises to prevent financial and emotional stress inflicted upon families losing their homes.

Senator Reed has introduced a similar bill, S. 1386 - the Homeownership Protection and Enforcement (HOPE) Act, that would provide $610 million for non-profit counseling agencies and state agencies to provide forbearance and loan modification services to distressed borrowers. Servicers are required to make reasonable loan mitigation efforts before foreclosing on loans. In addition, Senator Reed's bill would create a database on foreclosures and delinquencies that would be linked with HMDA. This valuable data would help policymakers understand which loan terms and conditions (such as loan-to-value ratios and fixed or ARM) are more likely to be associated with delinquencies and foreclosures.

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[11] Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, April 11, 2007, http://jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf.

CRA Modernization Must Accompany an Anti-Predatory Bill - At the same time that Congress is enacting an anti-predatory bill, NCRC also believes that Congress must pass the CRA Modernization Act of 2007, or HR 1289. HR 1289 would strengthen CRA as applied to banks and would apply CRA to non-bank institutions including independent mortgage companies. Federal Reserve research has demonstrated that CRA encourages banks to increase their prime lending, particularly in geographical areas in which their branches are located. CRA, therefore, acts to introduce product choice in traditionally underserved neighborhoods, meaning that these neighborhoods are less susceptible to steering and abusive lending.[12]

[12] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data* in the Federal Reserve Bulletin, September 2006.

Testimony Appendix

CRF Case Studies

Case Study 1 – Miami, Florida: Steering into Over-Priced and Unsuitable Loan, Fasifying income, Stated-Income and Exotic Mortgage Loan

In January of 2006, Ms. Jean-Simon of Miami, Florida was seeking to become a first-time homeowner. She had a good credit score of 747, and she had a modest income of $3,200 per month. She was a hard-worker, holding a full-time job at the University of Florida and two part-time vendor jobs at local sports stadiums. Incredulously, her mortgage broker pressured her to not use a first-time buyer program through Miami Dade County or other government programs. She was told these programs "take too long" and "require too much paperwork"

The broker falsified Ms. Jean-Simon's income to $5,000 per month. In other words, her income was exaggerated by 56%. The total loan amount was for $170,000 and was financed at 100%. Her first loan was an option ARM (four payment options, with the lowest being "negative amortization"). The maximum rate on the option ARM was 9.95%. To make matters worse, she had a piggyback loan, which was a line of credit with a maximum rate of 11.75%. Because her income was falsified, she could only afford the minimum payment. Therefore, she was increasing her principal balance through negative amortization.

Case Study 2 – Trevose, Pennsylvania: High Broker Fees, Steering, 2/28 ARM, Abusive Servicing

Sixty-nine year old Gladys Christian refinanced her home twice in her 31 years of homeownership. She used her cash equity from both transactions to pay for a car and to make home improvements. The second refinance, however, presented Ms. Christian with more problems than benefits. Ms. Christian's loan settled at the cost of over $10,000 in broker and third party fees, and also generated high monthly payments. Despite Ms. Christian's good credit history, she was qualified for an 8.9% two-year fixed, twenty-eight year adjustable rate mortgage that could climb as high as 15.90%.

Even though Ms. Christian was retired, she used her 33 years of experience in nursing to continue provide nursing services for the elderly. She used this income along with her pension and Social Security payments to keep up with her payments in order to avoid serious delinquencies on her loan. She only called Legal Aid of Southeast Pennsylvania for assistance when she became ill, missed a payment, and struggled to manage this delinquency with her lender's servicer. Rather than work out a forbearance plan, her lender and servicer initiated foreclosure proceedings.

Case Study 3 – Belgium, Wisconsin: Falsified Income, Hybrid ARM, Piggyback Loan, Risk Layering

In September 2006, Duane and April West, a vibrant young African-American couple, contacted NCRC because they could no longer afford their mortgage payments. Although the West's both worked full time jobs (Duane works for Enterprise Rent-a-Car, and April works as a loan closer for a title company), they knew that they were one or two months away from missing their mortgage payments and sinking into foreclosure.

Upon reviewing the West's loan documents, CRF staff noticed the loan had layers of financial risk. First, the West's loan relied on a combined household income that was falsified by 66%. Second, the Wests hoped their refinance loan would pay off their car note, but the loan only increased their indebtedness, left them with an unpaid car note, and not enough funds to pay off any other debt. Third, the two refinance loans were usurious and predatory. The first loan was a two-year fixed, twenty-eight year adjustable rate mortgage combined with a five-year interest only period. The second, piggyback loan was a balloon mortgage with a 13% rate. While severe payment shock was built into these refinance loans, the couple had enough experience to realize that the income falsification was presenting them with unaffordable loans before the reset.

Case Study 4 – Oakland, California: Flipping, high fees, predatory prepayment, stated income loan, ARMs, mortgage payment out of proportion with income.

Ms. Smith is an African-American who bought a home in Oakland, California in December 1999. Her income was $47,328 annually, or $3,944 monthly. She has undergone a series of unnecessary refinances, each of which has added a multitude of duplicative fees and has inflated the amount that she owes.

In December 1999, Ms. Smith purchased her home for $108,000. Approximately nine months later, she underwent her first refinance, which she thought would lower her rate and allow her to cash out a modest amount of money for roof repairs. Instead, this new mortgage for $140,250 stripped equity by paying off a prepayment penalty without her knowledge. Further, the Good Faith Estimate for this transaction also shows that Ms. Smith was to be charged lender and broker fees of 5.76 points (5.76 percent of the loan, or $8,076), an amount much greater than typical prime fees of 1 percent of the loan amount. Also, Fannie Mae and Freddie Mac have pledged not to purchase loans with fees exceeding 5 percent of the loan amount, and 5 percent is often the threshold in anti-predatory lending laws, triggering additional protections.

In August 2001, less than a year after her first refinance, Ms. Smith refinanced a second time. The new loan for $187,500 was adjustable and carried a three-year prepayment penalty. In October of 2003, Ms. Smith refinanced a *third* time, this time a 30-year fixed loan for $240,000. She refinanced for a *fourth* time in July 2004. On this loan, her

income was greatly inflated at $6,000 monthly, when it in fact was only $3,944. Consequently, the monthly payment on this fourth and final refinance was $1,887, which was an overwhelming 47.87 percent of her income.

CRF Encounters Entire Devastated Communities Due to Predatory Loans

In the communities of Staten Island and Long Island, New York, the Consumer Rescue Fund is assisting over 100 New York City police officers and fire fighters who purchased homes from an unscrupulous housing developer and mortgage broker. The broker manipulated the origination system by quickly dumping the fraudulent loans onto the secondary market. For these heroic public employees, the American dream of owning a home has now become their nightmare.

Written Testimony By Anthony M. Yezer

Professor of Economics

George Washington University

U.S. Senate

Committee on Banking, Housing, and Urban Affairs

Subcommittee on Housing, Transportation and Community Development

Hearings on Ending Mortgage Abuse: Safeguarding Homebuyers

June 26, 2007

Mr. Chairman and members of the Subcommittee, thank you for this opportunity to discuss what economic research has been able to determine about the role and function of the market for subprime mortgage credit, including recent experience with high default and foreclosure rates. I have done research on high-risk lending for over 25 years, beginning with my work as for the Federal Trade Commission as an external consulting evaluating the economic effects of the Credit Practices Rule. More recently, I co-edited the papers for two special issues of the *Journal of Real Estate Finance and Economics* on the topic of subprime lending and I am currently supervising an active research project regarding default and prepayment on subprime loans. We know quite a bit about subprime mortgage lending. I understand that you are particularly interested in proposed amendments to the Truth in Lending Act section 129 A, or S.1299, the Borrower's Protection Act of 2007. I will consider that specific proposals in the third section of my remarks. I will begin with some observations on what we know about subprime mortgage lending that bear on the consideration of S. 1299 and then give my perspective on the role of an economist in informing this debate. After I discuss the legislative proposal

in detail in the third section, I will conclude with suggestions for an alternative approach. I previously testified before the U.S. House of Representatives Committee on Financial Services on March 30, 2004 on subprime lending and believe that the observations made at that time are still relevant today but will not repeat them.

Background On Subprime Mortgages Relevant to S. 1299

Current academic literature provides a good understanding of subprime lending

There is an extensive literature in academic journals of economics and housing finance that provides a good understanding of the functioning of mortgage markets in general and subprime lending in particular. This literature provides valuable insights that should inform attempts to regulate these markets. Some points from the current literature are noted below – this is but a small sample of the potential benefits of consulting the literature before acting.

One standard finding in the literature is that there is no financial free lunch. In the context of the current regulatory discussion, this means that imposition of additional regulations on mortgage credit markets will raise the price of credit, raise underwriting criteria, or both as it results in a restriction in the supply of credit.

Reasons for the measured rise in subprime lending

The reported increase in subprime lending over the past decade is partly the statistical artifact of the way in which subprime lending is measured but also it is the result of deliberate government policy, designed to increase mortgage credit availability to "underserved" borrowers and/or underserved areas.

Subprime lending is generally measured using the Home Mortgage Disclosure Act (HMDA) and, for a variety of reasons, the fraction of all subprime mortgages reported under HMDA has

increased over time. Furthermore, the flattening of the yield curve tends to increase the number of mortgages classified as subprime under HMDA. Accordingly, year-to-year changes in the reported number of subprime mortgages should not be taken as an accurate measure of the actual change in subprime mortgages.

An important factor in the growth of subprime lending over the past decade has been pressure from both the legislative and executive branches of government, particularly bank regulators, on the need to increase mortgage lending to what has been termed "underserved" borrowers and neighborhoods. Over this period of time, lenders anxious to please regulators and achieve excellent CRA ratings have developed specialized products to accommodate applicants who would have been regulated in the past. Thus, at some point, the government itself must take credit for the current volume of subprime lending. To the extent that the problem is now that some borrowers and neighborhoods are "overserved", perhaps the answer is to be honest about the reasons for the problem and to try less regulation rather than more regulation.

What is different about subprime mortgage credit?

Based on the Financial Services Research Program Dataset, there are three distinguishing characteristics of subprime mortgage credit: higher interest rate (based on measured APR or annual rate), high percentage of cash-out refinancing, and the low credit score of the borrower.[1] Specifically for the 2001 cohort of fixed rate loans, average APR was 12.36%, 57% were cash-out refinancings,

[1] The Financial Services Research Program at George Washington University data are from a subprime mortgage database, which the Federal Reserve estimated to account for nearly a quarter of originations of higher priced home purchase and refinance mortgages on owner-occupied homes in 2004 (see Robert B., Glenn B. Canner, and Robert E. Cook. "New Information from HMDA and Some Implications for Fair-Lending Enforcement." *Federal Reserve Bulletin*, 91 (Summer 2005): 344-94). The database contains loan-level data on all originations of subprime subsidiaries of eight large financial institutions between third quarter 1995 and third quarter of 2004. My subsequent comments on results from the FSRP database will be based on statistical analysis conducted by Jevgenijs Steinbuks currently a Ph.D. candidate in economics at George Washington University and visiting assistant professor of economics at Ohio University.

and mean FICO score was 595. Average loan to value ratio was 86%, payment to income ratio 27%, 57% were cash-out refinance loans, 18% were broker initiated, and 40% has prepayment penalties. It follows that much of the demand for subprime loans arises from the desire of households to reduce their home equity and the inability to accomplish that goal in the primary mortgage market – I have termed this the "home equity trap" and discussed it at length in my previous testimony. Accordingly subprime mortgage credit should be viewed as a blend of consumer credit (given its use for debt consolidation and durables finance) and home finance.

The current high default and foreclosure rates are NOT a surprise

Anyone familiar with the literature on the determinants of credit risk in mortgage lending could have forecast the high default and foreclosure rates on subprime mortgages. My long-standing position has been that "underserved" borrowers and markets were high credit risk and thus represented lending that was not economically viable at prime interest rates. The primary reason for this prediction is the low credit scored associated with these loans, note the 595 mean FICO score in the FSRP data. The Department of Housing and Urban Development commissioned a number of studies to monitor the high default and foreclosure rates on loans deemed subprime by its definition. These results were discussed in some detail in a conference paper from 2001.[2] The recent rise in default and foreclosure rates is also not a surprise because when house prices stop rising, lenders are no longer able to refinance borrowers out of default (see discussion below).

There is no credible evidence that elevated foreclosure rates are due to product type

While it is quite common to attribute currently high default and foreclosure rates to subprime products like the option ARM, there is no credible evidence that these products have caused higher default and foreclosure rates. The fact that and assertion of truth is repeated by many individuals does

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[2] See, Harold Bunce, Debbie Gruenstein, Christopher E. Hebert, and Randall M. Schelesse, "Subprime Foreclosures: The Smoking Gun of Predatory Lending," Proceedings of a HUD Conference

not verify it as truth or substitute for formal statistical analysis. In this case, the problem may be a common confusion due to sample selection bias. We all know that some of the finest hospitals in the country have the highest patient fatality rates. This does not mean that the hospitals cause the death rate to be higher – rather this is a sample selection effect in which the most complex and least treatable cases are sent to the finest hospitals. Similarly, comparison of loss rates on mortgage products says nothing about the effect of product on expected future losses because the product is chosen by the borrower. To the extent that borrowers with the most fragile finances tend to choose the option ARM, default rates are higher due to sample selection rather than to the product itself. Eliminate a product with high loss rates and the fragile borrowers will choose another project which will then be incorrectly cited as a cause of default and the process repeats itself.

Sorting out the effect of product type on default, foreclosure, and prepayment is extremely complex statistically. Thus far our efforts with the FSRP database using joint hazard estimators with time varying coefficients and endogenous heterogeneity indicate that product type is not an important determinant of differences in default and foreclosure. While this may be counterintuitive for some, I can only state that economics is full of counterintuitive results which make it interesting to economists and important for those concerned with market performance.

Recent evidence indicates that borrowers are using hybrid (2/28) ARMs cleverly

An excellent recent paper by Pennington-Cross and Ho estimates a model of prepayment and default for hybrid arms and fixed rate subprime loans.[3] They examine differences in the pattern of prepayment and default over time for the hybrids that adjust and produce a "payment shock" after two years versus the fixed rate loans with no shock. Again the statistical inference is complex and requires joint estimation of prepayment and default. The results are that the payment shock after two years

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on Housing Policy in the New Millennium (2001).

[3] Anthony Pennington-Cross and Giang Ho, "The Termination of Subprime Hybrid and Fixed Rate Mortgages," (2007).

produces a spike in prepayment of the hybrid arms but not a spike in defaults. This indicates that borrowers are well aware of the provisions of their mortgages and exploit the lower rates on the hybrid arms by refinancing when they reprice. Note that this formal statistical evidence is in sharp contrast to assertions that borrowers will be caught unaware by payment shock and massive foreclosures will result from use of this loan product.

It appears that, on average, subprime mortgage prices have been too low, not too high

Given the lack of profitability of subprime lenders, it appears that, on average, mortgages have been priced too low rather than too high given the level of credit risk. This does not mean that there were not cases in which prices were too high, simply that these cases were apparently more than matched by transactions on which price was below average cost. This is consistent with evidence from high-risk automobile lending where profitability of firms appears to be lower for those in the highest risk and highest price segment of the market. One reason for the low returns to subprime lenders may be the pressure of regulators to expand high risk lending.

When housing prices are rising, lenders may refinance borrowers out of default

The subprime mortgage is an alternative to higher-cost consumer credit or sale of the family home for households needing temporary financing who have poor credit histories. Many households use subprime mortgages in this fashion and prepay them in the first 24 months. For households whose financial problems persist and who would ordinarily default on their mortgage, rising house prices generate additional equity that allows the lender to refinance them out of default. This process can continue until households either cure their financial problems or sell the housing unit. However, if house prices are flat or falling, lenders are restricted in their ability to refinance households out of default and forced sale, deed in lieu of foreclosure, or foreclosure are likely to result. If house prices are rising very troubled borrowers can continue to refinance and remain owners while periods of flat or falling house prices trigger a spike in default and foreclosure.

Current delinquency, default, and foreclosure rates on subprime mortgages are misleading

Because lenders can refinance borrowers out of default the current rates of delinquency, default and foreclosure on subprime mortgages are misleading. A subprime mortgage currently in foreclosure may the cumulative result of a series of mortgage lending decisions that were earlier classified as "successful" prepayments and new subprime loans. Just as rejection rates can be deceptive because a single borrower may apply for many mortgages, the ratio of troubled subprime mortgages to total subprime mortgages in force does not reflect the average experience of subprime borrowers.

In general, when house prices are rising and troubled borrowers can be refinanced out of default, the current rate of foreclosure will tend to understate the proportion of distressed borrowers. Alternatively periods of flat or falling house prices will tend to overstate the proportion of distressed borrowers because those who were refinanced out of default in the past will now face termination.

Another problem arises because the duration of successful subprime mortgages tends to be much shorter than that of troubled mortgages. Accordingly troubled mortgages are over represented in the population of subprime mortgages in force at any time. This is analogous to the problem of hospital evaluation raised by the fact that seriously ill patients stay longer. Thus the proportion of seriously ill patients in a hospital population at any time overstates the average illness of patients admitted to the hospital.

The issue of "negative amortization" is often misunderstood

There appears to be a general prejudice against mortgage instruments that offer negative amortization (except for the reverse annuity mortgage where negative amortization is encouraged by federal policy). First, it is important to note that, in the first ten years of a 30-year note, the vast majority of amortization of the loan is due to inflation. Required amortization is negligible. The borrower "pays" this amortization in the form of the inflation premium in the mortgage interest rate (thus approximately half of the current 6% mortgage interest rate is amortization of the real mortgage balance

by inflation.) A borrower choosing a mortgage instrument that provides for 2% negative amortization, is still paying down the real mortgage balance. Clearly it is optimal for some borrowers to amortize at a rate lower than the expected inflation rate and for these households, a negative amortization rate is appropriate.

Currently academic economists are puzzled by the overinvestment of U.S. households in home equity. Our reliance on the standard fixed rate self-amortizing mortgage along with the current inflation rate and appreciation in real house prices has led to a situation in which U.S. households appear to hold too much housing equity and too few of other risk assets.

General Observation on the Role of Economic Analysis

Solution to problems can often create bigger problems

There is no doubt that market outcomes are not always favorable for all participants. In financial markets, there are clearly vulnerable individuals who can easily be convinced to endorse contracts that are not in their self interest and public policy has taken steps to limit the possibility for such bad choices. Truth In Lending and Regulation Z created the APR to allow borrowers to shop for credit more easily and recently the Board of Governors has been reconsidering disclosure. Various creditor remedies have been banned – I was the Federal Trade Commission expert on the trade regulation rule concerning creditors' remedies. Such interventions should only be taken after careful benefit/cost analysis.

In the case of subprime lending, there are issues arising due to vulnerable borrowers. However, in considering regulations, it is important to recognize that the vast majority of borrowers have used subprime credit successfully and regulations that would deny them access to mortgage credit could force them to use higher cost sources, including grey market lenders, or generate a forced sale of their home in order to meet urgent expenditure needs. Careful benefit/cost analysis should precede regulatory

initiatives to make sure that benefits exceed costs of regulation. Economists are particularly adept at identifying unintended consequences of regulation in the form of hidden costs that should be considered in the legislative process.

In the final section of my remarks, I will make a tentative suggestion for a federal government initiative. This change might have a benefit cost ratio greater than unity but it needs substantial elaboration and should be subject to a careful and independent analysis.

Specific Comments on S. 1299

Mortgage applicants should not treat loan officers as financial advisors

The legislative proposal appears to confuse the duties, capabilities, and obligations of loan officers with those of financial advisors. It asserts that the loan officer has a "fiduciary relationship" with the applicant and should be subject to the requirements for fiduciaries otherwise applicable under State or Federal Law.

The relation between mortgage applicants and loan officers, employees who take mortgage applications, is not analogous to the relation between investors and financial advisors and applicants should not treat loan officers as financial advisors. There are three major reasons for this position. First, employees who take mortgage applications are not financial advisors and do not assess the creditworthiness of the applicant. Creditworthiness is evaluated by underwriters who view the entire loan file and assess the financial condition of the applicant in relation to the proposed loan to determine the ability to repay the mortgage or by an automated underwriting system designed to perform the underwriting function. ***Fair lending is based, in part, on this separation of function in which the underwriter does not meet or directly become aware of the personal characteristics of the applicant.*** Second, applicants should not be encouraged to reveal their financial condition to loan officers, beyond information needed for underwriting purposes. If an applicant knows that future

income is uncertain or that expenses may rise, that information should not be revealed to the loan officer. We do not want to encourage applicants to reveal information that could lead to rejection of their application. Similarly, applicants should not be encouraged to reveal their prepayment plans, etc. Third, major lenders often have hundreds of loan products, many introduced in connection with regulatory fair lending objectives. Loan officers are generally aware of a very small fraction of these loan types and are in no position to determine which product is optimal for a given applicant. [4]

The loan officer has an incentive to direct the applicant toward loan products for which the applicant is qualified because rejection by the underwriter results in a loss to the lender that is often shared by the loan officer.[5]

Underwriters currently verify the reasonable ability of borrowers to repay loans except when distressed borrowers are refinanced out of default in connection with a workout

The legislative proposal seems to ignore the role of the underwriting process. My understanding is that all lenders have an underwriting process that is designed to insure the reasonable expectation of repayment. One exception may be cases in which borrowers are refinanced out of default. In this case, the prepayment of the old note and endorsement of a new loan should not be viewed as a new mortgage transaction but rather as part of a workout.

To the extent that this provision was interpreted by lenders as not allowing them to offer workouts to distressed borrowers, it reduces the options of such borrowers and has the potential to cause significant harm by forcing them into foreclosure.

The focus on payment to income ratios as a cause of credit risk is misplaced

As noted above, the average monthly payment to income ratio in the FSRP database of subprime loans is not high, 0.27. Furthermore in estimates of default models, the monthly payment to

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[4] My experience in advising some large lenders is that no one in the company is familiar with all of the loan products.

[5] Many loan officers are compensated based on the number of loans endorsed.

income ratio is often not significant as a "cause" of default. This is not unique to the FSRP data. Other econometric models of default and prepayment risk on higher risk loans estimated using modern statistical techniques often find that payment to income or debt to income ratios are non-significant.[6]

In addition to the statistical evidence that payment to income ratios are not major determinants of credit risk in subprime lending, there are obvious examples of situations in which current income has little to do with loan repayment – i.e. cases in which future income is likely to be much higher than current income, where borrowers have significant wealth, or where there is a cosigner. The classic case is the medical resident or individuals who return to school seeking advanced degrees.

Taken as a whole, the attempt of S. 1299 to regulate payment to income ratios and restrict the information used to compute such ratios is misplaced and could impose significant costs on many qualified borrowers.

Extension of joint liability for representations by mortgage brokers could impose large costs

The extension of liability for acts, omissions, and representations made by a mortgage broker to a lender purchasing a mortgage could literally shut down local mortgage markets. A similar experiment was performed about four years ago in Georgia with very costly results. The problem is that, given the narrow margins and particularly the lack of profitability in the subprime market, imposition of significant additional cost would likely result and a refusal to lend at all. It is important to consider the costs associated with additional regulatory burdens that require lenders to monitor the behavior of others.

The term "reasonably advantageous" is not defined and could impose high costs

There are three distinct ways that the requirement that loan officers recommend to a consumer a reasonably advantageous home loan could impose significant costs that would substantially curtail the extension of mortgage credit. First, a requirement that recommendations conform to an undefined

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[6] See, for example, Table III in Yongheng Deng and Stuart Gabriel, "Modeling the Performance of FHA-Insured Loans: Borrower Heterogeneity and the Exercise of Mortgage Default and Prepayment Options," Report to HUD, PD&R, (May, 2002).

criterion is an open invitation to litigation costs. Second, assuming that some definition of reasonable advantageous could be devised, lenders would have to hire, instruct and monitor loan officers capable of providing such financial services to applicants. Given the lack of returns in subprime lending currently and the generally thin margins, this would require a contraction of lending and/or an increase in price. Third, responsible application of the provision would subject the lender to fair lending litigation. Consider the case an applicant could meet underwriting criteria for a loan product and the loan officer either insisted that product was not reasonably advantageous while another product was advantageous. Applicants could easily regard this as a refusal to lend and the, particularly if the more advantageous product was more profitable to the lender, fair lending litigation could result. The suggestion that a loan officer refuse to forward an application for a particular product and suggest that the borrower apply for a different product at an alternative lender could also result in litigation.

This provision also has the standard problem that, for current borrowers being refinanced out of default, an entirely different standard for evaluating the mortgage transaction would apply.

Finally note the point made above in connection with fiduciary responsibility applies here also. Identification of a reasonably advantageous mortgage would require loan officers to seek information that applicants should not be obligated to divulge. Indeed, to suggest that loan officers collect such information would be a disservice to applicants.

Regulation of appraisers is best done at the state level

It is not clear why regulation of professionals who are licensed to appraise housing in local markets should not be conducted at the state and local level.

The effects of the proposal on the U.S. housing market could be very negative

By increasing the costs of mortgage lenders without producing compensating benefits, the legislative proposal would cause further contraction in the willingness to extend mortgage credit generally, and particularly subprime lending. This would tend to depress housing prices and further the

default and delinquency problems caused by negative equity.[7]

Problems in mortgage credit markets are often "self correcting" and do not require regulation

When a new product market develops or an existing market expands rapidly, product innovation follows a Smithian process.[8] Many new techniques and variations on products are tried. Some succeed and others fail. Over time, the "invisible hand of the market" rewards ideas that have high benefit/cost ratios prevail over those with low ratios. This has clearly happened in subprime lending where new products, pricing techniques, and underwriting criteria have been developed to meet demands of the public. Some approaches have failed. For example, it appears that some underwriting that relied on stated income was subject to fraud.

There are forces in the market place that will correct these problems. Indeed, I understand based on informal evidence that the correction is underway.

My overall opinion of S. 1299 is that it should not become law. This is NOT the time to add regulations that would contract the supply of mortgage credit, collapse housing prices, and exacerbate the current problems in the U.S. housing market.

An Alternative Suggestion

Expand the role of the FHA

Concern over vulnerable households who are likely to make bad decisions regarding the purchase and financing of owner occupied housing is not new. Indeed it was the underlying reason for

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[7] The empirical evidence indicates that negative equity (the put option) is very important in increasing default probabilities.

[8] This is commonly called a "Darwinian" process but the process of natural selection was first identified by Adam Smith in *The Wealth of Nations*, over 75 years before it was applied to biological populations by Charles Darwin based on his prior reading of Smith.

the operating model behind the FHA. Recall that FHA mortgage insurance had substantial property inspection requirements, mortgage interest limits and other provisions designed to reduce the possibility that households would make bad decisions when they purchased and financed housing. I have long recommended that FHA be revitalized and that it be made a more effective competitor with conventional lenders. Instead, regulatory pressure on Fannie Mae and Freddie Mac forced them to compete with FHA (once again government policy has operated in the wrong direction).

In addition to its role in home purchase, FHA could be given an expanded role in refinancing within the subprime market (FHA already has streamlined refinancing of FHA mortgages).

Design of a specific set of FHA programs would require careful benefit/cost analysis but my major point is that we do not need something new because the issue of vulnerable homebuyers and homeowners is not new and we have a program that, for many years, successfully addressed the problem. This is not a new position for me.[9]

Thank you again for allowing me the opportunity to present these thoughts.

