

TESTIMONY OF ALLEN J. FISHBEIN

DIRECTOR OF HOUSING AND CREDIT POLICY,
CONSUMER FEDERATION OF AMERICA (CFA),
ON BEHALF OF CFA AND NATIONAL CONSUMER LAW CENTER (NCLC)

BEFORE THE

SUBCOMMITTEE ON HOUSING & TRANSPORTATION AND SUBCOMMITTEE
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U.S. SENATE

REGARDING

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

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Good morning Chairmen Allard and Bunning, Ranking Members Reed and Schumer, and members of the Committee. My name is Allen Fishbein, and I am director of Housing and Credit Policy for the Consumer Federation of America. My testimony is presented on behalf of both CFA,¹ and the low income clients of the National Consumer Law Center.² We appreciate the invitation to appear here today to present our views concerning non-traditional mortgages and commend the two subcommittees for holding hearings on this important and timely subject.

Non-traditional mortgage are complex loan products that have enabled lenders to maintain high numbers of loan originations even in a rising interest rate environment. The initial low monthly payments are attractive to borrowers who want to leverage their purchasing power in a rapidly appreciating housing market. Unfortunately, many non-traditional borrowers may not fully understand the changing payment schedules,

¹ The Consumer Federation of America is a nonprofit association of about 300 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through research, advocacy and education. CFA published a research report, entitled: *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* (see www.consumerfed.org).

² The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. This testimony is co-written by Alys Cohen and Margot Saunders.

especially the sharp monthly payment increases that are common in non-traditional mortgages. Unsuspecting borrowers could face considerably higher monthly payments than they can afford. In the explosive housing market of the past five years, price appreciation created growing equity that protected the borrower, allowing them to refinance into a more practical mortgage. In a cooling market, stretched borrowers can simultaneously become upside down in their mortgages and have steeply rising monthly payments.

As housing prices have soared in recent years, non-traditional mortgage products, such as interest only mortgages and payment option adjustable rate mortgages (ARMs), have grown increasingly prevalent. These types of loans were less than one percent of mortgages in 2000, yet according to some they comprised a third or more of new loans made last year. In addition, lenders are increasingly combining these products with other higher-risk practices, such as simultaneous second-lien mortgages and stated income and other reduced documentation requirements to qualify borrowers for loans. Federal banking regulators, consumer advocates, and some in the industry all have expressed concerns that non-traditional mortgages, or “exotic” mortgages as they are also known, and these layered risk combinations may be too exotic for many that have taken them out. Ultimately, consumers may not adequately understand how the monthly payments on these newer, more complex loans will change over the life of the mortgage nor may they be able to afford the changing payment schedules, which could put their homeownership and financial stability in jeopardy. The delinquencies and foreclosures that result from unsustainable loans will have extremely negative implications for the credit ratings of

CFA/NCLC Senate Testimony on Non-Traditional Mortgages

borrowers that could prevent or make refinancing or a subsequent home purchase prohibitively expensive.

Non-traditional mortgages have existed in some form for many years. Interest only mortgages allow borrowers to pay interest but no principal in the loan's early years. Payment option ARMs offer borrowers multiple payment choices and often feature a low introductory rate, but can lead to a rising loan balance (also known as negative amortization) should the borrower choose the minimal payment option. Simultaneous second mortgages, or "piggyback" loans, combine a mortgage with a home equity loan or line of credit, allowing borrowers to finance more than 80 percent of the home's value without private mortgage insurance. Stated income or reduced documentation features are used by lenders to accept reduced or minimal standards to substantiate borrower income and assets and are used to qualify borrowers unable to meet traditional underwriting standards.

Traditionally, these types of loans were niche products that were offered to upscale borrowers with particular cash flow needs or to those expecting to remain in their homes for a short time. They typically feature lower initial monthly payments compared with traditional fixed rate and adjustable rate loans, but only for a limited period of time.