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[9] See the discussion in Anthony Pennington-Cross and Anthony M. Yezer, "The Federal Housing Administration in the New Millennium," *Journal of Housing Research*, Vol 11, No. 2 (Spring, 2001), pp. 357-372.

Prepared Testimony of

Denise Leonard, Director

National Association of Mortgage Brokers

on

"Ending Mortgage Abuse: Safeguarding Homebuyers"

Before the

Subcommittee on Housing, Transportation, & Community Development

Committee on Banking, Housing, & Urban Affairs

United States Senate

Tuesday, June 26, 2007

Good morning Chairman Schumer, Ranking Member Crapo, and Members of the Subcommittee, I am Denise Leonard of the National Association of Mortgage Brokers ("NAMB"). Thank you for inviting NAMB to testify today on safeguarding homebuyers and putting an end to mortgage abuse. We appreciate this opportunity to address the need to combat predatory lending practices while maintaining a strong and competitive housing market.

NAMB is the only national trade association exclusively devoted to representing the mortgage brokerage industry, and as the voice of the mortgage brokers, NAMB speaks on behalf of more than 25,000 members in all 50 states and the District of Columbia. NAMB members are typically small business men and women, who adhere to a strict code of ethics and best lending practices when presenting consumers with an array of mortgage financing options from which they can choose. Mortgage brokers typically maintain business relationships with various lenders so they can offer a variety of loan products for their customers to choose from. Our members play a critical role in helping the American economy and in making the dream of homeownership a reality for American families.

We applaud Chairman Schumer's initiative in introducing The Borrower's Protection Act of 2007 ("S. 1299"); however, we believe the value of an all mortgage originator approach lies in the uniformity of treatment between competing origination channels. Consumers deserve the same level of protection no matter which distribution channel they decide to use. We also commend this Subcommittee for holding this important hearing to specifically address the challenges of protecting homebuyers from abusive and predatory lending practices and ultimately eliminating such practices from our industry altogether.

I. The Mechanics of Today's Mortgage Market

The reality of today is that any regulatory, governmental or legislative effort must take into account how the mortgage market has evolved in relation to the burgeoning growth of the secondary market for mortgages. The problems facing the mortgage market are not exclusively attributable to one distribution channel and are the result of a combination of factors including: origination, underwriting, servicing, debt collection, the secondary market, securitization, and the bond rating system.

The *Watters v. Wachovia* Supreme Court decision has created a bifurcated regulatory landscape in the mortgage industry. Two separate mortgage camps now exist: those operating solely under federal regulation, *versus* those in the 'non-bank camp,' which are subject to both federal and state oversight. The 'non-bank camp,' which is subject to this layered oversight, includes mortgage bankers, mortgage lenders, mortgage brokers, in-house or affiliated lenders, state-chartered banks or savings institutions that are not FDIC-insured and state-chartered credit unions, and creditors. The *Watters* decision has created an imbalance in the mortgage industry oversight scheme that regulates a market vastly different from the one that existed 20 years ago, at the advent of the secondary mortgage market.

Today, mortgage originator entities and individuals operate in one of three ways, or sometimes in multiple capacities:

- As lenders;
- As correspondent lenders; or
- As mortgage brokers.

It is important to note at the outset that States license people and businesses, while federal mortgage-related statutes generally define and regulate mortgage transactions (*i.e.*, the Real Estate Settlement Procedures Act of 1974 ("RESPA") and the Truth in Lending Act ("TILA")). So, irrespective of how a business or individual is treated by the governing state or federal authority, the federal statutes, by nature, will define the mortgage transaction. It is this treatment that gives rise to originator entities and individuals acting in various capacities, either in a true creditor capacity (lender), in a correspondent lender capacity,[1] in a table funding capacity,[2] or in a broker capacity (despite the fact that their business license may say "mortgage lender").

[1] When a lender is engaging in any one of these types of transactions and is offering multiple product lines of other lenders, that lender is acting as a correspondent lender.

[2] A correspondent lender can also engage in a table-funded transaction. Table funding is the origination of a loan by a correspondent lender with a simultaneous transfer or sale of the loan at the time of funding to a lender. In a table-

Historically a lender was an entity that used its own money to originate and fund transactions. The loan was not sold and was serviced by the originating lender. This lender maintained a direct relationship with the borrower from the time of origination through funding and collection of the loan. Today, this is no longer the case. Lenders typically originate loans using the secondary market's underwriting guidelines and standards. Lenders routinely contract with multiple secondary market participants to offer their product lines to consumers. While some lenders operate under a traditional model, an overwhelming number of lenders originate loans with the intention or practice of selling them either as whole loans or through securitization.

A correspondent lender is a mortgage banker or mortgage lender that does not typically offer its own product line. Rather, a correspondent lender is a mortgage banker or mortgage lender that has entered into multiple contracts with various other banks or lenders to offer their product lines to consumers. The multiple contracts enable the correspondent lender to offer an array of products and remain competitive in today's market.

Typically, a correspondent lender will close the loan in its own name and fund the loan through its warehouse line of credit. However, a correspondent lender knows in advance that they *do not* want to permanently fund, service or hold the loan, and therefore they act as an intermediary between the consumer and one of the bankers or lenders with whom they have contracted to sell the loan. A correspondent lender will, within one to ten business days after closing, sell the loan to the appropriate bank or lender and be compensated through a servicing release premium ("SRP").

Because correspondent lenders enter into multiple contracts, offer the loan products of various lenders and banks, and sell the loan in exchange for a SRP, they are functionally acting as brokers. The primary difference between a correspondent lender and a broker is that the correspondent lender *temporarily* funds the loan at closing and then, within one to ten business days, releases its interest in that loan and *does not* have to disclose all of the compensation (*i.e.*, SRP) earned on the transaction. Thus, the interest that the correspondent lender represents is wholly dependent on whose loan product the consumer qualifies for and chooses (*i.e.*, the correspondent lender represents the interests of any one of the multiple banks or lenders with whom it has contracted). In a correspondent relationship, the consumer generally does not know until days or sometimes weeks afterward whether they are receiving a loan from Bank A, Bank B or Bank C.

With respect to licensing and compensation, a mortgage banker can be licensed in a state so that it can act as *both* a mortgage banker and mortgage broker. This does not require the entity to obtain multiple licenses. Because an entity can act as both a mortgage banker and a mortgage broker, it can choose, transaction by transaction, whether it wants to originate a loan as a correspondent lender (requiring no disclosure of SRP) or a mortgage broker (requiring disclosure

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funded transaction, the originating company is a creditor for purposes of TILA and therefore, state and federal agencies treat them as lenders. However, The Department of Housing and Urban Development ("HUD") has determined that table-funded transactions are mortgage broker transactions for purposes of the RESPA, subjecting these transactions to the YSP disclosure requirement. Therefore, the correspondent lender who table funds is essentially both a lender and a broker.

of YSP). Thus, the consumer is not able to easily discern whether the mortgage originator is operating as a mortgage banker or a mortgage broker.

Mortgage brokers generally contract with several wholesale lenders to offer a variety of product options, which their customers may then choose from. Every mortgage provider – whether broker, banker or lender – offers a different set of product choices to borrowers. It is the borrower's responsibility to shop around to different mortgage brokers, as well as banks and mortgage lenders, until they find a loan product they are comfortable with. Although mortgage brokers typically offer a wider array of products to choose from, they do not act on behalf of their customers or shop around to find them the best loan product available.

Consumers Cannot Tell the Difference Between Brokers, Bankers and Correspondent Lenders

Most consumers enter the origination process through a retail branch. Retail branches allow banks, non-banks, and broker entities to offer their products directly to the consumer through loan officers working in brick-and-mortar retail shops. Retail origination can also occur on the phone or via the internet. In addition to retail branches, bank and non-bank entities can also offer products through their correspondent lending divisions or through their wholesale lending division (*i.e.,* broker division).

It is important to note that the bank and non-bank entities themselves can and do also engage in correspondent lending with other banks and non-banks through their retail shops. These entities choose to act as correspondent lenders when they know that they do not want to own, service or hold the loan on their books. The bank or non-bank entity 'pre-sells' the loan to another lender and so they know prior to and at closing that they must meet this other lender's criteria.

For example, Bank A can close a loan product in its own name and at closing know that they are almost instantly selling the loan to Bank B. At the time of closing, the consumer has no idea that the loan officer owes their interest not to Bank A, but to Bank B.

Another example is the non-bank national residential mortgage company licensed in multiple states ("Mortgage Co. X"). Mortgage Co. X has retail branches, a correspondent lending division, and a mortgage broker division. Through its retail channel, Mortgage Co. X can close a loan in the name of Mortgage Co. X or in the name of another bank, such as Mortgage Co. Y. In this fashion, Mortgage Co. X is acting as a mortgage broker for Mortgage Co. Y through Mortgage Co. X's retail branch.

In each scenario above, the entity has the ability to engage and does engage in the marketplace as an intermediary between the consumer and various other lending or bank parties through whom they obtain loan products for consumers to choose from.

It is important to note that employed loan officers are usually under an employer-employee agency relationship with their respective entities, be it a bank, correspondent lender shop or broker shop. It is the institutions behind the employed loan officers that have varying interests because they have entered into various contracts with banks and lenders.

Below are a few examples of mortgage bankers or lenders that functionally operate as brokers because they enter into multiple contracts to offer a variety of loan products that are not their own, present product choices to consumers and almost immediately after funding the loan sell it to the lender or to the secondary market.

- The in-house mortgage company of a real estate firm.[3]
- The in-house mortgage company of a builder.
- A bank or non-bank retail branch acting as a correspondent lender.
- Private label mortgage companies.
- Small community banks that act as correspondent lenders.

Consumers do not know the difference between various channels of distribution in retail branches for several reasons:

1. There is no official signage requirement;
2. The branch offices look exactly the same to the consumer, whether the branch is a physical location or a website;
3. The vast majority of mortgage bankers do not take deposits and therefore their operation looks no different than that of a mortgage broker;
4. These entities generally have "mortgage company" in their names and do not use lender, banker, or broker in their title;
5. In most states there is no written agreement or disclosure required to tell the consumer the nature of the relationship; and
6. As discussed above, regardless of the name of their company these entities can act in different ways in different transactions.

Therefore, it is not clear to the consumer whether they have walked into a mortgage banker shop and/or a mortgage broker shop. This is especially true where so many mortgage bankers get state-licensed as a mortgage banker or lender so that they can do correspondent lending as well as act as a mortgage broker. As a result, many consumers work with someone who they *think* is a mortgage broker only to learn later that he or she is in fact a mortgage banker who is not required to disclose their back-end compensation; not required to be licensed; not subject to criminal background checks; and not held to any standard of knowledge or expertise.

No Functional Difference

As discussed above, today the mortgage banker or lender functionally acts as a broker because they (1) have entered into multiple contracts with various banks and lenders to offer an array of products, (2) know at the time of closing they will quickly sell the loan, and (3) generally know how much they will make off the loan when they sell it. Today most lenders quickly sell their

[3] Commonplace in the industry today are mortgage companies affiliated with other service providers. It is quite common for a mortgage company to be a subsidiary or be affiliated with a real estate agency firm. This creates an ability of the real estate agency to represent the buyer or the seller, or both, in the real estate transaction while also profiting from the mortgage transaction. Similarly, builders of new homes routinely operate in-house mortgage providers and therefore, act also as a seller and a provider of financing. These companies routinely act as correspondent lenders.

loans onto the secondary market, blurring the line that once divided lenders and brokers, and destroying the risk-reward equilibrium that mortgage lenders claim is so critical to maintain. As a result, mortgage bankers and lenders are exposed to virtually the same risk as mortgage brokers, and significantly less financial risk than they have been exposed to in the past.

Mortgage bankers and lenders that operate as correspondent lenders are simply 'fronting' the funds for another bank, lender or secondary market investor, and then are being compensated from the market, in addition to the consumer, for such temporary fronting of funds. Unfortunately, none of this is apparent to the consumer. The consumer has no idea that these entities are getting paid directly as well as indirectly because mortgage bankers operating as correspondent lenders do not need to disclose the SRP they earn from the sale of the loan days after closing.[4]

II. Pressure on Appraisers & Other Service Providers

An integral part of the mortgage and underwriting process is the determination of the value of the collateral being used in the loan application. The determination of property value includes the hiring of an industry professional (an appraiser) or the usage of an automated valuation model. Some mortgage applications waive the requirement for any formal valuation report.

There has been great debate over the independence and the professional standards of individual appraisers hired to do an evaluation. It is alleged by some that the need to obtain workable loan to value ("LTV") ratios can and does lead some mortgage originators to exert inappropriate pressure on appraisers to achieve a predetermined value that will allow the loan to close. Although it is the responsibility of the appraiser to ensure that their work product complies with the appropriate codes of ethics and professional standards for their industry, NAMB opposes any effort by a mortgage originator to pressure or influence the work of an appraiser. Such practices should not be tolerated.

Roughly one year ago, NAMB amended its code of ethics to include language prohibiting NAMB members from pressuring any provider of services, goods or facilities to circumvent industry professional standards, or to respond or succumb to such pressure from others. Just last week at the 2007 NAMB Annual Convention in Seattle, WA, a representative from the Appraisal Institute gave a major presentation at both our Government Affairs Committee meeting and a special break-out session for convention attendees. NAMB and representatives from the Appraisal Institute have each extended offers to cooperate and have both expressed significant interest in working collaboratively to improve the appraisal process for brokers, lenders, appraisers, and most importantly consumers.

III. The Role of Wall Street

While we appreciate and understand the focus of this hearing is on the origination process, we do not believe one can get a full picture of what has occurred in the subprime mortgage market

[4] Brokers are still the *only* mortgage origination distribution channel that can claim *full* transparency of *all* fees – both direct (on the GFE through points) and indirect (on the GFE as required by RESPA Regulation X).

without hearing from the ones who actually fund, underwrite and invest in these loans. Indeed, it has been reported, that a "growing number of Wall Street investment banks and other active issuers of mortgage-backed securities are becoming direct owners of mortgage originators," some as long ago as 2002.[5] This "vertical integration" strategy – firms specializing in securitizations, purchasing originators so as to have a "steady supply" of loans and access to the income streams those loans generate – has become more and more important to Wall Street firms and their fixed income divisions who have come to rely on the revenues from mortgage underwriting and securitizations.[6] As a result of this rationalization of an efficient marketplace, it is becoming apparent that certain intermediary market participants, in this case lenders who provide only temporary funding for loans before quickly selling them on the secondary market, will be phased-out of the industry entirely.

As reported by Gretchen Morgenson in *The New York Times*, "While commercial banks and savings banks had long been the biggest lenders to home buyers, by 2006, Wall Street had a commanding share – 60 percent – of the mortgage financing market, Federal Reserve data show. The profits from packaging these securities and trading them for customers and their own accounts have been phenomenal."[7]

The involvement of these firms in the process became apparent two weeks ago when several of the firms reported earnings. Many of these firms reported decreases in their fixed income operations and stocks have lagged as a result of concern over the "sustainability of revenue from the subprime mortgage lending and trading."[8]

The reason all of this is relevant is because no originator can originate any loan without it being underwritten and funded by a lender. The lender often will not fund the loan unless they know ahead of time that they can sell the loan to Wall Street in a pool of mortgages. Wall Street then packages the loans into mortgage backed securities ("MBS") and sells those securities to the ultimate investor. This investor – whether it is a pension fund, insurance firm, Japanese bank, European hedge fund, etc. – is the one ultimately holding the credit risk because he or she is the one actually lending the money. In the end, the investors ultimately determine the risk profile of any particular loan because the investors tell Wall Street what vehicles they are willing to put their money into. Wall Street, in turn, tells the mortgage lender what they would like to securitize, particularly in terms of credit ratings, LTV ratios, etc. The mortgage lender, in turn communicates these risk profiles to its loan officers, correspondent lenders, and mortgage brokers. In short, what can be originated and funded is determined by the investors actually lending the money.

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[5] "Under Wall Street Ownership," McGarity, Mary, *Mortgage Banking*, December 1, 2006.
[6] Ibid; and, "The Vertical-Integration Strategy, Levine, Jeffrey M., *Mortgage Banking*, February 1, 2007.
[7] "Crisis Looms in Mortgages," Morgenson, Gretchen, *The New York Times*, March 11, 2007.
[8] "Wall Street to Report Smallest Profit Gain in 2 Years (Update1), Onaran, Yalman, June 11, 2007 (Bloomberg) http://www.bloomberg.com/apps/news?pid=20601103&sid=aAbjqUCrG7xA&refer=us; and "Goldman is Hit by Sub-prime Problems," Litterick, David, *The Daily Telegraph*, June 15, 2007.

Main Street and Wall Street: From Application to Securitization

After receiving the application and other documentation from the loan originator, lenders utilize underwriters, or underwriting programs, to decide whether an applicant falls within certain pre-set risk parameters that the lender or secondary market purchaser is willing to accept. It is important to note that today the secondary market is dominated by Wall Street participants and hedge funds.

Once the lender decides to fund and close the loan, the originator is notified that the loan is approved and therefore, moves forward with the closing. The lender can either hold this loan in its portfolio and service it, or sell the loan. It used to be, some 10 or 15 years ago, that the majority of lenders retained and serviced these loans. This was largely because there was no effective mechanism available for lenders to systematically remove the loans from their books and "free-up" their capital. However, the emergence and rapid development of the mortgage securitization market (Wall Street) has changed the way most lenders do business.

Today, the bulk of these loans are sold almost instantaneously to an investment bank and securitized for market investors. This is because the majority of non-depository lenders rely on lines of credit to finance closed loans, and they tend not to want to tie up their capital in existing loans and restrict origination volume. Thus, these lenders typically sell their loans as quickly as possible to the secondary market to avoid the risk and interest costs associated with carrying the loan. Most residential mortgage loans – some estimate nearly 85% – are quickly sold to Wall Street investors to avoid the risks associated with holding the loans in portfolio.

As a result, much of the current mortgage market is driven ultimately by Wall Street investors and the credit agencies charged with rating the risks associated with these pools of loans. These market players establish the risk tolerances acceptable for the pooled loans. This, in turn, informs the design of loan products and borrower risk profiles deemed acceptable by the lenders' underwriting criteria. In the end, Wall Street creates a demand for particular mortgage products and sets underwriting criteria designed to meet the demand for these products. It is the underwriting criteria, not the mortgage originator, which dictates whether a consumer qualifies for a particular loan product.

We believe it is important to note that the market is and has been adjusting to the increased level of defaults and late payments:

- Investment banks who securitize subprime have tightened their wholesale lending requirements and started enforcing buyback agreements;
- Many of the leading subprime lenders have closed their doors or gone bankrupt – largely due to margin calls and credit tightening by Wall Street;
- Contracts between mortgage lenders and mortgage brokers continue to require strong buyback commitments from the broker for originating nonperforming loans;
- Fair Isaac is making changes to its FICO scoring system to improve its "predictive strength by 5 to 15 percent."[9] Some believe this is to take into account the practice of

[9] "Fair Isaac Combats Credit Manipulation," Elphinstone, J.W., Associated Press, June 5, 2007; and Fair Isaac Press Release, May 17, 2007.

piggy-backing – where companies like Instant Credit Builders (http://instantcreditbuilders.com/) promise to increase a person's credit score, by allowing a person with bad credit to add his/her name as an authorized user of the credit score of the individual with good credit (for a fee of course).[10]

In the end, we believe the effects of poor underwriting of mortgage loans in 2005 and 2006 have not been fully felt or appreciated and hope Congress does not rush to judgment in this area until everyone has a better idea of exactly what happened, how it happened and why it happened.

IV. Mortgage Brokers' Responsibility to Lenders

Mortgage brokers originate loans; they do not set the qualifications or underwriting guidelines for the loans. The secondary market designs and underwrites loan products, which determines the qualifications under which originators operate.

Contrary to some notions of a mortgage broker's business, brokers remain vested in the long term success of the loans they originate. Mortgage brokers enter into binding contracts with various lenders to deliver loan products to the marketplace. In those contracts, mortgage brokers are required to make certain representations and warranties regarding the origination and likely future performance of the loans they originate. Mortgage broker contracts with lenders also typically contain buyback provisions, mandating that the broker repurchase any loan that defaults within a certain period of time. Mortgage lenders also maintain "score cards" on the mortgage brokers they engage in business with, which includes information relating to the performance of the loan. If a mortgage broker continues to deliver loans to the contract lender that do not perform, the lender will cease doing business with that broker.

Additionally, since most mortgage brokers operate small retail shops in the communities in which they live, brokers rely heavily on repeat and referral business from customers they call neighbors, friends, and family. The success of a mortgage broker's business hinges on the broker's ability to offer loan products that ultimately meet the financial needs and goals of their customers. A mortgage broker cannot and will not remain in business if his or her customers are not satisfied with the selection of products, pricing, and level of service that broker offers.

V. Mortgage Brokers Are Regulated at Both the State & Federal Level

Today, all 50 states and the District of Columbia have passed legislation regulating mortgage loan origination. This legislation requires mortgage brokers to obtain a license and/or register with the state agency charged with enforcing financial regulations. A growing majority of states also require the individual loan originators employed by or contracting with mortgage brokers to be licensed or registered.

Although every state licensing and registration law is different, each state's licensing or registration law involves some combination of testing, education, criminal background checks, compliance audits, and surety bond requirements for mortgage brokers. Additionally, mortgage brokers must comply with state and federal fair lending laws, RESPA, TILA, the Home

[10] "Piggyback Credit Worries Loan Industry," Elphinstone, J.W., *The Cincinnati Post*, June 4, 2007, p. B7.

Ownership and Equity Protection Act ("HOEPA"), the Fair Credit Reporting Act ("FCRA"), the Equal Credit Opportunity Act ("ECOA"), the Gramm-Leach-Bliley Act ("GLBA"), and the Federal Trade Commission Act ("FTC Act"), as well as various other state and federal regulations.

In most states, every mortgage broker, banker, and lender that is not exempt from state regulation by the Office of the Comptroller of the Currency ("OCC"), or by a specific provision in the state statute, is held to substantially similar standards. The growing problem, in the wake of the Supreme Court's *Watters v. Wachovia* decision, is that more and more industry participants are being exempted from state regulation that is designed to safeguard homebuyers and curb abusive lending practices. In fact, over the past five years, many states' regulation and oversight of mortgage brokers has eclipsed that of mortgage bankers and lenders, due in large part to the exemptions those entities have lobbied for and received at both the state and federal level.

VI. Key Principles

The impetus for today's hearing is to explore and evaluate ways in which we can safeguard homebuyers, curb predatory and abusive lending practices, and expel unscrupulous actors from the mortgage industry.

There are undeniable differences that exist between depository institutions, credit unions, mortgage lenders, and mortgage brokers, both in terms of their business models and how they are regulated, primarily because some of these entities are involved in other businesses, namely banking. However, when it comes to the origination of mortgage loans, these entities are virtually indistinguishable in the eyes of consumers.

Since 2002, NAMB is the only industry trade group that has consistently advocated for more stringent standards for all loan originators, in order to protect consumers and curb abusive and predatory lending practices in the mortgage industry. We urge Congress to adopt uniform national standards for education, testing, and criminal background checks for *all* mortgage originators, and we support the creation of a national registry that would include every individual mortgage originator, including loan officers at banks, lenders, and brokerages.

A primary example of why *all* mortgage originators should be subject to uniform minimum standards is best articulated by South Carolina Attorney General, Henry McMaster, in a March 2007 mortgage fraud report. Attorney General McMaster states that South Carolina has "directly and disproportionately been targeted for this type [mortgage] of fraud."[11] While both the mortgage broker and mortgage broker's company are required to be licensed in the state of South Carolina, "mortgage lenders [mortgage bankers] and their originators [loan officers] are basically unregulated. There is no oversight by the State."[12] Not coincidentally, the FBI has identified South Carolina as one of the top ten "hot spots" for mortgage fraud in the United States.[13]

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[11] *See,* Appendix A, "Mortgage Fraud Report," South Carolina Department of Consumer Affairs, March 2007, p.1.
[12] Ibid, p.4.
[13] Ibid, p.1.

Increasing professional standards for all mortgage originators is important, but is only one component of any larger effort to safeguard homebuyers and curb abusive and predatory lending practices. It is also imperative that consumers understand and embrace their role and responsibility as the decision-maker in mortgage transactions. We must not risk "turning back the clock" to a pre-Fair Housing Act era where certain segments of the population were unfairly and unreasonably denied access to mortgage financing. For this reason, improved consumer financial literacy and simplified consumer disclosures are two critical elements that should also be present in any reform effort.

Finally, we must exercise caution when contemplating sweeping legislative or regulatory reform of our industry. We urge Congress to consider the potential for unintended consequences that may result from the establishment of vague standards or arbitrarily imposed liability that affects only a small segment of the market and provides consumers with the illusion of protection, as opposed to the real safeguards borrowers should be afforded.

A. A National Registry, Governed by a Federal Agency

NAMB supports the creation of a national registry, provided: (1) it is governed by a federal agency such as the FTC, the Federal Reserve Board, or HUD; (2) the federal government requires every individual mortgage originator, including individual mortgage originators working for federal and state chartered banks and lenders, credit unions, mortgage brokers, and their loan officers to register; (3) every individual pays a fee to be in the registry, and the fee is used to cover operational costs for the registry, create funds earmarked for additional enforcement of mortgage laws, and assist ongoing consumer financial literacy programs.

We believe individuals who choose to work in our industry should be held accountable for their actions. If any mortgage originator is found guilty of improper conduct, he or she should be kicked out of the industry permanently. This national registry will stop bad actors from remaining in the mortgage industry, but only if it includes every individual mortgage originator at every state and federally-regulated entity. Without universal inclusion in the registry, bad actors will remain free to move, unchecked, from one entity to another and one community to another without any interference.

B. Increased Professional Standards for All Mortgage Originators

Unfortunately, the growth that has occurred in the mortgage finance industry has led to a corresponding rise in the number of uneducated and unlicensed mortgage originators. We must be careful however, not to allow ourselves to be blinded by the notion that these unlicensed and uneducated bad actors have found a home exclusively in one segment of the industry. There are unprofessional and unscrupulous originators working throughout the mortgage industry, including at banks, credit unions, brokerages, and loan companies. If we really want to safeguard homebuyers from abusive and predatory lending practices and provide them with more than the illusion of protection, professional standards must be established for *all* mortgage originators and enforced across *every* distribution channel.

As we mentioned above, when consumers are sitting across the table from a mortgage originator, they generally cannot distinguish one distribution channel from another. From the perspective of the consumer, there is essentially no difference between banks, lenders, and brokers when it comes to originating mortgage loans. Moreover, there is no reason to distinguish one distribution channel from another when each is engaged in essentially the same activity. It is not in the consumers' best interest to draw artificial lines between entities based upon their size, structure, or place in the federal-state regulatory dichotomy. Regulating only small segments of a larger industry leaves cracks for bad actors to continually slip through.