What has changed is that today non-traditional mortgages are aggressively mass marketed to a much broader spectrum of borrowers and are of used for borrowers who need to stretch their incomes to afford the higher prices of homes. These products may

help some people buy homes at prices they could not otherwise afford using traditional mortgages. At the same time, non-traditional mortgages expose borrowers to near certain significant monthly payment increases when loan terms reset after a brief period, usually two or three years. Borrowers could be vulnerable to “payment shocks,” making their homes suddenly unaffordable and potentially ruining their finances. As the FDIC pointed out in a consumer brochure last year, “Many new loan products are being widely offered that could benefit some people but be huge mistakes for others.”³

Many, including the federal banking regulators, are justifiably concerned that non-traditional mortgages are being offered to many borrowers who may not adequately understand the additional risks they carry or for whom these products simply may not be appropriate. As such, the rapid proliferation of new mortgage products as affordability tools pose a serious threat to sustaining home equity and homeownership, particularly for more vulnerable borrowers – highly leveraged first time homebuyers, modest and fixed income households, and those that rely on higher price subprime loans face financing additional risks from these products. Rising interest rates and a softening housing market could make these loans difficult, costly or impossible to refinance for some portion of borrowers. These borrowers could find themselves in the untenable position of owing more than their home is worth, being unable to afford the higher monthly payments and potentially face foreclosure. The resulting foreclosure stress also makes it more likely that they will fall victims of predatory and unscrupulous lenders.

³ FDIC, “A Shopper’s Guide to Bank Products and Services,” *FDIC Consumer News*, Summer 2005.

This testimony describes the changing face of the mortgage market and the rise of non-traditional mortgage market; the characteristics of non-traditional mortgage borrowers that demonstrates that they are no longer solely the affluent money managers they once were; the increased default and foreclosure risk these newly prevalent mortgages can pose to some borrowers; the lack of consumer understanding of the complexity of these new mortgage products; the impact that changing underwriting standards have on borrowers and on lenders; the relation between these new mortgages and the housing market; and presents the additional protections that consumers need in a changing mortgage market.

The Face of the Changing Mortgage Market

It is difficult to estimate with complete accuracy what the full range of nontraditional products represents as a share of the mortgage market. However, industry analysts have projected significant numbers of ARMs (including traditional ARMs – one-quarter of all outstanding mortgages) are due for interest rate resets over the next four years. Many of these are in the form of payment option mortgages and include interest only features. During 2006, \$400 billion in ARMs are scheduled to readjust for the first time, and in 2007, \$1 trillion to \$2 trillion in ARM mortgages will readjust.⁴ Already some industry

⁴ Jaffe, Chuck, “Painful ARM Twisting,” MarketWatch, August 2, 2006; Elphinstone, J.W., “Foreclosures May Jump as ARMs Reset,” *Associated Press*, June 19, 2006.

analysts predict that higher monthly payments resulting from these resets are likely mean that one in eight or more of these loans will end up in default.⁵

Of particular concern, are the 2/28 hybrid ARMs that are the predominate form of subprime mortgages that were originated in 2004 and 2005. These loans carry an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments for the remaining life of the loan. In essence, these mortgages are another form of non-traditional mortgage in that they offer the prospect that monthly payments may explode after the initial rate period expires. In 2005 subprime mortgages constituted about 25 percent of all mortgage originations and it is estimated that over 80 percent of these were adjustable rate loans. Already there are signs that many will have great difficulty in making these significantly higher payments. The concentration of ARMs and hybrid ARMs among subprime borrowers has additional risk of payment shock because these borrowers already have higher interest rates, so subsequent increases will be more difficult to afford.⁶

The Characteristics of Non-Traditional Mortgage Borrowers

Non-traditional mortgage borrowers generally have been portrayed as wealthier, financially sophisticated consumer, with better credit profiles than the typical mortgage borrower. In fact, the burden of these riskier mortgages is falling on many middle and

⁵ Knox, Noelle and Barbara Hansen, "More Fall Behind on Mortgages," USA Today, September 14, 2006.

⁶ Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 4.

moderate income borrowers. Recent CFA research analyzed the data for some 100,000 mortgages found:⁷

- **Significant shares of non-traditional mortgage borrowers earn less than \$70,000 annually.** More than one-third (36.9 percent) of interest only borrowers earned below \$70,000 annually and about one in six (15.6 percent) earned \$48,000 annually. More than one third (35 percent) of payment option borrowers earned under \$70,000 annually and about one in eight (12.1 percent) earned under \$48,000. (\$70,000 a year was about the median income for Atlanta, Philadelphia and Chicago, and \$44,300 is the national median. However, \$70,000 is below the area median income for many markets that have experienced rapid home price appreciation such as Washington, DC, Boston, MA, Long Island, NY, and San Francisco and San Jose, CA.⁸)
- **Many non-traditional mortgage borrowers have credit scores below the national median.** More than one-half of payment option ARM borrowers and 38 percent of interest only mortgage borrowers had credit scores below 700 (723 is the median Fair Isaac Company score.) More than one fifth (21.4 percent) of payment ARM borrowers and about one in eight (12.1 percent) of interest only mortgage borrowers had credit scores below 660.