Require Minimum Education, Testing, and Criminal Background Checks for All Mortgage Originators

We believe more can and should be done to increase professional standards for all mortgage originators. NAMB believes that part of the solution to successfully combating abusive and predatory lending practices is requiring a minimum level of education for all mortgage originators, regardless of where they are employed. Education of each and every mortgage originator helps to ensure that consumers will receive accurate and consistent product information in order to make an informed decision about different loan financing options available in the market. NAMB also believes that all mortgage originators should be subject to a federal criminal background check to prevent bad actors from entering or remaining in the mortgage origination industry. Additionally, to ensure all mortgage originators remain knowledgeable and competent to address customer concerns, NAMB supports periodic testing, continuing education, and ethics training.

The application of these minimum professional standards to *all* originators will create a mortgage market where consumers are free to shop and compare mortgage products and pricing across distribution channels without fear or confusion. We believe a federal effort must be undertaken to establish and implement minimum national standards that would function as the floor for all state and federal regulation, as well as internal corporate policies and procedures.

It has been suggested by some that requiring minimum standards for all loan originators is unnecessary, but we strongly disagree. The creation and implementation of a national minimum standard for every mortgage originator, which functions as a baseline for all regulation and corporate policy is neither burdensome nor duplicative. Such a standard, when implemented across every distribution channel, will raise the bar for anyone currently failing to meet it, and impose no greater restrictions on any state or entity whose requirements already surpass it.

C. Consumers' Role and Responsibility as Decision-Maker

It is imperative, regardless of what measures are ultimately pursued, that we ensure that the integrity of the consumer decision-making process remains intact. Consumers are and must remain the ultimate decision makers regarding the product, price, and services purchased in conjunction with mortgage financing. Selecting a mortgage is a very personal choice, and *only* the consumer can determine whether a particular loan product is "suitable" for his or her financial needs and goals, or if it might be in his or her "best" interest to continue shopping. No

mortgage originator, company, bank, investor, or government agency should ever superimpose or be required to superimpose its own judgment for that of the consumer.

Consumers currently enjoy the freedom and responsibility to choose their own mortgage products, take advantage of the competitive marketplace, shop, compare, ask questions, and expect answers. No law or regulation should ever take away consumers' freedom to decide for themselves what is or is not a valuable loan product. NAMB remains opposed to any contemplated law, regulation or other measure that attempts to impose a fiduciary duty upon mortgage originators and strip consumers of their ability to freely choose the product, pricing, and services that meet their individual financial needs and goals.

Because of the proliferation of affiliated business arrangements and the blurring of once clear lines of delineation between distribution channels, consumers are finding it more difficult than ever to choose a mortgage originator and understand the role that the originator will play in their loan transaction. We believe consumers would benefit from a clear, upfront, and uniform disclosure of the role of the mortgage originator in a given transaction. To enhance consumers' ability to comparison shop, this uniform disclosure should be required to be given by every single mortgage originator (whether state or federally-chartered or supervised) at the onset of the consumer's mortgage shopping experience. In 1998, NAMB urged HUD to adopt this disclosure as part of the required disclosures under RESPA. In 2002 and in 2005, NAMB again requested HUD to adopt this disclosure. To date, HUD has not responded.

This disclosure must clearly communicate to the consumer one of the following:

- Your mortgage originator has a fiduciary obligation to the bank, lending source, or other entity and therefore cannot act exclusively in your best interests in this transaction;

- Your mortgage originator does not owe any obligation or duty to you or any other entity involved in this transaction (*i.e.*, the bank, lending source, or other entity), and is acting as an intermediary only;

- Your mortgage originator is willing to enter into an agency relationship with you, the consumer, through a binding contract that will make the originator your "agent."

We strongly believe that this simple, straight-forward, and universally required disclosure of the mortgage originator's role in specific transactions would eliminate any confusion on the part of consumers and strengthen consumers' bargaining position when shopping for a mortgage. Requiring all originators to clearly and accurately inform consumers of their role in the transaction will level the playing field and enhance consumers' ability and perhaps desire to comparison shop and find a loan product and originator they are comfortable with.

D. Simplified & Modernized Mortgage Disclosures

NAMB supports clear, consistent, and uniform communication with borrowers from the mortgage shopping stage, through consummation and afterwards, throughout the life of the loan. When designed and used appropriately, in conjunction with originator education and consumer

financial literacy efforts, disclosures alert potential borrowers to the risks and benefits presented by particular loan products and support meaningful comparison shopping. Although disclosures alone are not enough, proper disclosure of critical information can aid the consumer in making an informed choice of loan product.

Current disclosures have failed to keep pace with market innovations. Consumers are not being given the tools needed to effectively shop for a mortgage in a market that is offering increasingly innovative and complex options. This is why NAMB believes it is necessary to create a revised GFE and a new, loan-specific payment disclosure that will: (1) educate consumers about the specific loan product being considered and/or chosen, and (2) enable consumers to comparison shop and ultimately exercise an informed and independent choice regarding a particular loan product.

1. Revised Good Faith Estimate ("GFE")

In 2005, NAMB proposed a one-page GFE in response to a series of roundtables conducted jointly by HUD and the Small Business Administration. [14] This one-page GFE mirrors the HUD-1 consumers receive at settlement, communicates the loan features and costs, and fully discloses the role of the loan originator in the mortgage transaction. Most important, the revised GFE provides specific information that is most valued by consumers – meaningful closing costs and monthly payment.

This one-page GFE can help curb abusive and predatory lending tactics, such as bait-and-switch schemes, and safeguard homebuyers by clearly and objectively informing them of the role of the loan originator in the transaction, and granting them a private right of action against their loan originator.

2. Loan-Specific Payment Disclosure

There is currently no loan-specific disclosure given to borrowers that effectively communicates the variability of the interest rate and monthly payments for specific loan products. As a result, some borrowers are choosing mortgages without really understanding how much or how often their interest rate and payments can fluctuate. This leaves consumers open to confusion, unable to meaningfully comparison shop, and susceptible to "payment shock."

NAMB recognizes that there is a critical need for a uniform loan-specific disclosure, and that such a disclosure must be required across *all* distribution channels if it is to be effective. A model loan-specific disclosure form should clearly and concisely outline the material terms (*i.e.*, actual rate and payment adjustments under a "worst case scenario") of the specific products that a consumer is considering. We believe this information, when clearly and accurately disclosed to the borrower, minimizes the risk of consumer surprise or "payment shock" at subsequent interest rate adjustments.

NAMB strongly encourages Congress to urge the Federal Banking Agencies to adopt a model loan-specific disclosure form and require *all* loan originators to provide this form to consumers,

[14] *See,* Appendix B, "NAMB Proposed GFE."

regardless of loan-product type. We believe such a mandate can and should be accomplished through regulation, in order to speed its implementation and ensure its application across all distribution channels. Specifically, we believe a loan-specific disclosure can be required early in the loan shopping stage through RESPA, Regulation X (*e.g.,* it can accompany the initial GFE); and an additional loan-specific disclosure can be required at closing through the TILA, Regulation Z. As with any disclosure, NAMB strongly believes that a loan-specific disclosure should be consumer tested by an independent third-party or government agency prior to requiring that all mortgage originators provide this form to their customers.

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

E. Consumer Financial Literacy

NAMB believes consumers should possess the necessary financial knowledge to carefully evaluate the risks and rewards of different loan products. Financial literacy is the tool that consumers need to make an informed decision as to whether a particular product meets their individual needs. Financial literacy can also be valuable in helping consumers avoid default and foreclosure. If a consumer understands the risks and rewards of the product they choose, they will be more likely to understand their obligations under that product and the ramifications of any failure to satisfy those obligations.

Regardless of how knowledgeable a mortgage originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a loan product to match his or her financial needs and goals. Borrowers must possess a certain financial acumen to properly evaluate the risks and benefits of different mortgage products that have been highlighted and communicated by an educated mortgage originator. NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school level so that consumers are educated about the financial decisions they make and retain their decision-making ability. NAMB also supports utilizing funds raised from the national mortgage originator registry, discussed above, to support ongoing financial literacy programs in the states.

NAMB has always been a staunch supporter and advocate for consumer financial literacy. Our firm belief that an educated borrower is significantly less likely to fall victim to abusive lending practices or face foreclosure is demonstrated by our active involvement in various consumer education efforts. For example, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently managed by NAMB state affiliates in California, Florida and Texas. In 2003, NAMB partnered with United Guaranty to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low and moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more. Recently, NAMB introduced a pamphlet entitled "What Happens When Your Credit Report is Requested – Stop the Calls; Stop the Junk Mail; Protect Your Credit; Protect Your Identity." This consumer-oriented piece offers tips to avoid identity theft and provides valuable information about what to watch out for in prescreened

credit solicitations. NAMB is also preparing to finalize a new consumer brochure that offers some basic tips for first-time homebuyers and defines a number of key mortgage shopping terms.

We urge Congress, state and federal regulatory agencies, and others in the industry to continue to explore avenues of outreach to borrowers and work to educate borrowers on financial literacy throughout their lives, rather than just at the time of application or at the closing table.

VII. Conclusion

Consumers want to get loans they can afford and keep. Consumers want to know how much their monthly payment will be, if it will change and how much getting that loan will cost them at the closing table. The mechanics of this industry are complex. The mortgage market has evolved, forcing the distribution channels to become hyper-competitive. As a result, the lines between the distribution channels have blurred. This is why we advocate for an all-originator standard. Consumers deserve the same level of protection no matter who they choose to do business with.

Thank you for the opportunity to appear before this Subcommittee and discuss this timely issue. I am happy to answer any questions that you may have.

SOUTH CAROLINA DEPARTMENT OF CONSUMER AFFAIRS: MORTGAGE FRAUD REPORT

March 2007

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The US Attorney, South Carolina District
The FBI, Columbia Division
South Carolina Field Office, HUD
The Internal Revenue Service, South Carolina Office
South Carolina State Housing Finance and Development Authority

Stop Mortgage Fraud: A Call to Action Brochure

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Mortgage fraud is one of the fastest growing crimes in the United States. In their latest report, the Federal Bureau of Investigation (FBI) identified South Carolina as one of the top ten "hot spots" for mortgage fraud in the United States. **The South Carolina Attorney General further indicates that South Carolina has directly and disproportionately been targeted for this type of fraud.**

WHAT IS MORTGAGE FRAUD?

Mortgage fraud is a material misrepresentation, misstatement or omission that is relied upon by an underwriter or lender to fund, purchase, or insure a loan. Mortgage fraud is insidious, robbing homeowners and seniors of the equity in their homes and preventing first time home buyers from buying a home - the American Dream. Mortgage fraud also hurts the economy, since the housing industry has been its driving force in recent years. Therefore, we all lose. There are generally three motives for mortgage fraud: fraud for profit, fraud for housing and fraud to support or hide other criminal activity.

Fraud for profit is generally perpetrated by those inside the housing and mortgage industry. To be able to perpetrate the fraud requires the insiders to work together, resulting in a conspiracy. The list of those involved includes real estate agents and brokers, loan originators for mortgage brokers and lenders, homebuilders, appraisers, title insurance agents and closing attorneys, as well as others. **Cases in the last three years prosecuted by the United States Attorney's Office in South Carolina have resulted in convictions or plea agreements of over 80 individuals who were insiders as described above.** The fraudulent schemes include property flips, loans based on fictitious properties, misrepresenting investment property as owner-occupied property, misrepresenting or using the personal identity of others (identity theft), using false or forged documents very often through "straw buyers" to obtain a loan, and creating fictitious or nonexistent payees.

Fraud for housing is generally initiated either by a homebuyer or with their assistance so they can purchase or refinance a home. This type of fraud, although assisted by the homebuyer, generally results in huge profits for the insiders. Typically, the borrower will misstate income and/or expenses or forge documents to qualify for a mortgage or lower interest rates.

Fraud to support or hide other criminal activity, usually involves criminals using the mortgage industry to launder money or using the proceeds from a mortgage fraud scheme to fund other criminal activity. The fraudulent schemes include drug traffickers purchasing homes at inflated prices to launder money, terrorists buying safe houses and homes purchased for other criminal

activity, such as drug manufacture, prostitution, "chop shops" or counterfeiting. According to the FBI, criminals see the large sums of money in the mortgage industry as more profitable and less risky than other crimes.

WHAT IS CAUSING THE INCREASE IN MORTGAGE FRAUD?

The following information is excerpted from various reports on the mortgage industry and provides a historical perspective on the changes that are attributable to the increases in mortgage fraud experienced today.

The mortgage industry used to be a highly regulated business. Most mortgages were originated "in house" by banks and savings and loan companies. "In house" means bank employees originated the mortgages and the bank retained and serviced the mortgages. The banks and savings and loan companies were all highly regulated, primarily by federal regulators, however with the collapse of the savings and loan companies, new players entered the market. These new players included mortgage brokers and mortgage bankers. The mortgage brokers essentially took the place of the "in house," employee/originators, and the mortgage bankers provided the funding, wholesale lenders. Mortgage bankers either sell their mortgages in the secondary market or hold them. If they hold the mortgages they will either service them or sell the servicing rights to others. Other new players include joint ventures between banks and others in the housing industry, for example, real estate agents/brokers, homebuilders and others. The mortgage bankers, brokers and joint ventures, in most cases, are only regulated by the individual states. Until recently, most states did not regulate these industries, or if so, only minimally.

The mortgage industry has seen phenomenal growth, grossing approximately $400 billion in 1999 to between $2 and $4 trillion in 2006. Based on recent history, it appears this growth will continue. Additionally, the mortgage industry is very competitive; forcing those in the industry to cut their costs, reduce the time from origination to closing and to introduce new products. Cost cutting has seen a shift from quality control to production. Quality control is where you would expect questionable loans to be identified. Reducing the time to close has taken the human element, the experienced eyes that would detect fraud, out of the process. Additionally, the shift to automated underwriting, again takes quality control out of the equation. In some cases, the new products, such as low documentation and no documentation loans (low doc and no doc) being offered are more prone to fraud. Low doc and no doc loans require less or no verification of the applicant's income or assets.

With these conditions and the possibility of making extraordinary amounts of money, the industry attracts unsavory characters with little or no experience or regulatory oversight.

WHO PAYS FOR MORTGAGE FRAUD?

We all pay, directly or indirectly. Homeowners and homebuyers pay directly through increased costs for mortgages and higher property taxes as fictitious appraisals and property flips increase property values. Indirect costs include taxes and lender costs to fight and/or prevent such crimes. Lenders also pass on their increased costs to consumers.

WHAT IS THE EXTENT OF MORTGAGE FRAUD?

The short answer is we do not know. Primarily because there is not a single repository or clearing house for mortgage fraud information, the extent of mortgage fraud is unknown. This need has been recognized by the FBI, industry and state regulators as a shortfall.

The FBI obtains their information based on Suspicious Activity Reports (SARs), however, only federally regulated entities are required to file SARs. Regardless, there is an increase in the number of SARs filed nationally, from 62,388 in 1996 to 522,655 in 2005. The latest report from the FBI states 279,703 SARs were filed in the first six months of 2006, with the expectation that 2006 will break all records. Also in this report, the FBI indicated South Carolina is one of the "Top Ten Hot Spots" for mortgage fraud. Additionally, the report shows that the foremost occupations for the fraudsters as finance related, including mortgage brokers, lenders and their employees. The types of fraudulent mortgage loan activity reported included falsification of the loan application, identify theft/fraud, misrepresentation of loan purpose or misuse of loan proceeds, appraisal fraud, fraudulent flipping of property and fraud involving multiple loans.

The Mortgage Asset Research Institute (MARI) is another source of information on mortgage fraud. MARI receives information primarily from subscribers, primarily mortgage lenders, therefore the data is not complete, but it paints a bleak picture as well. MARI attributes some of the reported mortgage fraud on the following factors: high origination volumes have strained lenders quality control processes, companies concentrating on production demands, assigning new, less trained staff in production where seasoned employees might detect mortgage fraud and the introduction of non-traditional products with less

quality control. MARI ranks individual states based on a mortgage fraud index. From 2001 through 2004, MARI reported South Carolina in the top ten in the United States in mortgage fraud. However in their latest report South Carolina has moved to number nineteen. An improvement, but we should not be satisfied, last place is our goal. To achieve this goal, we need to move forward with additional measures to further reduce mortgage fraud.

The FBI and MARI both agree that mortgage fraud is on the increase. A concerted effort is necessary to combat mortgage fraud; otherwise it could cripple the industry and prevent every American's dream of home ownership.

WHAT HAVE WE DONE IN SOUTH CAROLINA?

On June 3, 2003, South Carolina's Governor signed the South Carolina High Cost and Consumer Home Loans Act (the Act), with an effective date of January 1, 2004. This historic legislation's purpose was to curb abusive residential mortgage lending practices in South Carolina. Added to the Consumer Protection Code, the Act gave the Department of Consumer Affairs (Department) the primary responsibility for its enforcement. The Act is very similar to the Predatory Lending Act (PLA) in North Carolina. However, North Carolina soon realized that the PLA was not enough. Additional legislation was required to set minimum standards for all elements of the industry - lenders and brokers alike; and to give the State the authority necessary for enforcement. The solution was the Mortgage Lending Act (MLA). The MLA was a collaborative effort of consumer advocates, industry leaders and lawmakers. Without this comprehensive licensing law, authorities were unable to find those in violation of the PLA. In South Carolina, we find ourselves facing the same problem.

On January 13, 2005 Act Number 7, amendment to Title 40 Chapter 58, Licensing Requirements Act of Certain Brokers of Mortgages on Residential Real Property became law. The amendment required the licensing of originators for Mortgage Brokers and established minimum standards to be licensed. These standards provided a threshold for a segment of the industry and the Department enforcement authority. Prior to passage of this legislation no minimum standards, in experience or education, or a mechanism to check even state criminal records for originators employed by mortgage brokers existed. However, this was only the first step necessary for regulation and enforcement in the mortgage industry. **Mortgage lenders and their originators are basically unregulated. There is no oversight by the State. Additionally, first mortgages and junior liens less than 12% have little or no protections for consumers under the Consumer Protection Code. Most mortgages in today's market are funded and in some cases originated by non-depository mortgage bankers,**

who in most cases are only regulated by the individual states. In South Carolina, that regulation is missing.

The South Carolina Department of Consumer Affairs, in coordination with the North Carolina Commissioner of Banks, the Georgia Department of Banking and Finance, the Florida Office of Financial Regulation and the Department of Housing and Urban Development (HUD) (Southeastern Region) sponsored a mortgage fraud conference in Savannah, Georgia on June 22, 2006. The conference, Stop Mortgage Fraud, Spot it! Stop it!, was attended by state and federal regulators and law enforcement, including the sponsors, the FBI, the US Attorney for SC and NC, other law enforcement and regulators, and industry professionals. The conference resulted in increased cooperation and information sharing between all participants to combat mortgage fraud. As an example, the Department has referred several cases to the FBI, IRS and the Secret Service in recent months and routinely shares information with other state regulators.
(SEE ATTACHMENT)

In addition, the Department has sponsored and conducted numerous classes on detecting and preventing mortgage fraud. These classes were given to mortgage professionals in South Carolina. Also the Department participates in other educational events such as the Palmetto Affordable Housing Forum. Lewis Burns, Chair of the Department's Mortgage Broker Advisory Board said, "We still have a lot of work to do and I look forward to working with the Department in making South Carolina a state free of mortgage fraud."

HOW DO WE COMBAT MORTGAGE FRAUD?

We combat mortgage fraud by using a two-pronged approach: First, identify and prohibit known perpetrators from engaging in business, then investigate and prosecute the perpetrators.

To identify and prohibit known perpetrators (fraudsters), requires a licensing process that includes national records checks, including FBI and state criminal records and adjudicated enforcement actions by licensing authorities in other states. Fraudsters are known to be mobile, moving from one state to another, and migrating from one industry to another. For example, an investment adviser in South Carolina lost his securities license as a result of converting an investors funds to his own. This person then changed to the mortgage industry and was recently prosecuted for mortgage fraud. The licensing must include loan originators whether employed by mortgage brokers or lenders, first and second mortgage lenders and mortgage servicing companies. **(See Comparison of SC and NC licensing laws at Attachment)** The mortgage industry has become for the most part, national and even international in scope but regulation and enforcement should remain with the state where the actual

damage is felt. We looked at other states' laws, including North Carolina, and believe that there can be a balance between necessary regulation and any burden to the industry. **(See Attachment that show states that regulate mortgage brokers, lenders and services)**

We have also been working with our national associations, American Association of Residential Mortgage Regulators (AARMR) and the Conference of State Bank Supervisors (CSBS) to develop a National Licensing System. It is intended to be a web-based licensing application system that would be used by all states and make available licensing and adjudicated actions against a licensee to all states in which a license is sought. This will help curb fraudsters and bad actors from moving from one state to another as they do now.

The member states are also working to increase uniformity for licensing and regulation of the mortgage industry. We believe that this initiative will help lessen the burden on the industry as well. HSBC's Presentation to the National Conference of State Legislatures reinforces this concept. Furthermore, another area of concern is mortgage servicing. The Department receives a significant number of consumer complaints related to mortgage servicing, another part of the mortgage industry that is essentially unregulated, but affects our largest investment, our home.

To effectively prosecute requires a clearinghouse for all suspected mortgage fraud and a coordinated effort to investigate and prosecute the perpetrators, including local, state and national authorities. The Department is already working with state and national authorities, including the Attorney General of South Carolina, the FBI, the Secret Service, the IRS, the US Attorney's Office and HUD in this effort. We have formed a mortgage fraud task force and have started sharing information. More needs to be done; we need the assistance of local and state law enforcement and solicitors in the investigation and prosecution of perpetrators. In addition, state and local law enforcement need clear authority and guidance on the crime of mortgage fraud. And finally, the Department needs the law changes previously identified to assist in enforcement actions and identifying the fraudsters.

RECOMMENDATIONS

- Enact a Comprehensive Mortgage Lending Act
- Consider Participation in the National Licensing System
- Continue working with other states to develop uniformity in licensing and regulation of the Mortgage Industry
- Assist in establishing a National Clearinghouse for Reporting suspected mortgage fraud that includes a toll-free number.

TIPS TO PREVENT YOU FROM BECOMING A VICTIM OF MORTGAGE FRAUD

General Tips:
If it sounds too good to be true – it probably is!

Never sign a blank document or a document containing blanks. This leaves you vulnerable to fraud.

Don't sign anything you don't understand.

Mortgage Fraud Prevention Tips:
Get referrals for real estate and mortgage professionals. Check the licenses of the industry professionals with state, county, or city regulatory agencies.

Be suspicious of outrageous promises of extraordinary profit in a short period of time.

Be wary of strangers and unsolicited contacts, as well as high-pressure sales techniques.

Look at written information to include recent comparable sales in the area and other documents such as tax assessments to verify the value of the property.

Understand what you are signing and agreeing to. If you do not understand, re-read the documents or seek assistance from an attorney.

Make sure the name on your application matches the name on your identification.

Review the title history to determine if the property has been sold multiple times within a short period. It could mean that this property has been "flipped" and the value falsely inflated.

Know and understand the terms of your mortgage. Check your information against the information in the loan documents to ensure they are accurate and complete.

KEY TERMS OF FRAUD SCHEMES

Backward Applications: After identifying a property to purchase, a borrower customizes his/her income to meet the loan criteria.

Air Loans: These are non-existent property loans where there is usually no collateral. An example would be where a broker invents borrowers and properties, establishes accounts for payments and maintains custodial accounts for escrows. They may set up an office with a bank of telephones, each one used as the employer, appraiser, credit agency, etc., for verification purposes.

Silent Seconds: The buyer of a property borrows the down payment from the seller through the issuance of a non-disclosed second mortgage. The primary lender believes the borrower has invested his money in the down payment when, in fact, it is borrowed. The second mortgage may not be recorded to further conceal its status from the primary lender.

Nominee Loans: The identity of the borrower is concealed through the use of a nominee who allows the borrower to use the nominee's name and credit history to apply for a loan.

Property Flips: Property is purchased, falsely appraised at a higher value, and then quickly sold. What makes property flipping illegal is that the appraisal information is fraudulent. The schemes typically involve fraudulent appraisals, doctored loan documents, and inflation of the buyer's income.

Foreclosure schemes: The subject identifies homeowners who are at risk of defaulting on loans or whose houses are already in foreclosure. Subjects mislead the homeowners into believing that they can save their homes in exchange for a transfer of the deed and up-front fees. The subject profits from these schemes by re-mortgaging the property or pocketing the fees paid by the homeowner.

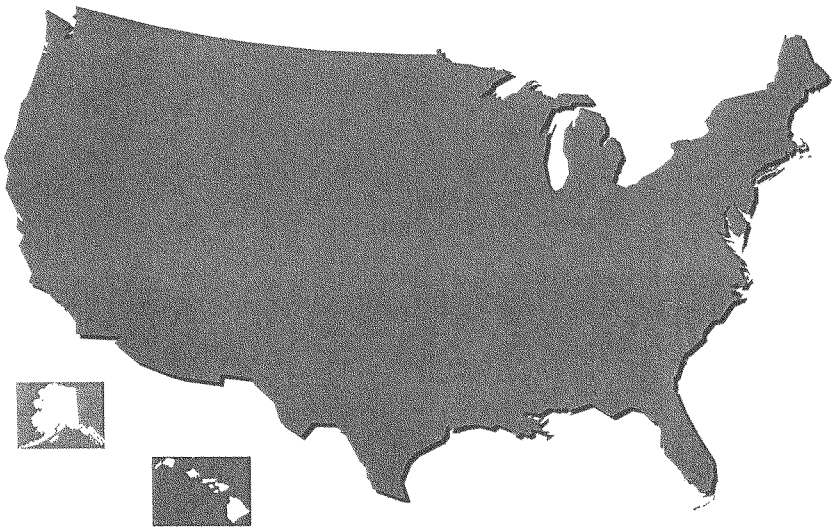
Equity Skimming: An investor may use a straw buyer, false income documents, and false credit reports to obtain a mortgage loan in the straw buyer's name. Subsequent to closing, the straw buyer signs the property over to the investor in a quit claim deed which relinquishes all rights to the property and provides no guaranty to title. The investor does not make any mortgage payments and rents the property until foreclosure takes place several months later.

COMPARISON OF SOUTH CAROLINA AND NORTH CAROLINA LAWS RELATED TO THE MORTGAGE INDUSTRY

Mortgage Brokers	South Carolina	North Carolina
Broker License	Yes	Yes
Originator License	Yes	Yes
Licensee Testing	**No**	Yes
Prelicensing Education	**No**	Yes
Continuing Education	Yes	Yes
Criminal records check	SC only, no fingerprints	NC and FBI, requires fingerprints
Surety bond	$10,000	$50,000
Registration for exemptions	**No**	Yes

Mortgage Bankers/Lenders	South Carolina	North Carolina
Lender License	Only for 2nd Mortgages greater than 12% (Supervised Lender)	Yes
Originator License	**No**	Yes
Licensee Testing	**No**	Yes
Prelicensing Education	**No**	Yes
Continuing Education	**No**	Yes
Criminal records check	**No**	NC and FBI, requires fingerprints
Surety bond	0	$150,000
Registration for exemptions	**No**	Yes

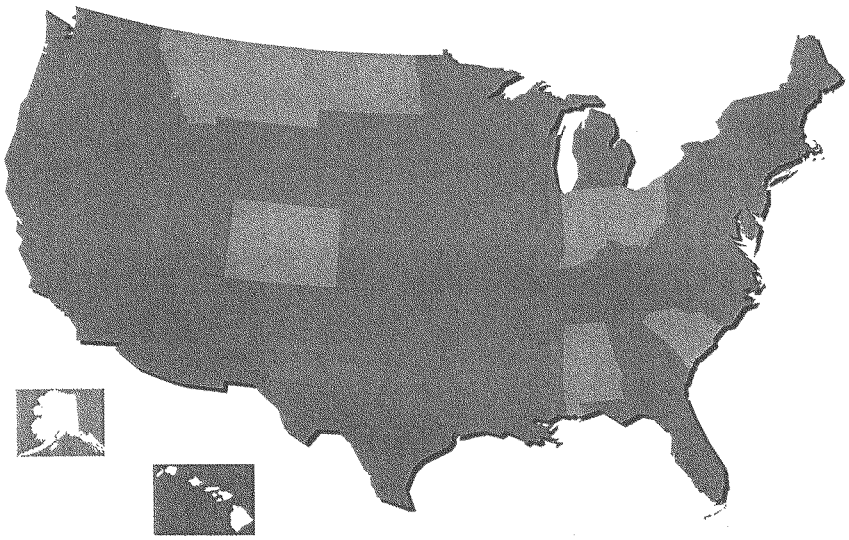
US MAP SHOWING STATES THAT REGULATE MORTGAGE BROKERS



States that regulate Mortgage Brokers are shown in green

States that do not regulate Mortgage Brokers are shown in red

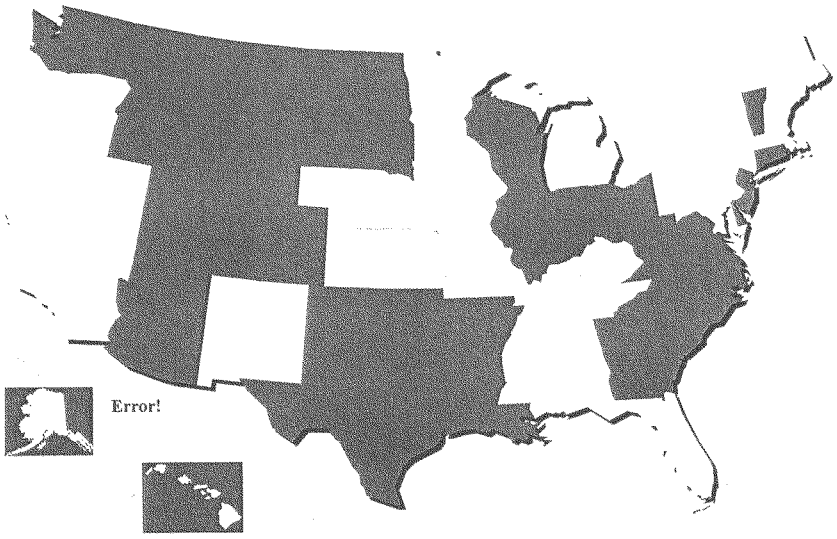
US MAP SHOWING STATES THAT REGULATE MORTGAGE BANKERS/LENDERS



States that regulate Mortgage Bankers/Lenders are shown in blue

States that do not regulate Mortgage Bankers/Lenders are shown in red

US MAP SHOWING STATES THAT REGULATE MORTGAGE SERVICERS



States that regulate Mortgage Servicers are shown in yellow

States that do not regulate Mortgage Servicers are shown in green

SOUTH CAROLINA
STATE HOUSING
FINANCE AND DEVELOPMENT AUTHORITY

Division: Special Projects

Subject: High Cost Home Loan Counseling Program

Calendar Year 2005 Update

The Legislation
On June 3, 2003, Governor Mark Sanford signed into law the South Carolina High Cost and Consumer Home Loans Act (Act No. 42) in an effort to protect consumers from predatory lending practices. Under the new law, borrowers seeking a "high cost home loan" must be advised by the lender that free counseling by an approved counselor is required before securing the loan. Along with definitions and procedures, the law also includes provisions for both enforcement and education. These are key provisions for the success of the law. Subsequently, the South Carolina Department of Consumer Affairs was tasked with enforcement of the law and the South Carolina State Housing Finance and Development Authority was tasked with educating consumers about the law, primarily in the form of consumer counseling.

The Loan
The law addresses loans that include home mortgages, such as first mortgages, mobile home and land, purchase money and home improvements and manufactured homes without land, auto title lenders and mortgage brokers. Aside from traditional loan closing procedures, those loans that are considered "high cost home loans" also have additional requirements specifically related to borrower counseling. That counseling is facilitated by the use of a checklist. The checklist is a list of items each counselor will cover with the borrower including questions regarding the borrower's individual circumstances, the terms of the loan, the fees of the loan and any other information deemed appropriate.

A High Cost Home Loan has the following components: having a principal amount that does not exceed the Fannie Mae conforming loan size limit for a single-family dwelling; is incurred for primarily personal, family, or household purposes; is secured either by a security interest in a manufactured home or a mortgage on real estate upon which there is or there is to be located a structure designed principally for occupancy for 1-4 families and which will be occupied primarily as a principal dwelling; and meets one of two thresholds. The thresholds are: Interest Threshold, first mortgage – 8% over US Treasury securities, second mortgage and manufactured housing – 10% over US Treasury securities; or, Points and Fees Threshold, loans greater than $20,000 – 5% of the loan, loans less than $20,000 – 8% of the loan, non-real estate manufactured homes – 3% of the loan.

The Borrower
The law was enacted to protect South Carolina's most vulnerable citizens. Typically, "high cost home loan" borrowers fall into one or more of the following categories: poor credit and/or insufficient collateral and either thinks or actually is incapable of being financed by a more traditional lender; good credit, but thinks he/she has bad credit; good credit, but trusts the high cost lender more or is hesitant to use a traditional lender; or, needs money quickly and feels a traditional lender would be too slow. It is because of these perceptions and 'feelings' that the role of the counselor becomes so critical. Some may be completely inaccurate and burden the borrower with unnecessary risk.

The Counselor
A High Cost Home Loan Counselor is primarily an educator. According to the law, the counselor is to counsel "...on the advisability of the loan transaction and the appropriate loan for the borrower." The South Carolina Department of Consumer Affairs has interpreted this to mean that "...the counselor's role should be that of an educator, facilitating the borrower's awareness of the loan's terms and costs."

The criteria for becoming a counselor is experience in housing counseling, credit or financial counseling, or a background in the mortgage lending industry – although a counselor must not have any current interest or affiliation with any lenders – attendance of a training session and signing of the Counselor's Assurance, which assures that the counselor will act in the best interest of the borrower, will neither collude with nor act on behalf of any lending institution and will conduct themselves professionally. With tools such as the Truth in Lending Disclosure, a good faith estimate of closing costs and a copy of the borrower's credit reports, the counselor educates the borrower on the terms of the loan, the importance of credit and other financial implications. It is the end-goal of the counselor, though, that is the most critical: to convey to the borrower the risks associated with high cost home loans.

The Program
The inception of the High Cost Home Loan Counseling Program was January 1, 2004 when the South Carolina High Cost and Consumer Home Loans Act became effective. For the first year, counselors were volunteers and were not compensated for their sessions conducted. In January 2005, The Board of Commissioners of the Authority decided to begin compensating counselors for their efforts. Compensation was set according to a determined schedule. Aside from these actions and the increase in recruitment with corresponding training, no major changes were instituted in the program in 2005.

Following is a review of the program since its inception.

Table 1. Measures of High Cost Home Loan Program Since Inception Presented by Calendar Year

Measure	2004	2005	2006	2007
Number of Sessions for	200	142		

Calendar Year				
Number of Sessions for First Quarter	37	38		
Number of Sessions for Second Quarter	63	35		
Number of Sessions for Third Quarter	54	42		
Number of Sessions for Fourth Quarter	46	27		
Number of Counselors	74	73		
Percent of Counselors Participating	51%	29%		
Number of Counties with Sessions	28	*		
Percent of Loans Less Than $20,000	69%	63%		
Percent of Loans Greater Than $50,000	8%	3%		
Percent of Loans for Debt Consolidation	43%	30%		
Percent of Loans for Home Improvement	29%	21%		
Percent of Loans for First Lien	85%	92%		
Percent of Loans for Refinance	32%	32%		
Average Amount Borrowed	$16,583.00	$18,741.00		
Highest Amount Borrowed	$180,000.00	$258,504.00		
Least Amount Borrowed	$2,300.00	$2,907.00		
Cost of Counseling Program**	$0.00	$7,590.00		

* Data is not available for the referenced year.
** Cost is based solely on invoices submitted to SCSHFDA by High Cost Home Loan Counselors. In 2004, counselors were volunteers.

Conclusion

The activity in the High Cost Home Loan Counseling Program seems to have dropped significantly, as has the participation of the counselors. Most of the other indicators for 2005 appear to be of an approximate level with 2004, varying more in the mix of the categories than in the categories themselves. The Authority staff will continue to develop more appropriate measures of the effectiveness of the program, including conducting open sessions for discussing issues that have arisen for counselors in the course of their provision of services, periodic updates to participating counselors and inclusion of information sessions during the Palmetto Affordable Housing Forum. Since the nature of the responsibility of the Authority in this legislation is to provide consumers with adequately trained counselors who can advise them on the appropriateness of the loan, no effort has been made to gather information on the effectiveness of the legislation; merely on the effectiveness of the educational program.

U.S. Department of Justice

United States Attorney

District of South Carolina

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Reply to: Columbia

October 2, 2006

Brandolyn Thomas Pinkston
Administrator
SC Department of Consumer Affairs
P.O. Box 5757
Columbia, SC 29250

Re: Mortgage Fraud Consumer Report

Dear Ms. Pinkston:

As you prepare your report on mortgage fraud to consumers in South Carolina, please consider for inclusion the following from the United States Attorney's Office, District of South Carolina:

The United States Attorney's Office, District of South Carolina, has actively prosecuted individuals involved in mortgage fraud, with approximately 80 convictions obtained over the last three years across the state. Federal law prohibits providing false information to a bank in connection with a mortgage loan, and authorizes sentences of up to 30 years in prison and a fine of $1,000,000.00. Federal agencies that investigate mortgage fraud include the FBI, Secret Service, IRS, the Postal Inspector, and the Department of Housing and Urban Development (HUD).

Those prosecuted in South Carolina for mortgage fraud include mortgage brokers, loan officers, developers, appraisers, real estate agents, closing attorneys, paralegals, and borrowers. In each case, the individual convicted played a role in misleading the mortgage lender as to the true nature of the transaction at issue, and usually a coordinated effort was undertaken by two or more individuals in the deception. For example, in Columbia last year a developer and appraiser conspired to fraudulently inflate the value of a residence, while in Anderson a mortgage broker and loan officer conspired to hide from the bank a borrower's debts on loan applications. In both cases, the respective lender was misled by the false

information, and those involved were held responsible.

Recent cases handled by the U.S. Attorney's Office included frauds involving: (1) false submissions to lenders concerning the creditworthiness of borrowers; (2) inflated appraisals; (3) illegal flip transactions, in which properties were bought at low prices, then immediately resold at falsely inflated prices; and (4) fraudulent refinancing transactions. In each case, false information was relied upon by the lender in making loans to otherwise unqualified borrowers to purchase or refinance over-valued houses. The illicit proceeds were often taken by the perpetrators as bogus repair or renovation costs, unearned commissions, or false creditor pay-offs. The borrowers victimized by these mortgage frauds found themselves owing more on their houses than they were worth, and saddled with monthly mortgage payments they couldn't afford. They ultimately defaulted on their mortgages and abandoned their homes, which adversely affected the values of neighboring homes.

Consumers considering a real estate transaction should be wary of unscrupulous individuals that purport to be working for the consumer, but who in fact are only interested in obtaining a share of the bank's loan proceeds for themselves. These individuals may attempt to convince potential mortgage loan borrowers that there is nothing wrong with omitting poor credit information on loan applications, or providing the lender with documents that misrepresent the condition and value of properties to be purchased. Consumers should realize that such activity is illegal, and can result in federal prosecution for a knowing participation in mortgage fraud. A key point for consumers to remember is that honest real estate professionals will never ask potential borrowers to lie about anything. Should such a request be made, borrowers are urged to contact law enforcement and the S.C. Department of Consumer Affairs immediately.

I hope this submission proves helpful. If you require anything further, please contact me.

Sincerely,

REGINALD I. LLOYD
UNITED STATES ATTORNEY

By _____
Kevin F. McDonald
Chief Assistant United States Attorney
General Crimes Section
1441 Main Street, Suite 500
Columbia, South Carolina 29201
(803) 929-3000

Mr. William Dudley Gregorie, Former Field Office Director, US Department of Housing and Urban Development (HUD) stated that "Mortgage fraud was one of the fastest growing crimes in America" with the number of pending cases nearly doubling in the past three years." One of the most common mortgage fraud schemes is to sell a home at a hugely inflated price, relying on phony appraisals.

A property is acquired at a low or modest price and little or no rehabilitation repairs are performed. The house is then placed on the market at a much higher price of up to several times the acquisition cost. The new price is supported by a bogus appraisal. This type of property flipping is a crime that takes the collusion of several parties to pull off," Gregorie states. "That's why when you see cases of flipping mortgage fraud, you'll usually find some combination of real estate brokers/agents, appraisers, and mortgage brokers involved.

New anti-flipping rules instituted by HUD for FHA mortgages have taken effect that restrict property flipping. Properties must be owned for ninety days before resale and the costs of repairs and improvements must be documented. These changes in policy have reduced mortgage fraud in property flipping resales." Mr. Gregorie also cited the work of HUD's approved Housing Counseling Agencies through their homebuyer education programs. "More knowledgeable purchasers have contributed to a reduction of Mortgage Fraud in South Carolina."

The U.S. Department of Housing and Urban Development, Atlanta Region and its partners including the South Carolina Department Consumer Affairs Office sponsored free symposium for Mortgage Professionals on "Stop Mortgage Fraud". Recent published and broadcast news reports highlight many cases of mortgage fraud. Georgia, Florida, North Carolina, South Carolina are among the top five states in the Nation where mortgage fraud was most prevalent. The Symposium and the news media increased awareness of fraud by identifying all types of fraud within the single family housing industry, fostered relationships with other industry partners, and raised consumer awareness.

IRS Nationwide Enforcement Actions Real Estate Fraud

Real Estate Fraud: Facts, Figures and Closed Cases

IRS Criminal Investigation (CI)
October 2006

Special agents with IRS Criminal Investigation are uniquely equipped to investigate mortgage fraud and illegal real estate crimes.

When times are booming, you can expect to see increases in frauds and schemes that victimize people and businesses, including struggling low-income families lured into home loans they cannot afford, legitimate lenders saddled with over-inflated mortgages and honest real estate investors fleeced out of their investment dollars.

IRS criminal investigators find common real estate schemes, which include:

- **Property Flipping** — A buyer pays a low price for property, and then resells it quickly for a much higher price. While this may be legal, when it involves false statements to the lender, it is not.
- **Two Sets of Settlement Statements** — One settlement statement is prepared and provided to the seller accurately reflecting the true selling price of the property. A second fraudulent statement is given to the lender showing a highly inflated purported selling price. The lender provides a loan in excess of the property value, and after the loans are settled, the proceeds are divided among the conspirators.
- **Fraudulent Qualifications** — Real estate agents assist buyers who would not otherwise qualify by fabricating their employment history or credit record.

In these real estate fraud cases, the income earned from these schemes is often laundered to hide the proceeds from the government. Money laundering is simply a process of trying to make money earned illegally to look like it was legitimately earned. Many criminal tax investigations focus on money laundering because it is often inseparable from tax evasion.

In addition, the IRS has thousands of returns under audit involving individuals and entities associated with the real-estate business.

As the following statistics indicate, IRS criminal investigations of real estate

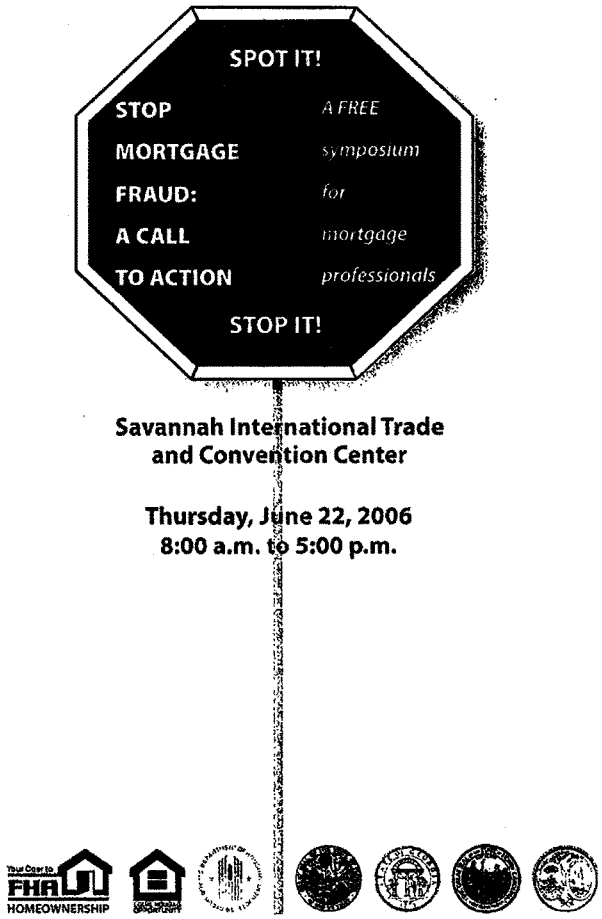
fraud continue to be an area of concern.

IRS Criminal Investigation
Real Estate Fraud Statistics

	FY 2004	FY2003	FY2002
Investigations Initiated	194	215	194
Prosecution Recommendations	148	117	148
Indictments/Informations	102	94	102
Convictions	89	81	89
Sentenced	78	65	78
Incarceration Rate*	92.3%	87.7%	92.3%
Avg. Months to Serve	41	46	41

*** How to Interpret Criminal Investigation Data**
Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year. Therefore, in fiscal year 2004, the data should reflect an increase in convictions and sentenced due to the fiscal year 2003 increase in case initiations, prosecution recommendations and indictments.

***Incarceration may include prison time, home confinement, electronic monitoring, or a combination.**


SPOT IT!
STOP
MORTGAGE
FRAUD:
A CALL
TO ACTION
A FREE
symposium
for
mortgage
professionals
STOP IT!
Savannah International Trade
and Convention Center
Thursday, June 22, 2006
8:00 a.m. to 5:00 p.m.
FHA
HOMEOWNERSHIP

STOP MORTGAGE FRAUD: A CALL TO ACTION
Savannah, Georgia
June 22, 2006

8:00-9:00 **Registration & Exhibits Open**

9:00-9:40 **Opening Session**

Introduction of Mayor Pro-Tem
Pattie Wainwright
President, Mortgage Bankers Association of Georgia, Savannah Chapter

Welcome to Savannah
Edna Jackson
Mayor Pro-Tem, Savannah, Georgia

Welcome
"Everyone pays for mortgage fraud."
Bob Young
Regional Director, Region IV, Department of Housing and Urban Development

Why Are We Here
"You can't stop mortgage fraud if you don't know what it is."
Brandolyn Thomas Pinkston
Administrator, South Carolina Department of Consumer Affairs

9:50-12:10 **Where Fraud Begins**

Moderator
"Mortgage fraud has been rapidly increasing over the last several years, and in North Carolina, we believe that the government and industry must work together to address the problem."
Tami Hinton
Director of Consumer Affairs, NC Office of the Commissioner of Banks

Money Laundering - How to Spot It
"Don't let dirty money ruin your reputation, your business, or your profession."
John Atkinson
Assistant Vice President, Federal Reserve Bank of Atlanta

Mission Possible: Preventing Fraud from a Lender Perspective
"Fraud: The dirty side of our business. Don't be a victim or a participant."
Susan Billings
CTX Mortgage

Recent Interviews: Prevention of Fraud from the Real Estate Agents View
"Zero Tolerance"
Grant Simon
President, First Florida Home Loans

Tainted Transactions
"Because that's where the money is."
Seth Weissman
General Counsel, Georgia Association of REALTORS

Regulatory Compliance Investigation and Inflated Property Values
"The real estate and lending regulatory agencies are at war with an elusive enemy identified as fraud, and currently it is believed by many that fraud is winning."
Larry Disney
President, Association of Appraiser Regulatory Officials

10:50-11:10 **Break - Exhibits Open**

Prevention from the Victim's View

"Mortgage fraud is a crime that devastates neighborhoods and destroys naïve 'investors'. It can only be stopped by the combined efforts of each segment of the industry using every available tool and resource."
Ann Fulmer
Vice President, Industry Relations, Interthinx

Results of Fraud- Who Is the Real Victim

"When interest rates rise, the potential for fraud also rises."
Debbie Kidd
Housing Director, Homeownership Resource Center, Family Services, Inc.

Over Reliance on Technology - What Lenders are Missing

"Because quality loans come from quality lenders."
Arthur Prieston
Chairman, The Prieston Group

ID and Income Fraud Detection

"Although technology intended to improve consumer services, it has also supported a new boldness by perpetrators of misrepresentation. There's a growing selection of powerful tools that lenders can use NOW to detect and protect against loss."
Robert Knuth
President, NCS/ National Credit-reporting System, Inc.

Questions and Answers

12:10 - 1:25 Luncheon - Exhibits Open

"I firmly believe that one of the best ways to prevent fraud is to have educated consumers. That's why we at FHA are trying very hard to get the word out about FHA products FHA products are designed to protect the consumer and the more folks know to ask for an FHA loan, the better off they are."
Brian Montgomery
FHA Commissioner, Department of Housing and Urban Development

Mortgage Fraud 2005 Trends

"Mortgage Fraud - Where and What's Hot"
Merle Sharik
Manager, Business Development, Mortgage Asset Research Institute, Inc.

1:25-3:00 **How Fraud Gets To Closing - Everyone's Obligations**

Moderator

"Fighting mortgage fraud—government and secondary market expectations"
Alfred Pollard
General Counsel, Office of Federal Housing Enterprise Oversight

What Is Being Done To Resist Mortgage Fraud

"Preventing mortgage fraud takes commitment AND imagination."
William Brewster
Director, Anti-Fraud Initiatives, Fannie Mae

What Expectations are of Market Participants

"If it sounds too good to be true, it IS too good to be true."
Jenny Brawley
Lead Fraud Investigator, Freddie Mac

Top Ten List: What Brokers Can Do to Stop Mortgage Fraud, "The Buck Stops Here!"

"To combat mortgage fraud, each party to the transaction must adhere to the motto, 'The Buck Stops Here!'"
Loretta Salzano
President, Franzen and Salzano, P.C.

The Role of Closing Attorneys in Mortgage Fraud and Expectations of State Regulators

"In S.C. you cannot have meaningful mortgage fraud without the assistance, whether knowingly or unknowing, of an attorney".
Henry Richardson
Disciplinary Counsel, Office of Disciplinary Counsel, Supreme Court of South Carolina

Fraud Affects All Market Participants

"Mortgage fraud - not a victimless crime."
Paul Lee
Chief Investigator, Office of Disciplinary Counsel, Supreme Court of South Carolina

"Mortgage Fraud-- Stealing the American Dream & Working Together to Stop It."

"Mortgage fraud is stealing the American Dream."
Charles Knight
Staff Attorney, South Carolina Department of Consumer Affairs

Questions and Answers

2:55-3:15 **Break**

3:15- 4:55 **Enforcement- After the Crime**

Moderator

"We owe it to the American public to constantly be alert for those who prey on the mortgage industry to illegally enrich themselves. Law enforcement and the industry must cooperate with one another and hold offenders accountable."
Michael Stephens
Deputy Inspector General, Department of Housing and Urban Development

"Stings by the FBI"

"One of the cornerstones of the American way of life is home ownership. Confronting and prosecuting those who strive to defraud and manipulate this aspect of American life is a priority for the FBI."
Brian Lamkin
Special Agent in Charge, Columbia Division, Federal Bureau of Investigation

"Shell Companies - Moving Money Off The HUD 1"

"The Shell Saga, a/k/a "scheme du jour:" the current alternative to the Classic Flip where fraudulently inflated loan proceeds are disbursed to shells companies listed on the HUD 1."
Gale McKenzie
Assistant U.S. Attorney, Northern District of Georgia, U.S. Attorney's Office

"Professionals Making Money Through Fraud"

"We prosecute dishonest brokers, appraisers and lawyers who participate in mortgage fraud because such schemes cannot succeed for long without their help and complicity."
Michael Savage
Chief, Criminal Division, Western District of North Carolina, U.S. Attorney's Office

"Flipping Schemes"

"Joining Forces and Combining Resources Can Significantly Impact Flipping Fraud."
Ruth Valdes,
Assistant Special Agent in Charge, Office of Inspector General, Miami Office, Department of Housing and Urban Development

"Crooked Sellers and Builders"

"Sellers, particularly builders, are the newest culpable group to join the ranks of mortgage fraudsters - happily selling homes at grotesquely inflated values and then kicking money back to other fraudsters."
David McLaughlin
Assistant Attorney General, Office of the Attorney General of Georgia

"Role of State Regulatory Agencies in Preventing Fraud"

"Mortgage Fraud - It can be prevented with your help!"
Andy Grosmaire
Financial Administrator, Bureau of Finance Regulation, State of Florida

Quality Control

"Mortgage Fraud- is like an infectious disease, if left untreated it will continue to spread."
Verlon Shannon
Director, Quality Assurance Division, Atlanta Homeownership Center, Department of Housing and Urban Development

Questions and Answers

4:55- **Closing Remarks and Wrap Up**

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North Carolina Commissioner of Banks
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Interthinx
NAREB
NeighborWorks
Verification Bureau, Inc./Prevent Mortgage Fraud
Quality Mortgage Services
Rural Development (USDA)
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Morton Associates
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Archie Mae
Charlotte Regional Realtor Association Housing Opportunity Foundation

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APPENDIX B

US Department of Housing and Urban Development

Uniform Good Faith Estimate Statement

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

Settlement Charges:		**Summary of the Borrower's Transaction:**	
800: Items Payable in Connection With The Loan:		Contract Purchase Price	
801 Loan Origination Fee (%) to:		Existing Loan Amount to be Paid Off	
802. Loan Discount Fee (%) to:		Personal Property	
803 Appraisal Fee to:		Total Settlement/Closing Cost Charges to Borrower(s): **1400 A**	
804 Credit Report Fee to:		Total Pre-Paids/Reserves Charged to Borrower(s): **1400 B**	
805: Lender's Inspection Fee to:			
806 Application Fee to:		**Gross Amount Due From Borrower(s):**	
807 Flood Certification Fee to:		<Deposit of Earnest Money>	( )
808 Mortgage Banker Fee (%)		<Principal Amount of new loan(s)>	( )
809 Tax Service Fee to		<Seller Paid Closing Cost Credit(s)>	( )
810. Processing Fee to		<Subordinate Loan Proceeds>	( )
811: Underwriting/Admin Fee to:		<Other Credit(s)>	( )
812: Wire Transfer Fee to:		**Amounts Paid By or In Behalf of Borrower(s):**	( )
813:			
900: Items Required By Lender To Be Paid In Advance		**Cash at Settlement Due From/To Borrower(s):**	
901: Interest for ____ days at $_____ /day			
902 Mortgage Insurance Premium for ____ mos. to _____		**Proposed Payment(s):**	
903 Hazard Insurance Premium for ____ mos. to _____		1st Mortgage: ☐Principal & Interest pmt ☐ Interest Only pmt	
904 Flood Insurance Premium for ____ mos. to _____		2nd Mortgage ☐Principal & Interest pmt ☐ Interest Only pmt	
905. VA Funding Fee / Mortgage Insurance Premium		Property Taxes	
1000: Reserves Deposited with Lender: Waived ☐Yes ☐No		Home Owners Insurance	
1001: Hazard Insurance: ____ months @ $_____ per mo.		Private Mortgage Insurance	
1002: Mortgage Insurance: ____ months @ $_____ per mo.		Homeowners Association Dues	
1003: City Property Taxes: ____ months @ $_____ per mo.		Other	
1004: County Property Taxes ____ months @ $_____ per mo.		Other	
1005: Annual Assessments ____ months @ $_____ per mo.			
1006: Flood Insurance ____ months @ $_____ per mo.		**Total Proposed Monthly Payment:**	
1007 months @ $_____ per mo.			
1008			
1100: Title Charges			
1101. Settlement or Closing/Escrow Fee to:			
1102. Abstract or Title Search to:			
1103. Title Examination to:			
1104. Title Insurance Binder to:			
1105: Documentation Preparation to:			
1106: Notary Fees to:			
1107: Attorney's Fee to: (Includes above item numbers:)			
1108: Title Insurance Fee to: (Includes above item numbers:)			
1109 Lender's Coverage $			
1110 Owner's Coverage $			
1111. Includes Commitment Fee to			
1112: Endorsement Fee to:			
1113: Wire Fee to			
1114: Electronic Doc Fee to:			
1115: Courier Fee to:			
1116:			
1117:			
1118:			
1200: Government Recording and Transfer Charges			
1201 Recording Fees: ☐Deed $ ☐Mortgage $ ☐Release(s)/Reconveyance(s) $			
1202 City/County Tax/Stamps: ☐Deed $ ☐Mortgage$			
1203 State Tax/Stamps: ☐Deed $ ☐ Mortgage $			
1204 Assignment Fee to			
1205 Subordination Fee to			
1300: Additional Settlement Charges			
1301 Survey to.			
1302 Pest Inspection Fee to:			
1303 General Inspection(s) to:			
1304 Home Warranty Fee to:			
1305. Elevation Certificate Fee to:			
A: Settlement Cost (Sections 800, 1100, 1200, 1300 above) **B: Prepaid Items (Sections 900 and 1000 above)**			
1400: Total Estimated Settlement/Closing Costs			

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

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

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

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

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

Borrower: _____ **Co-Borrower:** _____

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

GFE ver.1.2

Statement of John M. Robbins, CMB

Chairman of the Mortgage Bankers Association, Washington, D.C.

before the

Subcommittee on Housing, Transportation, and Community Development

United States Senate

Hearing on

"Ending Mortgage Abuse: Safeguarding Homebuyers"

June 26, 2007

Chairman Schumer, Ranking Member Crapo and Members of the Housing, Transportation, and Community Development Subcommittee, my name is John Robbins and I am Chairman of the Mortgage Bankers Association (MBA).[1] I appreciate the opportunity to testify before you today as you review and consider issues related to safeguarding consumers from abuses in the mortgage market. These are issues that are of central concern to the MBA and, with 36 years of mortgage banking experience, I am pleased to share my thoughts in these areas.