⁷ Fishbein, Allen J. and Patrick Woodall, Consumer Federation of America, "Exotic or Toxic: An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders," May 2006 at 22-26.

⁸ See Federal Financial Institutions Examination Council, Department of Housing and Urban Development, Estimated MSA/MD Median Family Incomes for 2005 CRA/HMDA Reports.

- **Borrowers of Color are More Likely to Receive Non-Traditional Mortgages:**

African Americans were more likely than non-African Americans to receive interest only loans and payment option mortgages. Latinos were nearly twice as likely as non-Latinos to receive payment option mortgages.

Thus more borrowers may be vulnerable to the payment shocks resulting from non-traditional products than often portrayed. For example, most payment-option mortgages permit borrowers to choose what they want to pay per month for a preset period, ranging from a fully amortizing standard payment to an interest-only payment to a rock bottom minimum payment even lower than the interest-only option. It is estimated that up to 70 percent of payment-option borrowers go with the minimum payment.⁹ That, in turn, causes them to increase their principal debt through a process known as negative amortization. Thus borrowers are allowed to increase their original loan by 10 to 25 percent before they must begin paying down the principal with significantly higher payments. The Comptroller of the Currency reports that half of the least creditworthy option ARM borrowers have mortgage balances that exceed their original loan amount.¹⁰ One lender that specializes in option ARMs, Golden West Financial's Herb Sandler, noted recently that some lenders are not fully explaining or disclosing the risks of option ARMs and "are clearly faking their borrowers out."¹¹

⁹ Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal*, November 29, 2005.

¹⁰ Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 7.

¹¹ Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.

Prospects for Increased Non-Traditional Mortgage Defaults and Foreclosures

Delinquency and foreclosure rates for subprime ARMs demonstrate the huge risk posed by non-traditional products. Over twenty local studies attribute a significant fraction of the increase in local foreclosure rates since the mid-1990s to subprime lending, especially subprime ARMs. Non-traditional interest only and payment option mortgages, with similar payment shocks, are potential ticking time bombs for borrowers as well. In addition, a subprime borrower who refinances with an adjustable rate loan instead of a fixed rate mortgage is 25 percent more likely to experience foreclosure than a borrower whose loan has an extended prepayment penalty.

The recasting interest rates for ARMs and resetting payment structures for non-traditional mortgages will generate significant payment shocks for many borrowers. Nearly three quarters (70 percent) of subprime loans issued since 2001 are scheduled to see their interest rates reset between 2006 and 2007.¹² For borrowers in typical \$200,000 ARM mortgages, payments could increase by 25 percent when the ARM interest rates resets from 4.5 percent to 6.5 percent, or a monthly payment rise from \$1,013 to \$1,254.¹³ For hybrid 2/28 ARMs issued in 2005 and that recast in two years the increasing interest rate environment is expected to increase monthly payments by more than \$300 for 2/28 ARMs and \$500 for 2/28 interest only ARMs.¹⁴

¹² Bajaj, Vikas and Ron Nixon, "For Minorities, Signs of Trouble in Foreclosures," *New York Times*, February 22, 2006.

¹³ Bajaj, Vikas and Ron Nixon, "Re-Refinancing, and Putting Off Mortgage Pain," *New York Times*, June 23, 2006.

¹⁴ FitchRatings, "Rating Subprime RMBS Backed by Interest-Only ARMs," March 9, 2006 at 10.

Although the super-heated housing market and rapidly escalating home prices in recent years has suppressed delinquencies and foreclosures, there are early signs this may be changing as the housing market cools. Already, the recasting ARMs are impacting delinquency rates. In 2006, delinquencies on ARMs have increased 141 percent over 2005 levels according to analysis by Credit Suisse.¹⁵ More recently originated ARMs are more likely to be delinquent. ARMs that were originated in 2005 were three times more likely to be delinquent than ARMs that were originated between 2003 and 2004.¹⁶ One in twenty (5.14 percent) of subprime 2/28 ARMs that were originated in 2005 were delinquent, a 35 percent increase over the previous year.¹⁷ During the second quarter of 2006, about one eighth (12.2 percent) of subprime borrowers were late paying their mortgages and in 18 states more than 15 percent of homeowners with subprime ARMs were behind in their payments.¹⁸ In 2006, the number of subprime mortgages that had at least one missed payment in the first three months after origination increased by 14 percent.¹⁹

Many borrowers in default will ultimately slide into foreclosure and lose their homes and damage their credit ratings for years. Seasonally adjusted subprime foreclosures increased between the fourth quarter of 2005 and the first quarter of 2006 from 1.47

¹⁵ Simon, Ruth, "Homeowners Start to Feel the Pain of Rising Rates," *Wall Street Journal*, August 11, 2006.