Today's hearing is being held during a significant transition affecting the mortgage market and borrowers including subprime borrowers. MBA and its members share the commitment of this subcommittee to assuring protections for consumers against abusive lending and foreclosures and assuring that borrowers continue to have the financing they need to buy and draw needed equity from their homes, and, most importantly, to stay in them.

The real estate finance industry provides many benefits. It is a driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Our industry has helped our country reach a near 70 percent homeownership rate. Thus, when abusive lending occurs, it is a stain on the mortgage industry just as it is a burden on our borrowers and communities. Foreclosures, likewise, are harmful and can be ruinous to borrowers and lenders and devastating to communities. We support improved protections for consumers and efforts to stem unnecessary foreclosures.

The challenge for policymakers is to balance consumer protections against the need to assure the availability of credit. This is not a simple equation in a $3 trillion mortgage market. We think the best approach would result in better educated consumers and honest loan originators, a goal that is impossible to accomplish with legislation alone. As we do legislate, we must do our best to anticipate unintended consequences that may be the inevitable companions of our best intentions. As a matter of prudence, any proposed solutions should address the real problems associated with a small section of the subprime mortgage market and be weighed against their impact on the broader mortgage market.

Going forward, MBA believes that in order to assure the continued availability of mortgage credit, there are three things the government can do to help protect consumers. First, make financial education a priority in this nation, empowering consumers with knowledge and giving them the tools they need to make good decisions

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

and protect themselves. Second, simplify and make more transparent the mortgage process and the functions and fees of key professionals so that consumers may better understand the details of their transactions and shop more efficiently from mortgage professional to professional. Third, we should achieve a strong and balanced uniform national standard for mortgage lending with increased consumer protections and more accountability for mortgage professionals.

The mortgage market in general has done an outstanding job for consumers and the larger economy. To assure its continued capability, we must guard against any policy that is not based on sound facts and that has the potential to undermine these benefits going forward – particularly for those most in need of credit.

I. STRUCTURE OF THE MORTGAGE MARKET AND KEY PLAYERS

Consumers in today's mortgage market can choose from among a wide array of lenders and mortgage brokers to obtain a mortgage to purchase a home, to refinance and/or to draw on their home's equity. In 2005, 8,848 institutions including 3,034 commercial banks, 974 savings institutions, 2,047 credit unions and 1,923 mortgage companies, reported under requirements of the Home Mortgage Disclosure Act (HMDA). The National Association of Mortgage Brokers reports 53,000 mortgage brokerage companies, as of 2004, employing an estimated 418,700 people at the time.

The delivery channels through which borrowers obtain loans from these institutions vary considerably based on the institutions' particular business models. In many cases, lenders originate mortgages through their own loan officers or correspondents in response to loan applications submitted through the Internet, call centers, by mail or a visit to a lender's office. Others obtain mortgages originated by mortgage brokers. While there is not definitive data on the breakdown of lender and broker originated loans, it has been estimated that mortgage brokers may originate more than 50 percent of all loans and at least 70 percent[2] of subprime mortgages in any given year.

Some borrowers shop effectively among the range of mortgage originators. Others rely on mortgage brokers to shop for them. As noted by former U.S. Senator Paul Sarbanes following a hearing concerning mortgage broker compensation on January 8, 2002, "a borrower's relationship with a mortgage broker is clearly different than with a lender. A borrower views the broker as shopping on the borrower's behalf, which is not the case with a lender."[3]

While a broker's functions are limited to facilitating the origination of a loan and receiving compensation for those services, lenders risks and responsibilities respecting loan transactions are much greater. Lenders design loan products for borrowers, originate loans, frequently service them and seek remedies when they fail. They have brick and mortar investments in communities. Significantly, they bear the risk of

[2] According to the Office of Thrift Supervision.
[3] Letter dated January 14, 2002 to the Honorable Mel Martinez.

repurchase from the investor if a loan fails and garner significant reputational as well as financial risk in the community if it does.

Loan originators – lenders and mortgage brokers – are compensated through direct front-end fees paid by borrowers. A mortgage broker may also be compensated by a lender based on the loan rate or yield on the loan to which the borrower agrees, with increased compensation resulting from a greater rate.

Since the early 1990s following the advent of mortgage brokers, the U.S. Department of Housing and Urban Development (HUD) has required the disclosure of yield spread premiums (YSPs) to mortgage brokers in table-funded transactions as settlement costs of the borrower. In its 2002 proposed Real Estate Settlement Procedures Act (RESPA) rule, which was withdrawn in 2004, HUD sought to make the disclosure clearer than the current requirements which permit disclosure as a notation on a list of fees as "YSP POC" or yield spread premium paid outside of closing. The existence of a greater YSP can affect the broker's and the borrower's choice of a mortgage.[4]

While a lender also may receive compensation based on a loan's yield by investors in the secondary mortgage market, HUD has not required the disclosure of these payments to lenders.[5] Where lenders receive such payments, they are not obtained at settlement. Moreover, many lenders hold loans in their own portfolio and do not receive such payments on loans. Also, when consumers shop among lenders, they have a clear sense of what their rates and costs are; disclosure of specific back-end fees to the lender is not necessary to protect consumers.

II. TODAY'S MORTGAGE MARKET

Homeownership today is near its highest level in history – nearly 70 percent overall. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2006, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2006 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2006 it was 49.5 percent. As a result of these increases in homeownership, across all demographics, more Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years.

---

[4] Properly used an increased rate can help the consumer defray some or all of his settlement costs.

[5] HUD has established an exemption under RESPA for secondary market transactions. Notwithstanding assertions by mortgage broker organizations of asymmetry of disclosure requirements, HUD has aggressively pursued improvement of mortgage broker disclosures and has not sought disclosure of secondary market payments to lenders. Considering the differing perceptions of borrowers regarding mortgage brokers and lenders, it is evident that HUD regards payments to mortgage brokers by lenders, and not secondary market payments to lenders, as requiring greater borrower understanding.

MBA's data indicate that more than a third of all homeowners own their homes free and clear of any lien. Of the 50 million mortgage holders, or two-thirds of homeowners who do have mortgages, three-quarters have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

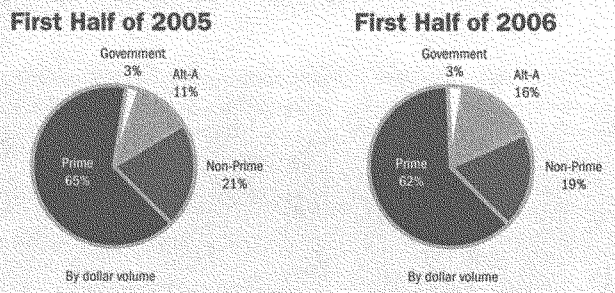
Homeowning Household Distribution
By Mortgage Type

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

Source: American Housing Survey; Mortgage Bankers Association

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

Mortgage Originations by Loan Type



Source: MBA's Mortgage Origination Survey

Based on first half 2006 data, nearly half of nonprime borrowers, or 45 percent, used nonprime loans to buy homes. One in four of these purchases was made by a first-time

homebuyer. Also, notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased markedly.

III. SUBPRIME MARKET TROUBLES IN PERSPECTIVE

Among current homeowners, 4.9 percent are subprime borrowers with adjustable rate mortgages. Of these subprime ARMs, 10.13 percent are seriously delinquent or in foreclosure. To put this in proper perspective, this is 10 percent of 4.9 percent of homeowners with mortgages or approximately 250,000 homeowners. Importantly, based on experience, fully half of those borrowers will find a solution that avoids a foreclosure sale. In other words, 99.75 percent of homeowners are not at risk of foreclosure. The current foreclosure rate, while important, is not out of line with rates in the past and does not characterize a macroeconomic event for the U.S. economy.

Notably, the problems associated with the subprime market were driven by a number of factors: over-capacity of capital, deceleration or drop in home price appreciation and an increase in unemployment in specific regions in the country.

The issue of over-capacity is being addressed both by market participants who are tightening underwriting standards or have left the market altogether and by federal regulators. For example, today the percentage of banks reporting tighter underwriting standards is the highest in 15 years and those who most abused the system are out of business. In fact, over 40 companies have closed due to being overly aggressive in their underwriting. Regulatory actions such as the recent comprehensive guidance related to nontraditional products and the expected final statement on subprime lending will further tighten underwriting of many mortgage products.

Most importantly, unemployment was and continues to be the main factor in the rise of delinquencies and foreclosures across the nation – not mortgage products. According to Freddie Mac, based on a sample of loans in Workout Prospector® from 2006, data demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. The data shows the following chief causes for mortgage delinquency:[6]

Unemployment or Loss of Income	**36.3%**
Illness in the Family	**21.1%**
Excessive Obligation	**13.6%**
Marital Difficulties	**6.0%**
Death in the Family	**3.9%**
Property Problems or Casualty Loss	**2.8%**
Extreme Hardship	**0.9%**

[6] Excludes delinquent loans in Louisiana and Mississippi due to the effects of the 2005 hurricanes. Note, Freddie Mac also published a summary of causes for mortgage delinquency based on data from 1999-2005, which essentially tracked these results.

Inability To Sell Or Rent Property	**1.4%**
Employment transfer or military service	**0.6%**
All other reasons	**13.3%**

An examination of MBA's National Delinquency Survey (NDS) for the first quarter of 2007 also confirms the causal relationship between unemployment and delinquencies. For example, the chart below shows the top five states that have the highest delinquencies across all loan categories (including subprime ARM, subprime fixed, FHA, prime ARM and prime fixed) including three that have the highest rates of unemployment – Ohio, Michigan, and Indiana.

Seriously Delinquent Loans - 2007 Q1

Subprime ARM		Subprime Fixed		FHA		Prime ARM		Prime Fixed		All Loans	
HIGHEST FIVE STATES											
Ohio	19.86	Mississippi	14.06	Michigan	10.01	Mississippi	4.77	Ohio	1.92	Ohio	5.14
Michigan	18.98	Ohio	12.70	Ohio	8.72	Indiana	4.16	Louisiana	1.75	Mississippi	4.52
Louisiana	18.27	Louisiana	11.48	Louisiana	7.82	Ohio	4.10	Indiana	1.67	Indiana	4.51
Mississippi	17.93	Michigan	10.51	Indiana	7.58	Oklahoma	4.01	Mississippi	1.65	Louisiana	4.23
Indiana	17.26	Indiana	9.90	South Carolina	7.14	Louisiana	3.92	Michigan	1.21	Michigan	4.16
US Average	**10.13**	**US Average**	**5.89**	**US Average**	**5.26**	**US Average**	**1.66**	**US Average**	**0.67**	**US Average**	2.23
California	7.57	California	2.92	California	1.96	California	1.22	California	0.20	California	1.36
LOWEST FIVE STATES											
Idaho	5.40	Utah	2.53	Idaho	1.91	Utah	0.77	California	0.20	Washington	0.88
Washington	4.72	Oregon	2.23	Montana	1.67	Oregon	0.67	Montana	0.19	Montana	0.80
Oregon	4.17	Hawaii	2.16	North Dakota	1.61	Hawaii	0.66	Hawaii	0.13	Oregon	0.79
Arizona	4.10	Arizona	2.07	Alaska	1.35	Washington	0.64	Wyoming	0.13	Hawaii	0.74
Utah	3.99	Alaska	1.38	Wyoming	1.22	Idaho	0.63	North Dakota	0.12	Wyoming	0.74

Seriously delinquent loans are those 90 days or more past due or in foreclosure
Source: Mortgage Bankers Association National Delinquency Survey

All three of these states have suffered large declines in manufacturing employment. While there has been some pickup in service sector employment in those states, that employment is not often in the areas where job losses occurred and the wages are often lower in the service sector. For example, while we have seen increases in employment in places like Cincinnati, Columbus, Ann Arbor, and Indianapolis, we have seen job losses in Detroit, Flint, Cleveland, Dayton and Muncie.

While Ohio, Indiana and Michigan account for 8.7 percent of the mortgage loans in the country, those three states account for 19.9 percent of the nation's loans in foreclosure and 15 percent of all of the foreclosures started in the country during the first quarter. Without these three states, the percent of loans in foreclosure would be below the national average over the last 10 years, 1.12 percent versus an average of 1.19 percent.

To put these numbers in further perspective, the level of foreclosures and foreclosure starts for those three states has exceeded what occurred in Texas during the oil bust of

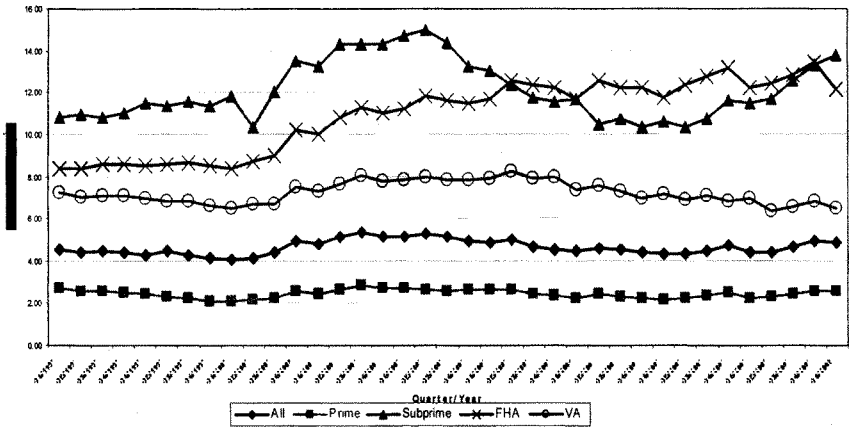
the mid-1980s, and Ohio has the highest level ever seen in the MBA survey for a large state.

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

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

According to MBA's NDS, delinquencies overall dropped in the first quarter of 2007 from the fourth quarter of 2006. Assertions that delinquency or foreclosure rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates have remained relatively low with some increases over the last year. The chart below traces delinquencies from 1998 through the first quarter of 2007. It reveals the fact that delinquencies were higher in

Chart 1. Total Delinquency Rate by Loan Type



the subprime market at the end of 2000 as well as during 2002 than they were in the first quarter of 2007.

The delinquency rate for mortgage loans on one-to-four unit residential properties stood at 4.84 percent of all loans outstanding in the first quarter of 2007 on a seasonally adjusted basis, down 11 basis points from the fourth quarter and up 43 basis points from one year ago, according to MBA's NDS. Both prime and subprime ARM loans had higher delinquency rates as compared to the fourth quarter of 2006. Delinquency rates for the fourth quarter increased 30 basis points for prime ARM loans (from 3.39 percent to 3.69 percent) and increased 131 basis points for subprime ARMs (from 14.44 percent to 15.75 percent). The delinquency rate for prime fixed loans decreased 8 basis points (from 2.27 to 2.19 percent), while the rate increased 16 basis points for subprime fixed rate loans (from 10.09 percent to 10.25 percent).[7]

MBA's first quarter 2007 NDS found that the percentage of loans in the foreclosure process was 1.28 percent, an increase of nine basis points from the fourth quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.58 percent, four basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the first quarter of 2007 was 5.10 percent, up from 4.53 percent in the fourth quarter of 2006 but still well below historic high points in the early 2000s. The foreclosure inventory rate for prime ARMs went from 0.92 percent in the fourth quarter up to 1.09 percent in the first quarter, for nonprime ARMs from 5.62 percent to 6.46. The foreclosure inventory rate increased for subprime fixed rate mortgage loans it went from 3.19 percent to 3.29 percent.

IV. MBA CONCERNS WITH S. 1299, THE "BORROWER'S PROTECTION ACT OF 2007"

We applaud the Chairman's and the Subcommittee's commitment to better protecting consumers from predatory lenders. While we agree with the purposes of Senator Schumer's proposed bill, S. 1299 the "Borrower's Protection Act of 2007," the outcomes it would propose to mandate would be frustrated, subverted by litigation and market forces. In fact, quite perversely, the very provisions it proposes to protect people would actually diminish the availability of credit.

MBA joins many on the committee in supporting increased consumer protections and greater transparency in the mortgage process. Improved disclosures, increased professional standards for mortgage brokers, broker accountability and a robust financial literacy campaign would protect consumers and help them lower the costs of their home financing. If Congress undertakes legislative action, we would support uniform national standards that create balanced requirements and bright line compliance standards. Anything beyond this could lead to significant and unnecessary

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

liability exposure that will threaten the availability of mortgage credit and increase its costs. S. 1299, however, amends section 129 of the Truth in Lending Act (TILA) to include several new troubling provisions that would subject lenders to substantial liability that could result in limiting credit and credit options. Most importantly, the approaches in the bill raise the question of whether government intervention of this nature is preferable to allowing the market to correct itself as is occurring today. It is through this lens that we examine some of the most problematic provisions of S. 1299.

A. Lender Duty of Care Obligations

S. 1299 requires that a mortgage originator – lender and broker – "act with reasonable skill, care, and diligence, and act in good faith and with fair dealing in any transaction, practice, or course of business associated with the transaction." While mortgage lenders work every day to serve their customers fully and fairly, the establishment of such a standard risks unintended consequences. S. 1299 provides no definition of what this standard means and how lenders can comply with it. As a subjective standard, its imposition would risk significant potential liability exposure, adversely affecting the affordability of mortgage credit to consumers and increasing its costs.

MBA is also concerned with language regarding the prohibition against lenders and brokers steering borrowers into loans or loan terms that are not "reasonably advantageous to the consumer, in light of all the circumstances." While MBA opposes steering and favors informed consumer choice, this type of standard would force loan originators to determine whether a loan is suitable for a borrower. MBA has carefully studied the issue of the potential effects that the imposition of a variety of approaches to suitability would have on the mortgage market. MBA has concluded that imposition of such a standard would not provide benefits that would outweigh the costs to consumers, lenders and other market participants. We respectfully refer the subcommittee to a report on suitability standards published earlier this year by MBA which contains the bases for these conclusions.

MBA is also concerned about the bill's mandate requiring the lender or broker who cannot recommend or offer a reasonably advantageous loan to a consumer to either:

- Originate or facilitate "a reasonably advantageous home mortgage loan by another creditor to the consumer" or,

- Disclose to the consumer that it does not offer a reasonably advantageous loan but that other creditors may in addition to listing the reasons that the products and services offered by the originator are not available to or reasonably advantageous for the consumer.

MBA believes these provisions in the first instance are unclear because they do not define what is "reasonably advantageous," again risking significant potential liability and concomitant increases in cost and limitations of credit. Beyond this, the provision unreasonably demands that lending institutions in a free market facilitate originations for

lenders' competitors. It also requires lenders to be aware of and in a position to offer other lenders' products to satisfy this requirement. With thousands of lenders offering many mortgages each with different loan and rate characteristics, lenders are not in a position to intimately know whether competitors' products are advantageous to a consumer and should not be required to do so.

B. Rigid Underwriting Standards

Safe and sound underwriting is the cornerstone of responsible lending. While MBA supports underwriting to assure that the borrower can repay the loan as well as the taxes and insurance, enactment of standards along the lines in S. 1299 will only choke off the availability of affordable credit that has made today's record homeownership rates possible.

Specifically, the bill proposes that originators determine a borrower's ability to repay an adjustable rate mortgage based on the maximum payment that could be due from the borrower during the first seven years of the loan using the maximum interest rate allowable and assuming no default by the borrower and a repayment schedule which achieves full amortization over the life of the loan. It also requires that originators must base a determination of an ability to repay on documentation of income and financial resources and the debt-to-income and residual income of the borrower as determined under federal regulations.

In today's market, lenders carefully consider and evaluate relevant risk factors such as credit reports, credit scores, debt-to-income ratios, type of property and down payment to determine a consumer's ability to make their mortgage payments and they have every incentive to do so. In the event that a loan fails, they can be forced to repurchase it and risk a decision by an investor or investors not to do business with them in the future.

At the same time, however, innovations in the underwriting process have opened the door of homeownership to a much greater percentage of American families than could have dreamed of it a generation ago. Through innovation and computerization, lenders today have a much better understanding of risk factors and have developed much more precise and inclusive risk assessment tools. Enactment of overly rigid standards will only counter these strides.

We would also point out that MBA and its members agree that borrowers of subprime hybrid ARMs should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of a loan. However, the imposition of overly broad underwriting standards beyond these limits, such as requiring an evaluation of the maximum payment during the first seven years, are ill-founded and will unduly limit credit to borrowers.

When rates have trended downward, the average life of a mortgage has been as low as nine months. Some report recently that 30 months has been the average duration in

the subprime market with slightly greater than four years the average duration in the prime market. In any case, the average length of a mortgage is far shorter than the seven years required for underwriting loans under the bill. Far too prescriptive underwriting approaches like the seven year standard would bar the availability of loans with lower initial rates to those borrowers, such as military personnel, who frequently move, and deny others products that offer them the ability to get into a home and to repair their credit histories on a path to obtain lower rate loans.

Additionally, by effectively barring stated income loans the bill could be detrimental to the ability of immigrants and self-employed borrowers, who sometimes have difficulty documenting their income, to obtain competitive mortgage financing. This is notwithstanding the fact that lenders report that stated income loans, when used appropriately, perform very well. We would caution Congress to advance very carefully in this area as stated income loans have been a meaningful way for important segments of borrowers to get mortgage credit.

Finally, while MBA recognizes and points out in its suitability paper, that hard and fast underwriting standards limit credit, such standards are preferable to subjective standards.[8] For example, while requiring a specific debt-to-income standard will exclude borrowers, a subjective standard such as "reasonableness" risks litigation and raises much broader concerns. While MBA prefers much more flexible approaches to underwriting to facilitate homeownership, it is willing to work with the subcommittee on bright-line standards, which at least have the virtue of making the rules clear.

C. Lender and Broker Liability

MBA is greatly concerned with Section 129A (d)(3) as it would hold the lender liable for any "acts, omissions, and representations" by a broker in delivering a "rate spread mortgage" to the lender. We strongly believe that this provision unfairly makes the lender liable for the acts of an independent mortgage broker over which the mortgage lender has no control and which may have occurred before the lender purchased the mortgage. If Congress wants to create greater broker accountability, a sentiment we support, we strongly urge that better licensing, clear disclosure and the establishment of precise standards applicable to independent brokers are the most effective means to that end.

V. STEPS CONGRESS CAN TAKE TO PROTECT CONSUMERS

There are at least three things Congress can do to help consumers become better informed through the mortgage process, protect themselves and help them make the best choice for themselves.

[8] MBA Policy paper Series – Policy Paper 2007-1. "Suitability – Don't Turn Back the Clock on Fair Lending and Homeownership Gains."

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including this important subject into general educational programs and increasing access to transaction-specific borrower counseling. It would be a worthy undertaking to conduct a review of total government efforts in the area of financial literacy to see what is working is what is not. This study could also include the amount of resources expended for this purpose. MBA believes that better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, MBA believes simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. We commend to the Committee the fact that Federal Trade Commission staff just issued a comprehensive study that strongly supports this view.[9] Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders. This approach would also go a long way to help borrowers shop for mortgages among loan providers, increasing their ability to make an apples-to-apples comparison.

In particular, MBA believes that many abuses could be prevented and costs lowered if there were much better borrower information on the function and fees of the mortgage broker in each borrower's loan transaction, and if there were stronger licensing and a registry of mortgage brokers and other loan originators. For almost a decade, MBA has advocated a clear disclosure to the consumer concerning the functions and compensation of mortgage brokers that would advise the consumer of whether the broker is or is not the borrower's agent and of the total compensation that the broker receives. Such a disclosure would alert the borrower in cases where the broker is not an agent that the borrower should either shop for himself or risk higher mortgage costs. Moreover, if a mortgage broker holds himself out as an agent, MBA believes it is appropriate to consider him an agent as a legal matter. In MBA's view, disclosures along these lines are a much better approach than imposing an undefined standard or standards on the industry, again increasing liability and greater costs to borrowers.