¹⁶ Simon, Ruth, "Late Payments on Mortgages Rise," *Wall Street Journal*, May 18, 2006.

¹⁷ *Ibid.*

¹⁸ Knox, Noelle and Barbara Hansen, "More Fall Behind on Mortgages," *USA Today*, September 14, 2006.

¹⁹ Wei, Lingling, "Subprime Mortgages See Early Defaults," *contra Costa Times*, August 30, 2006.

percent to 1.62 percent.²⁰ A recent study by First American Real Estate Solutions reported that \$368 billion in adjustable rate mortgages that were originated in 2004 and 2005 are sensitive to interest rate adjustments that would lead to default and \$110 billion are expected to go into foreclosure.²¹ To put this in perspective, this represents 1.84 million defaults and 550,000 foreclosures of median priced homes (nationally, about \$200,000).

Moreover, although many borrowers had been relying on escalating housing prices to allow them to refinance their subprime mortgages as an escape valve from payment shocks, as the housing market cools, this escape will no longer be available to many borrowers. Because many borrowers have little or no equity in their homes, refinancing may not be a viable option. Nearly a third (29 percent) of borrowers who took out loans in 2005 had no equity in their homes or owed more than their homes are worth – this is nearly a three-fold increase over the 11 percent of 2004 borrowers who had no equity in their homes.²² Homeowners who used simultaneous second mortgages to finance 100 percent of their home’s value are unlikely to be approved for a refinance mortgage. In markets where prices stagnate or decline, borrowers may not be able to refinance their mortgages and might be unable to sell their homes before going into foreclosure.²³

²⁰ *Ibid.*

²¹ Cagan, Christopher L., First American Real Estate Solutions, “Mortgage Payment Reset: The Rumor and the Reality,” February 8, 2006 at 38.

²² Simon, Ruth, “Late Payments on Mortgages Rise,” *Wall Street Journal*, May 18, 2006.

²³ Elphinstone, J.W., “Foreclosures May Jump as ARMs Reset,” *Associated Press*, June 19, 2006.

Additionally, the increasing interest rates combined with the cooling housing market creates an environment that drives more homeowners into foreclosure. The ARMs that were issued in 2003 and earlier had their rates reset as interest rates were falling and home prices were increasing, which lowered the interest rates and reduced monthly payments and rising home equity also allowed borrowers to refinance their loans.²⁴ The number of existing home sales in 2006 is projected to drop 7.6 percent below 2005 sales.²⁵ Sales prices are projected to rise modestly by 3.5 percent, but are far below the 12 and 13 percent price increases in 2004 and 2005 respectively.²⁶ Rising interest rates and stagnant or falling housing prices inverts the trends of a few years earlier. Rather than being cushioned by falling rates and rising prices, recent ARM borrowers are likely to be punished by rising interest rates and declining housing prices.

Consumers Do Not Understand the Risks Associated with Non-Traditional Mortgage Products

We are concerned that many borrowers using non-traditional mortgage products are not fully aware of the financial implications and potential hazards these products entail. It is easy to understand why. Consumers today face a dizzying array of mortgage products that are marketed and promoted under a range of products names. While the number of products has exploded, there appears to be little understanding by many borrowers about

²⁴ FitchRatings, "Rating Subprime RMBS Backed by Interest-Only ARMs," March 9, 2006 at 2.

²⁵ "Realtors Slash Home Sales Forecast," *Reuters*, September 7, 2006.

²⁶ Izzo, Phil, "Housing Slowdown Takes Its Toll," *Wall Street Journal*, September 8, 2006.

key features in today's mortgages and how to compare or even understand the differences between these products.

A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage.²⁷ According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate from 6 percent to 8 percent by approximately 30 percent. Younger, poorer, and less formally educated respondents underestimated by as much as 50 percent.

The results of a recent Federal Reserve survey of ARM borrowers provides further indication that many borrowers are unfamiliar with even the basic terms of their mortgages. The survey found that 35 percent of them did not know the maximum increase that their interest rate can rise at one time, 44 percent were unsure of the maximum rate they can be charged, and 17 percent did not know the frequency with which their rate could change.²⁸

Public Opinion Strategies, a nationally known polling organization, last year convened a focus group comprised of recent non-traditional mortgage borrowers. It also found that when consumers are shown the rate sheet with the various mortgage options they are

²⁷ CFA, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.

²⁸ Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.

surprised by the magnitude of the payment shock. Although upper-income focus group participants are less surprised, lower-income participants described the payment shock on the rate sheet as “shocking” and they were largely unaware of the size of the payment shock.²⁹ These lower-income consumers were also less informed about the payment increases and debt risks of non-traditional mortgages, with some noting the “wish they had known more.” All of the lower-income segment in one of the studied cities said that the higher payments after the mortgage recast would create a financial hardship for their families, and three quarters of them were concerned about their ability to make the monthly mortgage payments when the payments increased after the loan recast.

These payment shocks can be severe. For a \$200,000 loan, the monthly payment increase for different loan products can vary significantly when the loan is recast at higher interest rates. Monthly payments on a payment

Monthly Loan Payments for Different Types of \$200,000 Mortgages				
Interest Rate	30-Year Fixed	5/1 ARM	5/1 Interest-only ARM	Option Arm
5.00%	\$ 1,104	\$ 1,074	\$ 875	\$ 643
6.50%	\$ 1,104	\$ 1,244	\$ 1,350	\$ 1,472
Monthly Increase	\$ - 0.0%	\$ 170 15.8%	\$ 475 54.3%	\$ 829 128.9%
8.00%	\$ 1,104	\$ 1,422	\$ 1,544	\$ 1,652
Monthly Increase	\$ - 0.0%	\$ 348 32.4%	\$ 669 76.5%	\$ 1,009 156.9%
5/1 ARMs are at 5.25% for first 5 years then reset to scenario rate, Option ARM has a 1-month teaser rate of 1.0%, then resets to scenario rate. Payment option rate capped at 7.5% and negative amortization limit of 110%.				

option ARM with a 5.00% interest rate would more than double if the interest rate were reset at 6.50% and would be one and a half times higher if the note were reset at 8.00%,

²⁹ See Fisbein and Woodall, CFA, “Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders,” May 2006 at 21-21.

an interest rate that was seen as recently as 2000. Monthly payments on a 5/1 interest-only ARM would rise by half at 6.5% and rise by three quarters if the note were reset at 8.00%. Monthly payments for a 5/1 ARM without non-traditional features would nonetheless increase by 16% if the loan were reset at 6.5% and rise by one third if the note recast at 8%.

It is likely that this lack of knowledge has helped encourage borrowers to take out loans based on their initial repayment schedule without appreciating the possible risk of rising interest rates and increased monthly costs.³⁰ The lack of consumer understanding, especially among financially unsophisticated consumers, could set borrowers up to fail. Borrowers that do not fully appreciate the extent to which their notes will be recast or interest rates re-adjust will be ill-prepared to face the likely payment shock and could face losing their homes and their financial well being.

Concerns About Weaker Underwriting Practices on Non-Traditional Mortgages for Consumers

A basic premise in the mortgage lending industry has always been that adequate underwriting is necessary to protect the lender from loss. Indeed, evaluating the borrower's ability to repay the loan has historically been the basis for assurance against loss to the lender. Evaluation of the borrower's ability to repay the loan provides

³⁰ Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 2.

protections for both the lender and the borrower. It assures the borrower that someone schooled in the business of lending has determined that the borrower can afford to repay the loan. This underwriting process is essential for the borrower, who generally does not have the expertise to assess this question. However, in recent years the subprime mortgage industry has developed mechanisms to avoid the consequences of bad underwriting and still make substantial profits from mortgage lending. Neither the lenders nor the investors bear the risks that arise from the lack of underwriting or poor underwriting, as practical matter.³¹ The industry and investors have developed a myriad of ways to protect themselves from themselves. The real risk of loss due to lender misconduct is now borne almost exclusively by the homeowner.