Notably, MBA does not believe that a disclosure of function and fees is warranted for mortgage lenders. Unlike a broker whose role may be uncertain – agent or loan provider – a lender's role is clear. A lender underwrites, approves and funds the loan. The lender does not hold himself out as an agent of the borrower. While a lender must serve its customers fairly, and the industry has done much to assure high professional standards, a lender owes a duty to its shareholders and investors. A borrower knows a lender offers its own products and does not offer to shop for borrowers. In MBA's view, the fact that the lender may sell the loan into the secondary market and receive

[9] Improving Consumer Mortgage Disclosures, An Empirical Assessment of Current and Prototype Disclosure Forms, by James M. Lacko and Janis K. Pappalardo of the Federal Trade Commission (June 2007).

compensation for the sale does not change our view that a broker, and not a lender, need disclose its fees. A lender offers a loan to a borrower at a price and rate and points which are fully disclosed and there is no additional payment which a borrower needs to consider in light of the lender's functions.

Also, as has been pointed out, in some states, the standards for licensing a hair dresser are more rigorous than those applicable to mortgage brokers. MBA supports national, uniform regulation of mortgage brokers including a national database of approved brokers. A clear, fair national regulatory standard for mortgage brokers is an essential step to establishing much better mortgage lending protections for borrowers.

Third, uniform lending standards applicable to all originators that are clear and objective, but do not unduly restrict the market, would improve consumer protections to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings. MBA would support the expansion of the types of loans to be covered in a uniform national standard to include purchase money loans and open-ended lines of credit.

VI. INDUSTRY EFFORTS TO HELP CONSUMERS

While working with policymakers to address the transformation in the mortgage market, MBA and its partners are leading the way to help stabilize and preserve the subprime mortgage credit system, provide assistance for homeowners facing foreclosure, and finally, prevent this from ever occurring again.

MBA has met with Fannie Mae and Freddie Mac, with FHA, with our largest servicers, consumer groups and civil rights leaders to search for solutions. We did so both separately and as a participant in a housing summit convened by Senate Banking Committee Chairman Christopher Dodd where an agreement was reached on principles for mortgage lenders and servicers to assist troubled borrowers.

MBA also has partnered with NeighborWorks America, a national nonprofit organization created by Congress, to help troubled borrowers. Specifically, MBA has dedicated financial and staff resources to help promote a free counseling hotline, 888-995-HOPE, which is staffed by the Homeownership Preservation Foundation and provides a helpful place for troubled borrowers to turn. In addition, through the partnership, we hope to establish foreclosure intervention programs in cities with high rates of foreclosure and to conduct a national public education campaign with the National Ad Council to improve contact rates for homeowners in financial distress. The partnership also seeks to improve counseling capacity and provide certified training programs for foreclosure counselors through the NeighborWorks Center for Homeownership Education and Counseling (NCHEC).

MBA is also seeking to arm consumers with good information so that they can make intelligent choices. That's why MBA has launched Project Clarity, an initiative to simplify and demystify the mortgage process. We're working on documents to be given to borrowers upfront that clearly state the pros and cons of the variety of loans available today. And as part of MBA's ongoing financial literacy effort, we have re-tooled and re-launched our consumer Web site,[10] which is also available in Spanish.

Conclusion

MBA members have worked hard to put Americans in homes, facilitating the development of communities, increasing consumer wealth and improving the stability of families across the nation. The transitioning of the subprime mortgage market, and the affect it is having and will likely continue to have on access to mortgage credit, is a challenge for us all. MBA implores Congress not to act hastily but to partner with industry and consumer groups to develop new approaches to assure that borrowers continue to get mortgage credit to fulfill their dreams of homeownership while effectively protecting them against abuse.

MBA has been long committed to fighting predatory lending and we would welcome the opportunity to work with Congress to develop solutions that weed out bad actors and allow the mortgage industry to continue to serve borrowers. Better financial literacy, mortgage simplification and establishment of a uniform national standard are steps that should be taken.

MBA looks forward to continuing to work with this subcommittee and the Congress to address these challenges in the housing market and we stand ready to assist you however we can.

Thank you.

[10] http://www.homeloanlearningcenter.com/

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STATEMENT OF
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U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT

"ENDING MORTGAGE ABUSE: SAFEGUARDING HOMEBUYERS"

JUNE 26, 2007

Chairman Schumer, Ranking Member Crapo, and members of the Subcommittee: I am Wade Henderson, President and CEO of the Leadership Conference on Civil Rights (LCCR). Thank you for the opportunity to testify in today's hearing on protecting homeowners and on eliminating abusive and predatory mortgage lending.

LCCR is the nation's oldest and most diverse coalition of civil rights organizations. Founded in 1950 by Arnold Aronson, A. Philip Randolph, and Roy Wilkins, the Leadership Conference seeks to further the goal of equality under law through legislative advocacy and public education. LCCR consists of approximately 200 national organizations representing persons of color, women, children, organized labor, persons with disabilities, the elderly, gays and lesbians, and major religious groups. I am privileged to represent the civil and human rights community in submitting testimony for the record to the Committee.

Today, I would like to discuss what has caused the subprime mortgage market to break down, what it means for the communities LCCR represents, and what needs to be done. While a wide range of private stakeholders in the housing, lending, finance, and nonprofit sectors are already working hard to address the problems that have been emerging, problems that include a drastic rise in subprime foreclosures, I believe that the problems in the subprime market today are systemic ones that, ultimately, will require a strong Congressional response.

The Problems

While I am honored to speak before you today, I must say how much I wish that we had this hearing years ago. For years, civil rights and consumer protection groups have been arguing that the modern subprime mortgage lending system is fundamentally flawed, that countless numbers of irresponsible and abusive loans were being made, and that the consequences for both borrowers and our economy at large would be drastic. It has long been clear to our groups that America has a separate and unequal lending system, and that African-American, Latino and other minority consumers disproportionately secure credit from an unscrupulous and unregulated lending market.

I would also like to say at the outset, in order to make sure that my words are not misinterpreted, that I agree with many here today that *responsible* subprime lending does indeed serve a valuable role. *Responsible* subprime lending creates opportunities for many people who might otherwise never own a home or obtain credit, and we all have an interest in preserving it.

The basic problem that we face today, however, is that the "responsible" part of "responsible subprime lending" has essentially gone out the window. Over the past few years, we witnessed an explosion in the use of risky mortgage products and a rapid decline in the use of sensible lending practices.

Some of the root causes of today's foreclosure crisis lie in the abuse of normally-sound subprime lending practices. In a gross perversion of a practice normally used to lend money to self-employed borrowers who lack W-2 documentation, for example, many Americans were carelessly given home loans without being required to show *any* proof that they had enough income to pay them back. Many others, perhaps under the mistaken notion that home values would continue to spiral upward indefinitely, were only required to show they had enough income to pay low "teaser" rates for the first two or three years of hybrid ARM loans – and were led to believe that they could easily refinance or sell their home once their monthly payments increased. Still others fell victim to loan originators who encouraged appraisers to artificially inflate the home's market value causing untold thousands of consumers to take out refinance mortgages that were much more than what the home was worth. In order to make mortgages look cheaper and more enticing than they actually are, many lenders did not factor other critical expenses such as property taxes and hazard insurance into the cost of home loans. Practices such as these drastically increase the likelihood that financially unsophisticated borrowers will be given home loans that they cannot afford to repay.

This recklessness has been aided and abetted by the rapid growth in the secondary mortgage market. While securitization, the repackaging and selling of mortgages to investors, plays an important role by making more funds available to lenders so they can provide additional mortgage loans, it can easily become counterproductive if it reduces the incentives for lenders to carefully ensure that the mortgages they originate can actually be repaid.

At the same time, other aspects of the subprime mortgage lending system have reflected not just carelessness and a lack of accountability, but outright greed. Many mortgage brokers, for example, are given bonuses, or "yield spread premiums," for steering unwitting borrowers into higher-rate subprime mortgages than their incomes or credit scores would otherwise dictate. Many subprime mortgages also include heavy penalties for early repayment, penalties that require borrowers to sacrifice thousands of dollars of equity in their homes if they wish to refinance at a lower rate. Such practices are of particular concern to LCCR because, according to extensive research by the Center for Responsible Lending, they disproportionately target many of the racial and ethnic minority communities that our member organizations represent.

In any normal market situation, such unsound and even predatory lending practices are inherently bound to backfire on borrowers, lenders, and investors alike. However, when such tactics are used on a widespread basis in a housing market where supply greatly exceeds demand, and where prices have simultaneously been driven up to unsustainable levels through widespread

speculation as well as through appraisal practices that range from overly-optimistic to downright fraudulent, you have a recipe for a widespread meltdown. Unfortunately, it appears that this is the situation in which we find ourselves today.

What has further exacerbated this situation is that the current problem we are facing is due, in part, to the ineffectiveness of federal regulatory agencies in ensuring that their member institutions fully meet their obligations under the Fair Housing Act and Community Reinvestment Act. The truth is that if federally regulated institutions were meeting their fair lending and CRA requirements and making affordable, sustainable, prime loans to deserving borrowers, we would not have seen such an explosive growth in abusive subprime lending. The hard truth is that African-Americans, Latinos and female householders disproportionately receive unsustainable high cost subprime loans. Federally regulated lenders, who routinely have denial rates for African-American and Latino loan applicants that are at least double the rate for Caucasian loan applicants, are not lending as they should to African-American, Latino and female borrowers. This gap in fair lending has opened the door for the unregulated lending market to come in and take advantage of these borrowers.

This failure is particularly disheartening when one considers that borrowers are unwittingly receiving higher cost loans when they actually qualify for lower cost loans with less onerous terms. Various sources report that a significant percentage of subprime borrowers could have qualified for a prime loan. Freddie Mac was the first agency, to our knowledge, to report this finding. The GSE reported in 1996, based on an analysis of loans it had reviewed, that 35% of subprime mortgages could have qualified for a conforming, prime loan.[1] More recently, Freddie Mac has conservatively estimated that 15% of subprime borrowers could qualify for traditional loans.[2] Fannie Mae has reported estimates that up to 50% of subprime borrowers could qualify for prime loans.[3]

Moreover, Congress has allowed the Office of Comptroller of the Currency to exempt its member institutions, their affiliates and third party contractors from state anti-predatory lending laws. This is problematic because OCC members own and operate and have owned and operated subprime affiliates and utilize third party contractors, such as mortgage brokers, to originate loans. This has meant that for a broad section of the mortgage market, the only entity regulating loan originations is the bank itself.

The Consequences

While I hope that there is widespread consensus at this point about the root causes of the problems we are observing in the subprime mortgage market today, what remains to be fully determined are the effects. So far, one thing is clear: the number of foreclosures on subprime mortgages has been rapidly increasing. There is also ample reason to believe that in the absence of drastic changes, foreclosures will continue to rise in the next several years. According to one estimate, by the Center for Responsible Lending, as many as 2.4 million subprime mortgages are likely to fail in the next several years. If this prediction holds true, it will mean that subprime

[1] "Automated Underwriting", Freddie Mac, September, 1996.
[2] Kimberly Blanton, "Dark Side of Subprime Loans", Boston Globe, August 3, 2005.
[3] Fannie Mae Foundation, "Financial Services in Distressed Communities", August, 2001.

lending did not result in any net gains in this country, but will instead have resulted in a net *loss* in homeownership for families in the subprime market.[4]

LCCR and its member organizations have been particularly concerned about the growing number of subprime mortgage foreclosures taking place in the communities that we represent. We are all too aware, to put a twist on Chief Justice John Marshall's classic phrase, that the power to lend is the power to destroy. Minority and low-income communities have long been targeted by a wide range of predatory lending practices, such as ballooning car payments, rent-to-own contracts, and payday loans – practices that strip borrowers of what little wealth they have and cause lasting damage to their ability to obtain more affordable credit in the future. Such practices have made our communities especially vulnerable to the wave of unsound mortgage lending that has taken place in recent years.

The information we have so far is incredibly troubling. According to Home Mortgage Disclosure Act data, in 2005, over half of the loans to African Americans were higher-rate subprime loans, including 54.7 % of purchase loans and 49.3% of refinance loans. For Latino borrowers, these figures were 46.1% and 33.8%, respectively. That same year, African Americans were 3.2, and Latinos 2.7, times more likely to receive a higher-rate home purchase loan than white non-Latino borrowers. And for refinances, African Americans were 2.3, and Latinos 1.6, times more likely to receive a higher-rate loan than non-Latino whites.[5] According to research by the Center for Responsible Lending, these racial and ethnic disparities exist even after controlling for borrower traits such as credit scores, equity, and other risk factors.[6]

In other words, and while it is certainly important to remember here that not all subprime loans can be characterized as abusive or predatory, it is evident that the race or ethnicity of borrowers – factors that should never play a role in lending decisions – frequently determines the cost of a mortgage loan. And as foreclosures continue to increase nationwide, minority communities are likely to be hit especially hard as a result.

How the growth in subprime foreclosures will affect the economy at large is difficult, at best, to predict. However, we are seeing troubling signs. Last week, the investment bank Bear Stearns sent waves of concern through the financial world with its announcement that it would lend up to $3.2 billion to bail out a hedge fund that has been deeply troubled by rising defaults on subprime loans, and is working on plans to bail out an even larger fund.[7] According to the Commerce Department, retail sales in home-related areas such as building and gardening supplies dropped 6 percent from April 2006 to April 2007, and a Merrill Lynch report recently found a record 2.2

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[4] Center for Responsible Lending, "Subprime Lending is a Net Drain on Homeownership," CRL Issue Paper No. 14 (March 27, 2007).

[5] One in every four home loans originated in 2005 was subprime. Robert B. Avery, Kenneth P. Brevoort, and Glen Canner, *Higher-Priced Home Lending and the 2005 HMDA Data,* Federal Reserve Bulletin (amended September 18, 2006).

[6] Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, (May 2006), p. 19 available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf. See also, Debbie Gruenstein Bocian, *Center for Responsible Lending Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data*, September 28, 2006 available at http://www.responsiblelending.org/pdfs/HMDA-Comment-9-28-06.pdf.

[7] "$3.2 Billion Move by Bear Stearns to Rescue Fund," THE NEW YORK TIMES, June 23, 2007.

million vacant homes and condominiums for sale, about one million above the norm.[8] It is certainly possible that high vacancy rates and increasing foreclosures could drive down property values in many areas, leaving numerous borrowers owing more on their mortgages than their homes are worth, which in turn could affect other areas of the economy such as employment and consumer spending – with especially harsh effects on minority and low-income families that are already struggling to make ends meet.

The Solutions

It is tempting to point fingers and assign blame for the disastrous situation in which we now find ourselves. Depending on who you ask, mortgage lenders blame brokers, brokers blame appraisers, appraisers blame realtors, realtors blame developers, borrowers blame all of the above, and vice-versa, and so on.

It certainly does not help that our society as a whole is so heavily dependent on all forms of credit, and that we had hoped, basic laws of economics notwithstanding, that the good times brought on by the housing boom in the first half of this decade would last forever.

Ultimately, however, I believe that the blame should not be laid on any one group or sector, but on the fact that the entire subprime mortgage lending system, as we currently know it, is fundamentally broken. The legal and regulatory structure that governs mortgage lending has utterly failed to adapt to the widespread changes that have taken place in the subprime market in recent years.

I am encouraged that many stakeholders, as well as federal and state regulators, are acknowledging the extent of the problems in the subprime market and are taking a variety of steps to reduce the prevalence of irresponsible loans in the future. But to date, these efforts have amounted to a piecemeal approach that will not adequately protect borrowers.

Perhaps we should heed the sagacity of Dr. King, who warned us against succumbing to the "tranquilizing drug of gradualism." In this instance, not doing enough will ultimately do us more harm than good. History has shown us that large corporations and financial institutions can protect themselves. It is more often than not consumers who lose when government does not do its part to make sure that effective protections are put in place, and that current laws are fully enforced.

Many lenders, often in cooperation with local and national community development organizations, have commendably expanded the use of voluntary programs to avert foreclosures, including mortgage "rescue" programs, debt counseling, and financial literacy campaigns. These can certainly be helpful, and should be encouraged. Legislators, and the industry, however, must always bear in mind that the loan originator has superior knowledge over the borrower. While we strongly encourage Congress to ensure that there is adequate funding for loan, default and fair housing counseling, Congress must also ensure that lenders and organizations delivering the counseling or other assistance are soundly equipped, knowledgeable, and genuinely working

[8] "Economists See Housing Slump Enduring Longer Than Expected," THE WALL STREET JOURNAL ONLINE, June 12, 2007 at http://www.realestatejournal.com/buysell/markettrends/20070612-hagerty.html.

with the interests of the borrower in mind. Moreover, Congress should make sure there is an adequate system in place to provide pre-closing loan counseling to borrowers, so that borrowers are made aware of the full terms and conditions of their loans *before* arriving at the closing table.

In April, LCCR and its member groups called on lenders to take another crucial step in responding to the developing crisis: an immediate moratorium on all on subprime home foreclosures on mortgages in which "payment shock" has occurred. Such a moratorium would allow lenders to work actively with homeowners to help them keep their homes, by putting borrowers into more affordable loan products. While I am mindful that some borrowers utilized subprime loans in an effort to reap profits during the recent real estate boom, as opposed to borrowers who simply wanted to own homes in which they and their families could live, a moratorium would provide time to find and assist borrowers who truly deserve help.

On the whole, however, such voluntary efforts are far from sufficient. Many mortgage bankers and some other stakeholders should be commended for their efforts to improve lending standards and for working to keep existing borrowers from unfairly losing their homes. But the "good apples" in the subprime industry are not the problem. In the absence of strong leadership at the federal level, there will surely be other lenders who happily continue prey on financially vulnerable borrowers, harming both them and the economy at large in the process.

I am also encouraged that the Federal Reserve and other regulators, earlier this year, issued its *Proposed Statement on Subprime Mortgage Lending*,[9] which also acknowledges the growing concerns with the current state of the subprime lending industry. It, however, falls short in several important respects: it does not *require* (1) documentation of income, (2) a meaningful evaluation of the long-term affordability of monthly payments to adjustable rate mortgages, or (3) truly helpful disclosures to borrowers – which would, at the very least, include a disclosure of the maximum possible monthly payments on adjustable rate mortgages. In addition, the Statement would only apply to subprime loans originated by federal depositories or their affiliates, and does not address unsound or predatory loans originated by state-chartered lenders. And while some states have enacted strong anti-predatory lending protections, many have not.

Under the Home Ownership and Equity Protection Act of 1994 (HOEPA), the Federal Reserve has not only the statutory authority but the obligation to take much stronger action that would apply to all mortgage lenders. HOEPA states that the Federal Reserve "shall prohibit" mortgage loans that are "unfair, deceptive or designed to evade the provisions" of HOEPA, or that "are associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[10]

To date, the Federal Reserve has utterly and inexcusably failed to use its authority, under HOEPA, to curtail abusive subprime mortgage lending practices. In doing so, it missed a vital opportunity to prevent countless numbers of Americans from losing their homes in the rapidly-growing nationwide wave of foreclosures. If the Federal Reserve will not act, Congress should

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[9] Dept. of the Treasury *et al.*, *Proposed Statement on Subprime Mortgage Lending*, 72 Fed. Reg. 10533-07 (proposed Mar. 8, 2007).
[10]

immediately give parallel authority under HOEPA to another regulator or agency that will, such as the Federal Trade Commission or the Federal Deposit Insurance Corporation.

Ultimately, however, even strong action by the Federal Reserve or another regulator would not be adequate, because the ongoing meltdown of the subprime mortgage industry cannot be blamed exclusively on lenders. Instead, as I have discussed above, the problems are rooted in the inability of the various elements of the modern subprime lending system – including lenders, brokers, appraisers, secondary market investors, and others – to work together in a manner that adequately serves the interests of homeowners.

For this reason, I believe that Congress must step in to enact strong protections for subprime borrowers, and I am pleased to express LCCR's strong support for S. 1299, the "Borrower's Protection Act of 2007." In addition to providing additional funds for ongoing community development organizations' efforts to prevent subprime borrowers from losing their homes, the Borrower's Protection Act would take a number of sensible – and long overdue – steps to ensure that the subprime mortgage system more effectively protects borrowers in the future. It would:

- Establish a fiduciary duty for mortgage brokers and other non-bank mortgage originators;
- Create a "good faith and fair dealing" standard for all originators;
- Require originators to underwrite loans at the maximum possible payment for the first seven years of the mortgage;
- Require mortgage originators to create escrow accounts to set aside anticipated property taxes and hazard insurance;
- Prohibit the "steering" of borrowers into more expensive loans than their credit scores or other factors would warrant;
- Hold lenders responsible for policing their associated appraisers and brokers; and
- Prohibit originators from influencing the appraisal process.

In addition to the realistic and utterly compelling steps taken by your bill, I believe that Congress should go one step further, and restrict the usage of pre-payment penalties. Studies show that borrowers in predominately African-American and Latino neighborhoods disproportionately receive prepayment penalties. A recent Center for Responsible Lending analysis showed, for example, that borrowers in predominately minority communities face 35% greater odds of receiving a prepayment penalty with a term of two years or more, compared to residents in zip codes with a "low" concentration of minority residents. For borrowers in medium-high minority areas, the odds of receiving prepayment penalties of two years or more is 10% greater than that of similarly situated borrowers in low minority areas.[11] Moreover, contrary to claims made by the lending industry, prepayment penalties do not always inure to the benefit of the borrower. Indeed, in the subprime world, prepayment penalties do not necessarily provide the borrower with any interest rate savings at all. For subprime refinance loans, prepayment penalties produced no meaningful difference in borrowers' interest rates. For subprime purchase loans, borrowers who had loans with prepayment penalties paid higher interest rates than similarly situated borrowers who had loans without prepayment penalties. For an estimated 380,000

[11] Center for Responsible Lending, "Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans", January, 2005.

borrowers that received subprime purchase loans in 2003, the lifetime cost of this higher interest rate is up to $881 million.[12]

Finally, I strongly urge Congress to hold hearings on the failure of the regulators and the U.S. Department of Housing and Urban Development to adequately enforce fair housing laws. For example, although the Federal Reserve has flagged 270 institutions for potential fair lending violations, there have been no cases brought or public actions taken by HUD, DOJ, or any other entity. In addition, Congress should hold hearings on the failure of the regulators to adequately ensure that their member institutions are meeting their obligations under the Community Reinvestment Act. By driving large numbers of prospective lenders into the arms of abusive subprime lenders, the failure of federally-regulated lending institutions to live up to their obligations under these laws has been one of the key contributing factors to the mess in which we currently find ourselves.

I am well-aware, as I am sure you are, that some players in the subprime mortgage lending industry have spoken out against the mere idea of federal legislative action, in general, and against the Borrower's Protection Act, in particular.[13] The arguments raised by these critics to date seem to reveal a baffling level of denial about what is currently taking place in the subprime sector. As the current crisis continues to unfold, however, I am confident – regrettably so – that the need for the common-sense approaches outlined in your bill will become more and more self-evident with every passing day. Indeed, if the current pace of foreclosures and other spillover effects of the subprime meltdown continue for much longer, it will only be a matter of time before the public debate over your bill will focus on one and only one fundamental question: *why on Earth didn't Congress enact it years ago*?

Thank you for both the opportunity to speak today and for your leadership as we move forward in addressing this developing crisis. I look forward to answering any questions you may have.

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[12] Center for Responsible Lending, "Prepayment Penalties Convey No Interest Rate Benefits on Subprime Mortgages," January, 2005.
[13] *See, e.g.*, Stacy Kaper, "Benign? Many Say Schumer Bill Would Bring Drastic Changes," AMERICAN BANKER, May 8, 2007.

Testimony presented on behalf of the

Appraisal Institute
American Society of Appraisers
American Society of Farm Managers and Rural Appraisers
National Association of Independent Fee Appraisers

Before the Senate Committee on Banking
Subcommittee on Housing, Transportation and Community Development

On

"Ending Mortgage Abuse: Safeguarding Homebuyers"

Presented by

Alan E. Hummel, SRA
Chair, Government Relations Committee
Appraisal Institute
Senior Vice President and Chief Appraiser
Forsythe Appraisals, LLC
Minneapolis, MN

June 26, 2007

Joint Testimony Presented by
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Before the
Subcommittee on Housing, Transportation, and Community Development
Committee on Banking, Housing and Urban Affairs
United States Senate

Chairman Schumer, Ranking Member Crapo, and members of the Subcommittee on Housing, Transportation and Community Development, I am Alan E. Hummel, SRA, Senior Vice President and Chief Appraiser of Forsythe Appraisals, LLC in Minneapolis, Minnesota. I am the Chair of the Appraisal Institute's Government Relations Committee and Past President of the Appraisal Institute. Today, I am pleased to be here on behalf of the Appraisal Institute, American Society of Appraisers, American Society of Farm Managers and Rural Appraisers, and the National Association of Independent Fee Appraisers, the four largest professional appraisal organizations in the United States, representing 30,000 real estate appraisers.

Thank you for the opportunity to testify before this subcommittee hearing on "Ending Mortgage Abuse: Safeguarding Homebuyers" addressing disorders in today's mortgage market. People have lost their homes to foreclosure, entire segments of the mortgage market have collapsed, and mortgage fraud has surged. Neighborhoods throughout the country have been devastated by mortgage lending abuse. The practices creating these problems must stop.

For years, professional real estate appraisers have been warning Congress about the endless schemes perpetrated on consumers and lenders by real-estate rogues, including some mortgage lenders, mortgage brokers, realty agents, title officials, and investors. Bad appraisers deserve blame, too. Too often, appraisers, either through incompetence or by turning a blind eye, facilitate bad mortgage loans. The entire real estate industry faces critical problems. We urge Congress to curb these abuses.

We believe that much of the mischief grows in the boundary dividing those segments of the real estate industry that are regulated from those that operate without effective oversight.

Real estate appraisers call your attention to three problem areas in this context:

1) Disparate oversight and regulation of mortgage brokers and mortgage lenders;

2) Systemic appraiser coercion, and

3) Weak regulation of real estate practitioners.

Let me describe these issues in more detail below, with suggestions for remedies.

Disparate oversight

Our organizations are deeply concerned with the disparity of oversight and regulation of the appraisal process in the mortgage market today. There are rules governing federally regulated financial institutions, but virtually none for all other mortgage originators in the marketplace. Greater appraisal problems spring up in the unregulated wilderness.

Pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), federally regulated financial institutions must maintain independent appraisal processes. Individuals within these institutions responsible for making final loan decisions are prohibited from playing a role in the appraisal management function. For example, a loan officer signing off on a loan decision cannot also be the person ordering and reviewing the appraisal. These rules attempt to enact an effective institutional "firewall" for appraisal independence.

After identifying widespread breakdowns in appraisal independence, lately federal bank examiners have been forced to issue guidelines reminding federally regulated institutions of their appraisal independence obligations, reemphasizing the need to maintain independent appraisal processes in mortgage transactions. The federal bank regulatory agencies are to be commended for identifying and addressing this issue. Yet our members still report problems with bank staff with a vested interest in a transaction controlling the appraisal process inappropriately. To work, the guidelines must be rigorously enforced.

Yet members find that such noncompliance isn't the biggest appraiser coercion problem. Different rules—or no rules at all—commonly govern entities under state jurisdiction, especially mortgage brokers and non-bank mortgage lenders. Except for the few states prohibiting appraiser coercion, intimidation, and bribery, we are not aware of any state-mandated appraisal management requirements for either non-bank mortgage lenders or mortgage brokers.

Today, unscrupulous lenders and brokers have a totally free shot at the appraisal. They can coerce, pressure, entice, or conspire with appraisers, virtually without consequences. As a result, many deem appraiser coercion the way to do business. Too many brokers and lenders unfortunately view the appraisal process as something to be manipulated.

We stand against such cynicism. Professional appraisers treasure their integrity and take great pride in upholding strong ethics as a critical part in the mortgage financing process. To preserve an independent appraisal process, we believe that this gaping hole must be closed.

Appraiser coercion

Appraiser pressure has received a great deal of media attention in recent months, and it was the subject of an independent study conducted earlier this year by the October Research Corporation. This study found that 90 percent of appraisers were pressured by mortgage brokers, lenders, realty agents, consumers and others to raise property valuations to enable deals to go through. This was nearly double the abuse findings of a similar study three years ago. Moreover, the survey found that 75 percent of appraisers reported "negative ramifications" if they did not cooperate, alter their appraisal, to provide an artificial valuation. The prime culprits of pressure, according to the survey, were mortgage brokers (71 percent), real estate agents/brokers (56 percent), consumers (35 percent), lenders (33 percent), and appraisal management companies (25 percent). Pressure comes from every direction. We must do everything we can to ensure an independent appraisal process in mortgage transactions. We cannot do that in a market half-regulated.

Pressure is especially strong when appraisals are delivered to parties whose compensation depends on getting people to the closing table to complete the sale and mortgage. If the loan doesn't close, these parties don't get paid. They do what they can to be sure they get paid.

Unfortunately, these parties with a vested interest in the transaction are often the same people managing the appraisal process within many financial institutions, and therein is a terrible conflict of interest. In this situation our members experience systemic problems with coercion. Appraisers are ordered to doctor their reports or else never see work from those parties again.

Coercion can be subtle or blatant. Some parties boldly demand overlooking material issues or conditions to make the appraisal arrive at the desired number - or else. Such direct threats typically occur over the phone or through an informal communication. And as a result, it is very difficult to document instances of inappropriate pressure on appraisers.

I have personally experienced such threats. On several occasions clients have told me that failing to comply with their wishes will result in my firm's not being paid or never receiving work from that institution in the future. In these cases, for not bowing to these pressures, I lost clients and was not paid for my services. I am one of many appraisers with this experience.

Our organizations are also concerned about the subtler practice of "blacklists" or "exclusionary appraiser lists," particularly when they are used as levers to pressure appraisers. It is one thing to maintain a list of reputable businesses to work with, or to maintain a list of firms to avoid as the result of poor performance; it is another to place an appraiser on an exclusionary list for no other reason than the appraiser failed to hit a predetermined value.

Subtle tactics may fall short of outright coercion, but the implication is the same. For instance, it is common for a client to ask an appraiser to remove details about the material condition of the property to avoid problems in the underwriting process. However, doing so would amount to a violation of appraiser ethical requirements. Just last week, I received the following email from a broker client:

> *Greetings,*
>
> *I have a question on the following: "...with the exception of an area of the front porch flooring which decayed. According to the owner, the basement gets some dampness during storms through the newer area of the foundation..." Page 1of 6.*
>
> *Do you guys know Appraisals 101? This statement should never be on the report. Now we face a big problem with the lender here and this makes the customer very unhappy as well.*
>
> *This decayed area, is this essential to notice? What if it was covered with a rug?*
>
> *I need to know what to do here. How can you help us get this in line? What is the exact problem? What is cost to cure?*
> *Anything?*
>
> *Please respond ASAP.*
>
> *Thanks.*

I can assure members of the Committee that the cost to "cure" the decaying front porch flooring is a little more than the cost of an area rug to cover up the damage.

Weak or non-existent enforcement

Where there are few rules prohibiting appraiser coercion, little enforcement takes place. Outside of some diligent law enforcement officials and observant legislators who have recognized the importance of maintaining appraisal independence, we see very little enforcement occurring on these issues. For several years, our organizations have highlighted the importance of this issue on the state level, achieving some results.

For instance, the issue between 40-plus states and Ameriquest largely involved breakdowns in appraisal independence. Investigators found that, between 1999 and 2005, Ameriquest employees deceived thousands of consumers with high-pressure tactics to boost their monthly quotas and commissions. Consumers accused the company of engaging in unfair and deceptive lending practices such as misrepresenting the actual amount of interest, inflating their home appraisals, delaying funding of consumers' loans after closing and failing to clearly disclose fees or penalties associated with paying the loans off ahead of schedule.

In the settlement, Ameriquest denied all allegations but agreed to adhere to new standards to prevent what the states alleged were unfair and deceptive practices. Ameriquest had to overhaul its appraisal practices by removing branch offices and sales personnel from the appraiser selection process, by instituting an automated system to select appraisers from panels created in each state, by limiting the company's ability to get second opinions on appraisals, and by prohibiting Ameriquest employees from influencing appraisals.

In the past twelve months three states passed laws prohibiting brokers and lenders from pressuring appraisers to reach value. Last June, Ohio passed a law that prohibits a person or business from improperly influencing the judgment of an appraiser with respect to value. Following suit, the Attorney Generals of two other states, backed by our chapters, pushed for the passage of similar provisions. The Colorado legislature passed a bill that says no person shall improperly influence an appraiser, while Iowa passed a more extensive provision, banning appraiser coercion or attempted appraiser coercion. These laws join the list of state laws

protecting appraisers from undue pressure, in Arkansas, Kansas, North Carolina, Utah and West Virginia. Legislatures and public officials in other states are exploring similar actions.

The new Ohio predatory lending law has produced the recent indictments of 10 mortgage brokers, mortgage lenders and an appraisal management company, charged with improperly influencing the appraisal process. New York's attorney general is now investigating whether home appraisers were improperly pressured by mortgage brokers and lenders to inflate estimates, damaging the New York real estate market's integrity.

Outside of these cases, we are not aware of any administrative action taken by a state regulator of mortgage lenders, mortgage brokers or others involving improper influence over the appraisal process. However, this may change as the result of the recent laws passed in the last year, and several others currently pending in Michigan, California, and Florida.

Other problems

Other mortgage market problems certainly involve appraisals. State appraisal regulators indicate that identity theft of appraiser license information numbers has increased substantially. As many as 30 percent of complaints against appraisers pending in some state appraiser regulatory agencies involve it. This is consistent a recent report by the Financial Crimes Enforcement Network (FINCEN) that from 2004 to 2005 identity theft in mortgage fraud cases doubled.

It is also very difficult for non-bank personnel like appraisers to report instances of fraud. Suspicious Activity Reports (SAR) are available only to bank staff, and no such document exists for other parties to a transaction. Appraisers, as eyes and ears of lenders, would benefit by the development of a SAR for Non-lenders.

Solutions

Given the multitude of issues identified above, and others with an impact on abusive mortgage lending, we believe the solution requires a multi-faceted response by Congress and the entire real estate industry. All told, we believe that current mortgage lending abuses could be curtailed by the following actions:

- Establishing a single, legally defined and enforceable standard for all parties on appraiser coercion and appraisal independence;
- Enforcing the rules aggressively against bad actors throughout the real estate industry;
- Strengthening appraiser regulation; and
- Educating better all parties about the inter-related processes and issues.

Single Standard on Anti-Appraiser Coercion

We live in a world split between two different standards for appraisal independence and appraiser coercion. One segment is relatively robust, monitored by federal bank regulators; the other devoid of such protection, with alarming results.

By and large, we believe the federal bank regulatory agencies have it right. Their guidelines separate those ordering appraisals and managing the appraisal process from those signing off on final loan decisions. Whether these guidelines get enforced as rigorously as they should is one question, but overall, these regulatory agencies have identified the core issue and have established rules to address it.

All parties involved in the appraisal ordering process should have minimum requirements regarding its management, including a ban on appraiser coercion, intimidation and bribery. We support the following actions:

- The Federal Reserve, in their current efforts to establish a definition of "abusive lending practices," should include an anti-appraiser coercion requirement applying to all parties in a real estate transaction. We encouraged the Federal Reserve to do such in their public hearing held on June 15, 2007;
- Development of state appraisal independence guidelines similar to those established by the federal bank regulators. This would be similar to the recent efforts by the Conference of State Bank Supervisors, which developed guidelines on nontraditional mortgage loan products for their member institutions.
- Federal licensing or registration requirements, including a minimum standard for appraisal management and anti-appraiser coercion. This would be an extension of

the state laws recently passed in Ohio, Colorado, and Iowa, which impose an anti-appraiser coercion requirements on mortgage lenders or mortgage brokers; and

- Accountability measures for those with the privilege of ordering and reviewing appraisals, or so called, "Lender/Broker Accountability."

These measures can crack down decisively on appraiser coercion.

Lender accountability provisions, a version of which is included in the Borrower's Protection Act, S. 1299, are important. Among other improvements, this provision would impose good faith and fair dealing requirements on mortgage originators with regard to the appraisal process.

As an overall policy, we recommend that Congress be as consistent as possible to established policy by the federal government. The Department of Housing and Urban Development has relevant rules. In 2005, the Federal Housing Administration issued Mortgage Letter 2005-06, entitled, "Lender Accountability for Appraisals." With this policy, FHA established a standard of accountability to which lenders, sponsor lenders, and loan correspondent lenders are held that is the same as the standard used to impose civil money penalties for program violations. That standard is one of knowing (actual knowledge) or having reason to know. In other words, if lenders knew, or should have known about a deficient appraisal, they are held accountable by FHA. We encourage the Subcommittee to review this policy and enact policies consistent with this standard.

We also believe the prohibited practices section of S. 1299 could be strengthened along the lines of the recently enacted states law prohibiting appraiser coercion. Such laws prohibit legally recognized and enforceable terms such as coercion, intimidation, extortion, and bribery of appraisers. In addition, given the increased propensity of appraiser identity theft, we suggest that penalties against stealing the identity of an appraiser be added here as well.

Bonding Requirement Implications

Troubled as we are with appropriate regulatory improvements, our organizations are concerned with the de facto bond requirement for residential real estate appraisers contained within the bill. It would require appraisers to carry a qualifying bond for no less than 1 percent of

the aggregate value of all homes appraised by a home appraiser in the preceding year. In many ways, the typical aggregate appraisal value would require a bond—essentially a line of credit—of over $1.5 million. According to estimates provided to our organizations, this would result in $10,000 to $40,000 in annual out-of-pocket expenses per appraiser. Since 98 percent of real estate appraisal firms are small businesses, the cost would either be passed on to consumers or drive many appraisers to simply leave the profession altogether. Consumers simply can't afford it.

Appraisers already face significant federal and state regulation. Congress requires them to be licensed or certified by state appraisal boards. They are required to pay annual appraiser licensing fees, and they are subject to state appraiser licensing laws, which include the Uniform Standards of Professional Appraisal Practice (USPAP). These standards carry the force of law, and many appraisers lose their licenses every year as the result of USPAP violations or other transgressions.

Several additional federal statutes can apply to appraisers. They certify to this with every home appraisal they prepare, specifically, when signing an appraisal report on any of the standard appraisal report forms. For instance, Certification #25 of the Uniform Residential Appraisal Report form, which is the flagship appraisal form for single-family appraisals, mandated by Fannie Mae and Freddie Mac, requires the appraiser to certify to the following:

> *"Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws."*

We urge that the bonding provision of S. 1299 be removed.

Aggressive Enforcement of Mortgage Fraud

Federal bank regulators and law enforcement officials need more resources to conduct enforcement activities. With SAR filings climbing through the roof, these agencies are overwhelmed with cases. Our members report that many agencies are turning down legitimate fraud referrals because they can't afford to pursue them.

There are several provisions of the STOP FRAUD Act, S.1266 that we suggest could be helpful in addressing mortgage fraud, including establishment of a central database of mortgage professional licensees, funding for enforcement, and resources for appraiser oversight by state appraiser regulatory agencies.

In addition, the federal bank regulators through the bank examination process must enforce existing regulations relating to appraisal independence. We urge the federal bank regulators to emphasize wherever possible the importance of appraisal independence, as they did in their recent statement on nontraditional mortgage loans. So far, however they have failed to follow suit in the draft statement on subprime mortgage lending.

Strengthen Appraiser Regulation

The appraiser regulatory structure currently suffers from significant weaknesses. Title XI of FIRREA needs to be updated, because it maintains day-to-day oversight over real estate appraisers. Yet its shortcomings actually are contributing to appraiser involvement in mortgage fraud. Federal and state appraiser regulators lack adequate tools and resources to properly oversee appraiser licensing and enforcement. Consequently, complaints against appraisers often languish unresolved before state appraisal boards, with virtually no ramifications.

Title XI of FIRREA addressed the weaknesses identified in 1989 regarding real property appraisals used in connection with federally related transactions. Prior to FIRREA, only a smattering of states regulated appraisals and the appraisers who performed them, and poor quality appraisals contributed to the numerous bank and savings and loan failures during that time. Title XI sought to address this situation, creating a unique appraisal oversight structure that involves private, state and federal entities. The Appraisal Subcommittee is part of that structure.

The most recent Annual Report of the Appraisal Subcommittee, the federal appraiser regulator, finds that more than 60 percent of the state appraiser regulatory agencies failed to uphold their 2006 enforcement responsibilities. Fourteen of the 23 states audited by the Appraisal Subcommittee did not resolve complaints expeditiously or did not adequately document enforcement files. Unfortunately, the Appraisal Subcommittee offered only a cursory summary of

these important points. Enforcement at the state regulatory level is vital to the success of the appraisal regulatory program.

Despite its brevity, the report appears to support the structural changes to Title XI that our organizations continue to advocate. In fact, we believe this report is evidence that the existing appraiser regulatory structure, including the Appraisal Subcommittee and the state appraiser regulatory agencies, needs to be enhanced in order to conduct meaningful oversight of licensed and certified appraisers. For several years, our organizations have called on Congress to enact reforms to Title XI to provide resources to state appraisal boards to support enforcement activities, increase the regulatory authority of the Appraisal Subcommittee over state appraisal boards, mandate public disclosure of the results of all field reviews of state appraiser regulatory agencies, and encourage use of professionally designated appraisers.

Education & Best Practices

The industry as a whole must improve communication and understanding among the components of real estate financing. Lenders and brokers ordering appraisals should understand basic appraisal processes, while appraisers should understand how their work product is being used by lenders and brokers and for underwriting purposes. Consumers deserve to have a full understanding of the documents they are signing. They should know whether multiple appraisals were performed for their loan, and why they were ordered. We support more resources being applied to consumer education about the mortgage process.

We are circulating an industry-wide statement of "best practices" on real estate appraisals and mortgage lending, which we believe is crucial to educate all parties involved about the importance of an independent appraisal process. We hope we can work with our industry partners to jointly develop and adopt such a statement for all major participants involved in the mortgage lending appraisal process.

Finally, we would be remiss if we did not point out that many of the problems associated with bad loans could be avoided if competent appraisers were retained to begin with. Of course, people determined to commit mortgage fraud will find ways to accomplish their schemes; yet it is important to emphasize that reputable parties can avoid problems much more effectively and

efficiently by incorporating mitigation techniques. One way to accomplish this is by hiring a competent appraiser.

Appraiser competency should not bow to cost and turn-around time. The federal bank regulators have attempted to emphasize this in recent years, but we face an uphill battle if participants continue to view the appraisal process as they do. We ask Congress to encourage reputable parties to seek out professional appraisers, including appraisers who hold designations from professional appraisal organizations like ours, in addition to any minimum credentials required by law.

Thank you.

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HEARING BEFORE THE SENATE BANKING, HOUSING AND URBAN AFFAIRS SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT

ENTITLED

ENDING MORTGAGE ABUSE: SAFEGUARDING HOMEBUYERS

WRITTEN TESTIMONY OF PAT V. COMBS, ABR, CRS, GRI, PMN PRESIDENT

NATIONAL ASSOCIATION OF REALTORS® JUNE 26, 2007

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

Chairman Schumer, Senator Crapo and Members of the Subcommittee, thank you for inviting me to testify today on the issue of protecting homebuyers from mortgage abuse. My name is Pat Combs, and I am the Vice President of Coldwell Banker-AJS-Schmidt, the second largest real estate company in Michigan. I have been a REALTOR® for over 35 years primarily specializing in buyer representation.

I am here to testify on behalf of our more than 1.3 million REALTOR® members who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors and others engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS®. We commend the committee for holding today's hearing on the very serious issue of mortgage abuse and public policy recommendations to protect our nation's homebuyers from harms way.

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, 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 and basing their lending on artificially high appraisals. 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. When 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. This is especially the case 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 made without sufficient regard to whether the borrower can afford the loan and avoid 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 February 7, 2007 Senate Banking, Housing, and Urban Affairs Committee hearing entitled, "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures."

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. Instead, the focus is now 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

[1] Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners, Center for Responsible Lending (December 2006).

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.

- 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

[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.

"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. We will continue to 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 property 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 money left each month 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

[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.

payments, such as taxes and insurance. Similar to the escrow requirement exceptions for prime loans that exist in some jurisdictions, borrowers who 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 should be for borrowers whose incomes derive from hard-to-verify sources (such as self-employed borrowers).

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 large 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, paying off a student or car loans, another member of the household entering the work force, or an inheritance.

4. Anti-Mortgage Flipping Policy. NAR supports an anti-mortgage-flipping rule requiring mortgage originators making or arranging a refinance loan to verify that the new loan provides a significant benefit to the borrower.[4]. The lender should consider the circumstances of the borrower, as discussed above, as well as all terms of the new loan including taxes, insurance, fees and other costs of refinancing, prepayment penalties, and the new interest rate, compared to those of the refinanced loan.

5. Bar Prepayment Penalties. NAR opposes prepayment penalties for all mortgages. Prepayment penalties often 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. NAR supports

[4] One test often proposed is the loan must provide a "reasonable net tangible benefit" to the borrower.

ongoing efforts to take into account consumer payment history not typically considered, such as rent, utility, telephone, and other regular payments. We urge HUD, the regulators, the GSEs, and lenders to work to strengthen these efforts. Use of alternative credit histories 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 an option for the borrower to consider, if the borrower qualifies for such a product offered by the originator; and

- before application acceptance, disclose 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.

- 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 for a subprime borrower.

- 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. Doing so will 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, more affordable 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 ask "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 has 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.

Strengthen the Independence of Appraisers

NAR believes that the independence of appraisers should be strengthened to ensure that appraisals are based on sound, fair and accurate appraisal principles and reflect a property's true value. An overwhelming number of appraisers, upwards of 90%, have experienced pressure to meet targeted values. The pressure is often subtle with an appraiser being asked whether or not they can provide an appraisal to match a general price. Over 75% of appraisers report concerns that if they do not meet such requests, they will lose both the appraisal job and future business.[5] In addition, many appraisers fear that they may be black listed and/or erroneously reported to their state licensing and regulatory agency.

[5] National Appraisal Survey, October Research (2007).

NAR supports the following measures to strengthen the appraisal process in federally related transactions:

1. Consumer Disclosure: NAR recommends that lenders be required to inform a borrower of the methods used to value a property to determine the amount of the mortgage loan, and borrowers have the right to receive a copy of each value estimate or value opinion. Furthermore, lenders should be required to obtain a detailed site visit appraisal for properties financed with nontraditional mortgage products.

2. Penalties for Improper Appraisal Influence: Congress should consider civil penalties against those who would coerce, intimidate or otherwise influence the appraisal process to meet a targeted value. Parties with an interest in the outcome of an appraisal should be limited to requests that the appraiser, (1) consider additional, appropriate property information, (2) provide further detail, substantiation, or explanation for the value conclusion and (3) correct errors in the appraisal report.

3. Assist States to Improve Regulation of the Appraisal Industry: While the appraisal industry is regulated at the state level, the Appraisal Subcommittee sets appraisal qualifications and standards for federally related transactions. Thus, state regulatory agencies both license appraisers and certify appraisers for federally related transactions. NAR opposes expanding the authority of the Appraisal Subcommittee to issue binding regulations on states. However, NAR would support providing greater assistance to states for the purpose of strengthening regulatory and enforcement activities. For

example, developing a grant program funded by an increase in the Appraisal Subcommittee roster fee would be a valuable resource for states.

4. Support Enhanced Education and Qualifications for Appraisers: The Appraisal Subcommittee, through its standards and qualifications authority, should recognize appraisers who have obtained special designations or training from professional appraisal organizations that are sponsors or affiliate sponsors of the Appraisal Foundation.

NAR believes that these four principles will help strengthen the appraisal process and ensure appraisal independence. These measures will provide the consumer added certitude that the appraised value of their purchase truly is a fair and accurate valuation.

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. Possible steps could include recasting 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 also 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. These abusive practices can contribute to, or even cause, delinquencies and foreclosures.

Strengthen Federal Programs to Provide Safe Financing Options

REALTORS® believe that FHA reform is critical to ensuring that borrowers with less than perfect credit have a safe, affordable mortgage alternative. The FHA program makes it possible for higher-risk, yet credit-worthy borrowers to get safe, affordable credit. By offering access to prime rate financing, FHA provides borrowers a means to achieve lower monthly payments – without relying on interest-only or "optional" payment schemes. FHA is also a leader in preventing foreclosures. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program; and two years later, nearly 90 percent of these borrowers are still in their homes. FHA products are safe, thanks to appropriate underwriting and loss-mitigation programs, and fairly priced without resorting to teaser rates or negative amortization.

In 1934 the Federal Housing Administration was established to provide consumers an alternative form of financing, during a lending crisis similar to that we are facing today.

At that time, short-term, interest-only and balloon loans were prevalent. When formed, FHA was a pioneer of mortgage products. FHA was the first to offer 30-fixed-rate financing at a time when loans were generally for less than five years. Unfortunately, FHA has not changed with the times and as a result has lost market share. Due to its loan limits, downpayment requirements, and antiquated pricing model, FHA is often simply unusable by homebuyers. We urge Congress to pass FHA reform, to offer borrowers a safer mortgage alternative and bring stability to local markets and local economies.

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, based on sound independent appraisals, 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, which is attached to the testimony. Thank you.

Testimony of Michael D. Calhoun
Center for Responsible Lending

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs - Subcommittee on Housing, Transportation, and Community Development

Ending Mortgage Abuse: Safeguarding Homebuyers
June 26, 2007

Chairman Schumer, Ranking Member Crapo, and members of the Committee, thank you for holding this hearing to focus on abusive lending in the subprime mortgage market and solutions for encouraging sustainable homeownership. Without question, America is experiencing an alarming rate of subprime foreclosures—the highest in the modern business era. These home losses are imposing a great hardship on families and communities, and they also are having larger effects on our entire economy, as evidenced most recently by Bear Stearns' 3.2 billion dollar bail-out of hedge funds which are hemorrhaging losses on reckless and abusive subprime mortgages.[1] Senator Schumer, you and Senators Brown and Casey are proposing strong, common-sense policies to ensure that families who get subprime loans have a fair chance of success, and I commend you for your leadership on this vital issue.

In my remarks today, I will emphasize that we have not yet seen the peak of the economic destruction caused by reckless lending and dangerous loan products in the subprime market. In fact, all indicators point to home losses getting worse before they get better. I also will present recent lending data showing that, in spite of widespread concerns about subprime foreclosures, subprime lenders are continuing to make loans with abusive terms—loans that set up families to fail from the very beginning.

In recent months, journalists covering the subprime crisis have profiled some of the millions of families devastated by dangerous home loans. A recent case reported by Newsweek and other sources involved a veteran of the war in Iraq, a man from Kentucky named Shawn Howell.[2]

Mr. Howell bought a home for his wife and four children shortly before he was deployed, and he felt good about having a secure place for his family while he served his country. Following the advice of his mortgage broker, the Howells took out two adjustable-rate mortgages. The interest rate started at 5.4%, but after Howell returned from a difficult and dangerous year in Iraq, the rate shot up to 9.9%. The increase was completely unmanageable, especially since Mr. Howell was no longer receiving combat pay. He took on two jobs and made numerous attempts to contact the lender to find a way to avoid foreclosure. In spite of Mr. Howell's best efforts, the lender (Countrywide Financial) refused to modify the terms of the loan, and the Howells weren't able to sell their home. They were forced to give up their house to foreclosure, and today they are living in a trailer.

Unfortunately, as the subprime market has grown in recent years, we have heard too many stories like Mr. Howell's. I am here today as President of the Center for Responsible Lending (CRL) (www.responsiblelending.org), which was formed in response to the rise of predatory mortgage lending that has stripped billions of dollars of wealth from low- and middle-income families all over the country. 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 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 subprime 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 worked at Self Help for a number of years, where I gained direct experience lending to people with blemished credit. In that capacity, I learned a great deal about what types of subprime mortgages are likely to support successful homeownership. Lenders who care about sustainable ownership take a few basic steps before approving subprime loans. They document the borrower's income with the best information available, and make sure they have accurate property appraisals. They escrow for taxes and insurance, and they refrain from applying prepayment penalties, which bring no benefit to subprime borrowers, but only trap them in high-cost loans or drain thousands of dollars of hard-earned family equity. Lenders concerned about sustainable ownership do not saddle debt-strapped borrowers with loans designed to ratchet up in cost, and responsible lenders also take a hard look at the borrower's ability to repay the loan. These are not industry secrets, but rather common-sense best practices that responsible lenders have always used in subprime lending, and that are still the norm in the prime sector.

In addition to my background in subprime lending, I have another bit of experience—a job that doesn't appear on my resume, but I believe it is relevant to this hearing. For a while, when my children were small, I was a stay-at-home dad. I learned a great deal from this experience, including this lesson: You don't instill responsible behavior with weak guidelines and lax enforcement. The most effective way to ensure positive behavior is to establish clear, firm rules and enforce those rules with clear, firm consequences. The subprime industry, which has been growing at a remarkable pace for the past decade, has been sorely lacking in accountability and standards that would have prevented the devastating home losses occurring today.

The lack of bright-line rules have been particularly damaging in a market that offers strong incentives to do the wrong thing. Subprime mortgage brokers, lenders, securitizers, and investors are operating in a market that rewards business practices that directly undermine homeowners and sustainable homeownership. Markets function effectively when transactions are likely to benefit all parties involved, but we don't have that situation in subprime lending. The unfortunate truth is that brokers, lenders and investors have reaped enormous gains by originating loans with payments that explode in

two short years, requiring homeowners, like clockwork, to refinance to a new subprime loan.

Brokers and lenders benefit from this regular and lucrative fee income, but homeowners lose the financial benefit of appreciation as their wealth is stripped away. Worse, when appreciation stops and the families cannot sell or refinance their homes, these loans bring families to foreclosure and ruin. And even with all the hard-gained knowledge we have today about the consequences of exploding ARMs, participants in the subprime market continue to market, originate and invest in them in large numbers.

It is notable that the suppliers who provide the majority of subprime loans—mortgage brokers—have the least financial interest in loan quality. According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[3] It is troubling that brokers, who have aggressively marketed dangerous loans in communities of color and low-wealth neighborhoods, and who have routinely charged excessive and unnecessary fees, have no financial interest in the ultimate success of the loans. Given the strong financial incentives to make unaffordable loans packed with fees, mere guidelines and suggestions will not be enough to stop risky loan practices and dangerous loan products.

Abusive Subprime Lending Persists Today

Even in the midst of the current epidemic of foreclosures, market forces have not reined in abusive lending. An industry publication, *Inside B&C Lending*, ran an article in mid-May that questioned whether lenders have actually tightened underwriting guidelines as much as they claim.[4] To take a more recent look at the evidence, we at CRL examined subprime loans included in 10 recent offerings of mortgage-backed securities—that is, investments made up of subprime loans. We found that these securities included significant shares of high-risk characteristics, as shown here:

Subprime Loan Characteristic	Average Share in our Sample
Prepayment penalties	70%
Stated income or low documentation	37%
Interest-only	12%
Adjustable interest rate	77% (90% of these ARMs were due to reset in 2-3 years)

Appendix 1, attached to this testimony, provides more details on our sample of mortgage-backed securities, including links to website information. In these securities, the overwhelming majority of mortgages was originated and securitized this year, well after the current crisis in the subprime market became apparent.

In today's environment of severe business losses and massive foreclosures, it is shocking to find these types of loans so prevalent in recent subprime loan originations. Here I will briefly comment on each of these categories:

Prepayment penalties:
Our analysis showed that, on average, more than 70% of the loans included in these securities came with prepayment penalties. As we recently argued before the Federal Reserve Board, prepayment penalties are an unfair practice in the subprime market because they provide no net economic benefit to consumers.[5]

Industry representatives often claim that borrowers receive a reduction in interest rates in exchange for prepayment penalties, but in the subprime market, this is not typically the case. According to quantitative research conducted by CRL, not only do prepayment penalties lock borrowers into higher-cost loans or force them to give up the wealth they have built through homeownership, but they also offer no benefit in the form of lower interest rates.[6] This finding is often confirmed in subprime rate sheets that lenders distribute to brokers to give up-to-date information on loan pricing. Rate sheets we have examined show that brokers receive a "yield-spread premium" for charging a higher interest rate than the borrower qualifies for on mortgages, often only if the broker convinces the borrower also to accept a prepayment penalty. In this way, even if there is a nominal reduction in the interest rate due to the prepayment penalty, this is offset or more than offset by the higher rate due to the yield- spread premium.

And this doesn't even account for the fact that once borrowers receive the loan, they are faced with the Hobbesian choice of remaining stuck in it and paying excess interest each year, or of getting out of the loan and forfeiting significant amounts of family wealth as a result. This situation has become more serious for families as property appreciation has slowed down in many areas of the country. A recent article in the *Wall Street Journal* highlighted this issue, noting that a high-school teacher in California seeking to refinance an option ARM discovered that he had a prepayment penalty of $18,000. An executive of U.S. Bank Home Mortgage commented, "The decrease in property values, combined with prepayment penalties, is making it very challenging for people to get out of these [adjustable-rate] loans." [7]

Not only are prepayment penalties expensive, but, as we reported in recent research on the performance of subprime loans, these penalties also significantly raise the chance that a homeowner will face foreclosure.[8] Yet, in spite of all the serious issues associated with prepayment penalties, they continue to be a staple of the subprime market.

Stated income or reduced documentation
Lenders evaluate the risk of a loan before approving it, but without adequate documentation of income, a lender's approval of a loan is meaningless.[9] Based on our review of the 10 mortgage-backed securities, we find that, on average, more than one third--37%--of these recently securitized subprime loans were approved based on stated income or reduced documentation standards for verifying the borrower's income. The vast majority of borrowers have readily documentable W-2 income; by putting them in low-doc loans, lenders are either charging them up to 1 percent higher interest for no reason, or inventing non-existent income in order to make them a loan that is doomed to fail.

As Comptroller of the Currency, John Dugan, has stated, "Sound underwriting—and, for that matter—simple common sense—suggest that a mortgage lender would almost always want to verify the income of a riskier subprime borrower to make sure that he or she has the means to make the required monthly payment. Most subprime borrowers are salaried employees for whom verifying income by producing copies of W-2 forms is just not that difficult."[10] We see no justification for lenders failing to use readily available data on a borrower's income. The reforms we are seeking would require lenders to verify and document all sources of income using either tax or payroll records, bank account statements, or any reasonable alternative or third-party verification.

Interest-only mortgages:
These loans were originally intended for high-income borrowers who used this type of loan as part of a larger investment strategy. Interest-only loans are rarely appropriate for borrowers in the subprime market, yet our analysis shows that, on average, 12% of the subprime loans securitized were interest-only loans.

Adjustable-rate mortgages:
Perhaps most surprising, over three-quarters of loans in the securities we examined came with adjustable interest rates, and over 90% of those loans are scheduled to reset to a higher interest rate within two or three years. These types of loans are called "hybrid" mortgages (also "2/28s" or "3/27s"), since they begin with a fixed-rate term for two or three years before shifting to an adjustable interest rate.

Hybrid adjustable-rate mortgages (ARMs) are structured to cause families to fail. Mortgage brokers and lenders use the initial low "teaser" interest rate to entice debt-strapped families into the loans. When the rate adjusts higher, homeowners are faced with the choice of another expensive and equity-stripping refinance or struggling to pay an unaffordable loan. Particularly in regions where housing prices are relatively flat, foreclosures are rising as many homeowners feel the pinch from "payment shock"—the large interest rate increases that result from most subprime ARMs.

Hybrid mortgages have been the predominant type of loan offered by subprime lenders in recent years, and these loans have been the largest single contributor to unnecessary foreclosures. Analysts expect payment shock to be a continuing concern. As of September 2005, about 80% of subprime home loans were ARMS—mostly 2/28 hybrid loans. "Exploding" loans or 2/28s operate as two-year loans that lead to another bad ARM or even foreclosure after the introductory teaser rate expires. Because subprime lenders typically qualify borrowers based on the introductory payment amount, most borrowers cannot afford to remain in these arrangements even if interest rates do not rise. According to Barron's, in the two year period from mid-2006 to mid-2008 homeowners can expect increased monthly payments on an estimated $600 billion of subprime mortgages.[11]

It is extraordinary that, at a time with an extremely flat and even inverted yield curve, ARMs with extremely high margins over the LIBOR index are being originated in such high volume for financially-challenged borrowers. This is even more stunning when one

considers that it costs only 0.5 to 1 percent more to get a fixed-rate loan, which is less than either the increased cost of a stated-income loan for someone with fully-documentable income or many broker yield-spread premiums. Yet, in spite of widely publicized problems, subprime lenders persist in offering these dangerous loans.

This recent information from the field makes it clear that subprime lenders are continuing to make loans packed with dangerous features, and they will continue to do so until their abusive products and practices are declared illegal. As further evidence, we found that subprime lenders are continuing to place prominent advertisements designed to attract consumers to mortgages with dangerous features. Here are just two of the many examples of ads on the web that could lead borrowers to more expensive, more risky loans:

- "**Convenience.** In most cases, there's no need to hunt for tax returns, bank statements or pay stubs. Simply state your income and assets on your application"

- "NO INCOME VERIFICATION. We can do loans for the self employed or the W2 employee without requiring verification of income."[12]

Inaction by the Federal Reserve Board

Federal neglect has played a critical role in enabling abusive lending in the subprime market. Thirteen years ago, Congress required the Federal Reserve Board to prohibit mortgage lending acts and practices for all originators that are abusive, unfair or deceptive, but the Board has taken no action under this authority, even though borrowers, state regulators, and advocates have repeatedly raised concerns about abuses in the subprime market.

Seven years ago, members of the House Banking Committee urged the Federal Reserve to use its authority under existing federal legislation, the Home Ownership and Equity Protection Act (HOEPA), to issue regulations banning predatory lending practices that were already devastating consumers. At that time, Representative Jim Leach told the Board:

> [C]ongress...passed a law which was very strong in its sense of purpose in outlawing predatory lending, in effect, and then because Congress felt that the subtleties of this were beyond Congress, we gave to Federal regulators, most specifically the Federal Reserve Board of the United States, the authority to make definitions and to move in this direction....So the question becomes, if there is a problem out there, if Congress has given very strong authority to regulators and the Federal Reserve, our regulators, is the Federal Reserve AWOL?[13]

We applaud the Board for the recent issuance, with the other banking and credit union regulators, of the Proposed Statement on Subprime Lending, which we hope will be finalized quickly and without weakening any of its protections. But the Statement alone is insufficient, applying to only the portion of the subprime market that is originated by

depositories or their affiliates, leaving no similar protections for the other half of the market that serves consumers that borrow from state-chartered finance companies.

Earlier this month, we testified at a Federal Reserve hearing and asked the Board to establish clear, bright-line rules, applicable to all mortgage lenders, to protect consumers from predatory lending practices ubiquitous in the subprime market today. In summary form, we are asking the Board to declare it to be an unfair or deceptive practice for subprime lenders to:

- Underwrite a loan that is not based, at a minimum, on the fully-indexed rate and fully amortizing payments, or to qualify borrowers on less than the full amount of their financial obligations, including property taxes, hazard insurance, and other debts;

- Exclude from the repayment analysis of a subprime loan the cost of hazard insurance and property tax escrows or to fail to escrow taxes and insurance in subprime loans;

- Fail to verify and document all sources of a borrower's income using either tax or payroll records, bank account statements, or any reasonable alternative or third-party verification;

- Make a prepayment penalty on a subprime loan;

- Fail to exercise sufficient due diligence regarding broker acts and omissions; and

- Allow deceptive subterfuge associated with abusive "piggy-back" second mortgages.

There is precedent for the Board to act, since following Representative Leach's plea in 2001, it made the extremely important and ultimately effective decision to discourage lenders from selling costly and unnecessary single-premium credit insurance. Today, the need is to address basic underwriting failures by subprime lenders under section 129(l)(2) for all subprime loans. The Board not only has the authority, but also the statutory obligation, to address these lending abuses under HOEPA.[14]

The Borrower's Protection Act of 2007

Particularly in light of the Federal Reserve's inaction to date, we are pleased that Senators Schumer, Brown and Casey have taken the affirmative step of proposing the Borrower's Protection Act of 2007. This proposal offers key protections that would help prevent unnecessary subprime foreclosures in the future, including:

- Fiduciary duty for mortgage brokers;

- Good faith and fair dealing standard for all mortgage originators;

- Require sensible underwriting to ensure that the borrower has the ability to repay a loan, taking into account payment increases, countering the practice of subprime lenders that underwrite to an artificially low initial "teaser" rate;
- Require verification of income when assessing whether the borrower will be able to sustain a loan;
- Prohibit steering (brokers may not direct a consumer to loans that are not appropriate or suitable for the them);
- Escrow accounts to pay taxes and hazard insurance on subprime loans;
- Lender responsibility for policing their associated appraisers and brokers; and
- Prohibition against originators influencing appraisal process.

In addition, Senators Schumer, Brown, and Casey have called for much needed funding to support community groups that specialize in foreclosure prevention. Senator Reed's Homeownership Protection and Enhancement Act (S.1386) is worthy of note as well as it would make important inroads on foreclosure prevention by expanding access to foreclosure prevention services for low- and moderate-income families, providing funding for homeownership prevention services, including grants and subsidized loans, and creating an affirmative duty for lenders and servicers to engage in some loss mitigation efforts prior to foreclosure.

Currently, the Federal Reserve Board is considering action on several of these items, including underwriting to account for payment increases, escrows for taxes and insurance [and] lender accountability for broker actions [prepayment penalties]. However, if the Board does not exercise its authority in this arena in a prompt and forceful way, Congressional action on the above items, in addition to those that the Board is not considering, will be crucial in providing much-needed protections for consumers in the subprime market. Here, let me briefly comment on the current problems that are driving the need for the policies included in the Schumer-Brown-Casey bill:

Broker Abuses:
Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. And brokers hold themselves out to borrowers as a trusted adviser for navigating the complex mortgage market; why otherwise would a person engage and pay for one? Yet, in most states, mortgage brokers have no legal responsibility to refrain from selling inappropriate, unaffordable loans, or to avoid benefiting personally at the expense of their borrowers.[15] Brokers and lenders are focused on feeding investor demand in exchange for high fees, regardless of how particular products affect individual homeowners. Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans.[16]

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[17] Similarly, a report issued by Harvard University's Joint Center for Housing Studies, stated, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[18]

Lenders should not be allowed to use their profitable relationships with brokers as a shield to make abusive loans – lenders cannot simply offload the responsibility to place borrowers in loans they can afford. At a minimum, lenders must engage in proper due diligence of the brokers they use and the brokered loans themselves. The establishment of lender liability for broker acts and omissions is a critical step to clamp down on unfair, deceptive and abusive practices.

Steering families into unnecessarily expensive home loans:
"Steering" is the practice of encouraging borrowers to accept higher-cost subprime loans even when they qualify for a more affordable prime loan.[19] Efficient financial markets should provide equally qualified borrowers with equally competitive prices on subprime home loans. However, both quantitative research and anecdotal evidence suggests that there are significant price disparities in subprime lending that indicate that some borrowers, particularly African-American and Latino families, pay more than necessary for subprime mortgages.

In May 2006, CRL analyzed data submitted by mortgage lenders for loans made in 2004 to assess the effects of race and ethnicity on pricing in the subprime market while controlling for the major risk factors used to determine loan prices.[20] Our findings showed that, for most types of subprime home loans, African-American and Latino families were at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors. In other words, if two families received subprime loans, one African American and one white, and they had the same credit score and were similarly qualified in every other way, the African-American family has a significant chance of receiving a higher-cost loan.

Failure to escrow:
The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance.[21] When lenders include escrow funds as part of the borrower's monthly house payment, they ensure that these funds are available when due, and they also make the true cost of the loan more transparent. Responsible lenders have always understood that establishing an escrow account is even more important for lower-income borrowers or those with high debt burdens and less disposable income.

Yet, in stark contrast to the prime mortgage market, where escrows are generally required,[22] most subprime lenders make loans based on low monthly payments that do not escrow for taxes or insurance.[23] This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs, and also gives unscrupulous lenders a huge advantage over lenders attempting to lend responsibly. When homeowners are faced with large tax and insurance bills they cannot pay, the original lender can benefit by enticing the borrowers to refinance the loan and pay additional fees for their new loan, or to pay the significant fees associated with force-placed insurance.

When refinances aren't possible, the results can be tragic. Just last week, the Raleigh *News & Observer*, while reporting on the trend of rising foreclosures locally and throughout the nation, described the situation of a North Carolina family that received a high-cost loan with no escrow. As stated in the article, "Cynthia Barrett McGowan wept as she described the home that was to be her legacy .... Instead, the Gastonia couple was swept up in the subprime lending mess that is roiling the housing industry. Their agent did not include insurance and taxes in escrow, requiring almost $2,000 they don't have. They couldn't refinance and now face foreclosure."

Appraisal inflation

Deliberately inflating the price of a home is a serious matter, since such false information can mean that families borrow more than the house is worth, making it difficult, if not impossible, to get out of an unaffordable loan. When lenders use inflated appraisals on loan products that already pose high potential for foreclosure, in a market where home prices are soft in many areas, homeowners are clearly set up to fail.

Consumer advocates have long expressed concerns about appraisal inflation in the subprime market, and this issue became more prominent with the notorious Ameriquest lawsuit. In 2006, Ameriquest—which was the largest subprime lender at that time—agreed to pay $325 million to settle a lawsuit brought by 33 state Attorneys General and the District of Columbia. One of the primary findings of the investigation was that Ameriquest had pressured appraisers to inflate home values.[24]

In spite of widespread publicity on the Ameriquest case, it is apparent that appraisal inflation remains a significant problem in the market. For example, the state of Ohio is suing 10 subprime originators, mostly mortgage brokers, for pressuring appraisers to inflate home values.[25] Ohio now has the third highest number of foreclosures in the country, and state leaders have identified appraisal inflation as a significant culprit. The state attorney general, Marc Dann, has been quoted as saying, "Predatory lending is driving Ohio's shameful home foreclosure rate. [This] crackdown on appraisal fraud will help protect consumers and move us one step closer to driving unscrupulous lenders out of our communities."[26]

It is heartening to note that appraisers themselves have expressed strong concerns about corruption in the lending process, and they are taking an active role in advocating reforms. Many of you here today are probably aware that the Appraisal Institute and

associates have recently held extensive discussions with regulators and members of Congress to ask for regulatory reforms to ensure the independence of the appraisal process, and to stop the widespread practice of appraiser coercion.[27] I am sure you will hear more on this topic from the Appraisal Institute today at this hearing.

Reckless underwriting that fails to consider ability to repay:
Lenders today have a more precise ability than ever before to assess the risk of default on a loan. Lenders and mortgage insurers have long known that some home loans carry an inherently greater risk of foreclosure than others. However, by the industry's own admission, underwriting standards in the subprime market have become extremely loose in recent years, and analysts have cited this laxness as a key driver in foreclosures.[28]

Lenders who market 2/28s and other hybrid ARMs generally do not consider whether the homeowner will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that most are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate will rise significantly even if interest rates in the economy stay constant, giving the borrower a much higher monthly payment.[29] In fact, it is not uncommon for 2/28 mortgages to be originated with an interest rate four percentage points under the fully-indexed rate. For a loan with an eight percent start rate, a four percentage point increase to twelve percent is tantamount to a 40 percent increase in the monthly principal and interest payment amount. As the lenders well know, virtually no subprime borrower can afford such an increase.

In fact, lenders know a lot more about mortgage financing than the typical consumer, and that isn't likely to change. That is why merely adding more disclosures to the loan process will not be enough to protect people from unaffordable loans. Shawn Howell's story, cited at the opening of my remarks, highlights this point. It is clear that Mr. Howell is an intelligent man, but like many consumers, he trusted the mortgage professional who assisted him through the loan process and didn't read all the fine print included in the reams of papers presented to him when the loan closed. Any effective lending laws will prohibit abusive practices without allowing lenders the loopholes that disclosures can provide.

The predatory lending practices we are discussing here today have been ignored for far too long, and with devastating consequences to families, the communities in which they live, and the country as a whole. Thank you very much for your interest in this issue and the opportunity to testify before you today. I would be happy to answer any questions you may have.

Appendix One: Loan Characteristics from Recent MBS Deals

The statistics below are from a sampling of recent MBS issues and offerings and contain information on the loan features therein. This collection does not encompass the entire subprime MBS market but is representative of the typical makeup of subprime MBS issues.

SOUNDVIEW HOME LOAN TRUST 2007-OPT2 available at:
http://www.sec.gov/Archives/edgar/data/1403447/000088237707001693/d685433_fwp.htm
76.06% ARMs
45.95% Stated/Reduced Doc
3.34% IO
73.29% Prepayment penalty
(Originator: Option One)

SOUNDVIEW HOME LOAN TRUST 2007-OPT1 available at:
http://www.sec.gov/Archives/edgar/data/1398202/000088237707001371/d671413_424b5.htm
73.71% ARMs
52.40% Stated/Reduced Doc
4.70% IO
74.46% Prepayment Penalty
(Originators: Option One)

Merrill Lynch First Franklin Loan Trust Series 2007-4 available at:
http://www.sec.gov/Archives/edgar/data/1402720/000095012307008675/x36019fwp.txt
83.16% ARMs
27.42% Stated/Reduced Doc
4.40% IO
69.20% Prepayment Penalty
(Originators: First Franklin)

Merrill Lynch First Franklin Loan Trust Series 2007-3 available at:
http://www.sec.gov/Archives/edgar/data/1398697/000095012307008073/y35327b5e424b5.txt
83.12% ARMs
28.69% Stated/Reduced Doc
6.40% IO
68.08% Prepayment Penalty
(Originators: First Franklin)

CWABS Asset-Backed Certificates Trust 2007-7 available at:
http://www.sec.gov/Archives/edgar/data/1021913/000114420407023344/v073913_424b5.htm
66.23% ARMs
35.95% Stated/Reduced Doc
19.64% IO
68.24% Prepayment Penalty
(Originator: Countrywide)

CWABS Asset-Backed Certificates Trust 2007-8 available at:
http://www.sec.gov/Archives/edgar/data/1021913/000114420407030120/v077325_424b5.htm
65.46% ARMS
34.04% Stated/Reduced Doc
17.65% IO
69.12% Prepayment Penalty
(Originator: Countrywide)

HSI Asset Securitization Corporation Trust 2007-HE2 available at:
http://www.sec.gov/Archives/edgar/data/1323260/000114420407023098/v073805_424b5.htm
82.93% ARMs
43.25% Stated/Reduced Doc
17.04% IO
71.56% Prepayment Penalty
(Originators: HSBC/Decision One, WMC)

WaMu Series 2007-HE4 Trust available at:
http://www.sec.gov/Archives/edgar/data/1401898/000088237707001650/d684569-424b5.htm
82.02% ARMS
28.23% Stated/Reduced Doc
9.23% IO
79.44% Prepayment Penalty
(Originators: WaMu and Long Beach)

Citigroup Mortgage Loan Trust 2007-AMC4 available at:
http://www.sec.gov/Archives/edgar/data/1399477/000088237707001671/d683201_ex424b5.htm
72.02% ARMs
32.34% Stated/Reduced Doc
19.67 IO
61.44% Penalties
(Originators: Argent and Ameriquest)

Structured Asset Securities Corporation Mortgage Loan Trust 2007-BC3 available at:
http://www.sec.gov/Archives/edgar/data/808851/000114420407029665/v077232_424b5.htm
79.02% ARMs
38.59% Stated/Reduced Doc
20.01% IO
70.79% Prepayment Penalty
(Originators: BNC and People's Choice)

END NOTES

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[1] Julie Creswell and Vikas Bajaj, *3.2 Billion Move by Bear Stearns to Rescue Fund*, New York Times (June 23, 2007).

[2] Dick Gordon radio broadcast, "The Story," American Public Media (June 12, 2007). *See also*, Karen Springen, "This is Not My Beautiful House," *Newsweek* web exclusive (March 28, 2007).

[3] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[4] *Investors Weary of Lenders' Underwriting Adjustments*, Inside B&C Lending (May 18, 2007).

[5] "Statement of Martin Eakes Before the Federal Reserve Board on the Home Ownership and Equity Protection Act" at http://www.responsiblelending.org/pdfs/Fed-6-14-07-ME-Statement.pdf.

[6] Keith Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (January 2005).

[7] Ruth Simon, *Mortgage Refinancing Gets Tougher; As Adjustable Loans Reset at Higher Rates, Homeowners Find Themselves Stuck Due to Prepayment Penalties, Tighter Credit*, Wall Street Journal (February 8, 2007).

[8] Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* Center for Responsible Lending (December 2006). *See also* Roberto G. Quercia, Michael A. Stegmen and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005).

[9] Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . .." "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices. *See Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 4.

[10] John C. Dugan, Comptroller of the Currency, "*Remarks Before the Neighborhood Housing Services of New York*," (May 23, 2007) at 3, available at: http://www.occ.treas.gov/ftp/release/2007-48a.pdf.

[11] *See* Jonathan R. Laing, *Coming Home to Roost,* Barron's (Feb. 13, 2006) at p.26. As a typical example, consider the situation of a borrower with an annual income of $30,354 who receives a 2/28 subprime home loan for $180,000. With a "teaser" interest rate of 7.55 percent, the borrower has an initial monthly payment of $1,265. However, the fully indexed rate climbs to 11.25 percent with a corresponding monthly payment of $1,726. Even more disturbing, the homeowner was placed in the loan with a debt-to-income ratio of 61 percent, meaning that well over half of the borrower's post-tax income would be spent on his mortgage. At the fully indexed rate, the debt-to-income ratio rises to 83 percent, a debt burden that is clearly unaffordable.

[12] *See* https://www.wellsfargo.com/mortgage/buy/loans/descriptions/mexpress; http://www.southernmortgagesolutions.net/specialty.htm; http://www.forthebestrate.com/no-money-down-mortgage.aspx

[13] Representative Leach, May 24, 2000. House Banking Committee's "Predatory Lending Practices" hearing. Available at http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.HTM.

[14] *See* "Statement of Martin Eakes Before the Federal Reserve Board on the Home Ownership and Equity Protection Act" at http://www.responsiblelending.org/pdfs/Fed-6-14-07-ME-Statement.pdf.

[15] About one-third of the states have established, through regulation or case law, a broker's fiduciary duty to represent borrowers' best interests. However, many of these provisions are riddled with loopholes and provide scant protection for borrowers involved in transactions with mortgage brokers.

[16] Brokers earn money through up-front fees, not ongoing loan payments. To make matters worse for homeowners, brokers typically have a direct incentive to hike interest rates higher than warranted by the risk of loans. *See* Howell E. Jackson and Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* pp 121-129 (January 8,2002), at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.

[17] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[18] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[19] A Freddie Mac researcher reports one out of five subprime borrowers could qualify for prime loans, (*see* Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005)), and a lending industry association recently acknowledged that many borrowers placed into 2/28 mortgages could have qualified for thirty-year, fixed rate loans for a rate typically just 50 to 80 basis points (i.e., .5 or .8 of a percent) higher than the teaser rate on the loan they received. (*see* February 5, 2007 letter from CRL to Senators Dodd, Allard, Schumer, Reed and Bunning, attached as an exhibit to the Testimony of Martin Eakes before the U.S. Senate Committee on Banking, Housing and Urban Affairs, at p. 7 [responding to claims made by the Coalition for Fair and Responsible Lending (CFAL)], available at http://www.responsiblelending.org/pdfs/martin-testimony.pdf).

[20] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006). This research examined lending data submitted under the Home Mortgage Disclosure Act for 2004, which was the most recent data available.

[21] *See, e.g.*, "B&C Escrow Rate Called Low," *Mortgage Servicing News Bulletin* (February 23, 2005), "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments... Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[22] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[23] *See, e.g.*, "Attractive Underwriting Niches," Chase Home Finance Subprime Lending marketing flier, at http://www.chaseb2b.com/content/portal/pdf/subprimeflyers/Subprime_AUN.pdf (available 9/18/2006) stating, " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower). 'Low balling' payments by omitting tax and insurance costs were also alleged in states' actions against Ameriquest. *See, e.g.* State of Iowa, ex rel Miller v. Ameriquest Mortgage Co. et al, Eq. No. EQCE-53090 Petition, at ¶ 16(B) (March 21, 2006).

[24] *See, e.g.*, Ameriquest Agrees to $325M Settlement with Spitzer at http://www.foxnews.com/story/0,2933,182520,00.html.

[25] Brian Louis and Sharon L. Crenson, *Ohio Sues Real Estate Firms for Pressuring Apprasiers*, Bloomberg.com (June 7, 2007) at http://quote.bloomberg.com/apps/news?pid=20601087&sid=aQdSUG9peQGM.

[26] Ibid.

[27] "AI Members Take Their Concerns to Capitol Hill," Appraisal Institute website at http://www.appraisalinstitute.org/publications/ano/default.asp?volume=8%20&number=7/8#3805. *See also* Kenneth R. Harney, *Appraisal Inflation*, Washington Post (April 21, 2007).

[28] *See e.g.*, Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005.* The Office of The Comptroller of Currency (OCC) survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions. *See also* Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

[29] For example, Fremont considered ability to repay based on initial payments due during the first year. Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm. Option One qualified borrowers at the initial teaser rate. *See* Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006), http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm, Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007), http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm. Likewise, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. "Best Practices Won't Kill Production at New Century," p. 3 *Inside B&C Lending* (November 24, 2006).