Risk to consumers is vastly different from risk to industry. Virtually all business risk can be protected against by a mortgage lender: more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way, insurance against loss can be purchased, securitized pools of mortgage loans can be overcapitalized. It is all a matter of numbers and actuarial acumen to the lending industry. However, to consumers, some risks cannot be measured simply in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon. It is not a risk that this nation's policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy does. Current policy permits mortgage products on

³¹ See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (working paper 2006), available at www.ssrn.com (hereafter "Engel & McCoy").

the market that are known to lead to foreclosure for a substantial number of borrowers. While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The subprime mortgage industry has a business model of making loans that have a 20 percent chance of going into foreclosure within the first five years after origination, and a 60 percent chance of being refinanced.³² Researchers have consistently marveled at the prevalence of refinancing of subprime mortgage loans, even when there are prepayment penalties present.³³ Despite the costs to the homeowners of these refinances, the lenders use this tool to transform a non-performing loan into a performing one.³⁴ These forced refinances are one way that the subprime mortgage industry ensures itself against loss: so long as there is sufficient equity in the home, regardless of the homeowner's ability to make the payments, there is unlikely to be a loss to the investor. Rather, because of the nature of the security – the family home – the debtor will go to great lengths to avoid that loss and will refinance, if at all possible.

³² See Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005. <http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf>. Tables 7 and 8. Each table shows that five years after a subprime loan with various characteristics typical in subprime mortgage loans (adjustable rates, prepayment penalty, balloon term), that loan would have over a 20 percent chance of being in foreclosure at some time in this five years, and a 60 percent chance of being refinanced in this five year period. Only approximately 19 percent of subprime loans were still in active five years after origination.

³³ *Id.* at Executive Summary.

³⁴ Vikas Bajaj, *Mortgages Grow Riskier and Investors are Attracted*, *New York Times*, Sept. 6, 2006 at C1 (investors are increasing exposure in mortgage backed securities despite rising default rates and serious concerns by regulators about faulty underwriting in non-traditional mortgages).

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

A recent article illustrates how the process of securitizing home mortgage loans facilitates the lack of underwriting – and thus the prevalence of predatory mortgages.³⁵ As the authors point out: “Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans.”³⁶ This is the case because:

[i]nvestment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from virtually all of the credit and litigation risk associated with predatory loans. Market and legal forces provide additional protections to investors.³⁷

The mortgage industry protects itself from anticipated defaults and foreclosures by charging everyone a higher price, by securitizing loans in pools with less risky loans, and

³⁵ Engel & McCoy, *supra* note 16.

³⁶ *Id.* at 3.

³⁷ *Id.* at 3-4. It is pointed out later in the article that lenders are essentially indifferent to the deceit of mortgage brokers about default risks because they can shift the risk of loss to the secondary market. *Id.* at 15 n. 52.

by adding credit enhancements.³⁸ That is fine as a business model for those in the mortgage industry. However, it is bad policy for this nation because it fails to account for the externality costs of the loss of homeownership and to communities into equation. The losses to the homeowner, the family, and the community from forced equity stripping refinancings and foreclosures are simply devastating.

Concerns About Improper Underwriting of Non-Traditional Products and Exploding ARMs for Lenders

Non-traditional mortgages require more assiduous underwriting to account for fluctuating payment schedules over the life of the mortgage. Non-traditional loans generally are suitable for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or for investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes, and those with fluctuating incomes do not see substantial upswings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan.

Banking regulators have been warning mortgage lenders about the consequences for improperly underwriting non-traditional loans without adequate consideration of the borrower's ability to pay back these loans. Mortgage risk is increasingly dispersed

³⁸ *Id.* at 23-29.

among a variety of market participants who may either underestimate or simply be willing to price for the greater risks of default and foreclosure that these loans entail in ways that the individual consumer cannot.

Because many non-traditional mortgage products and adjustable rate mortgages are made without adequate underwriting, they potentially present major risks to consumers and to the economy. The growth of ARMs and interest-only products in a low-rate environment means that interest rate increases could potentially lead to significant increases in defaults and foreclosures. Such a result would devastate individual consumers, their families, and communities. Moreover, consumers show extreme sensitivity to interest rate variations; upward adjustments in rates often result in unaffordable monthly payments. Because consumers are a major stabilizing force in the economy, a sharp upswing in rates leading to a significant decline in household spending and significant rise in defaults could have broad implications for economic instability.

Non-traditional mortgages also may present underwriting concerns and credit risks for lenders since there is little long-term experience with the current concentration of non-traditional mortgages. Although some thrifts have experience with some of the non-traditional loan products, the broader lending industry has never marketed the current volume or concentration of non-traditional mortgage products. The new mortgage products “have the potential to take risk to a higher level than bank managers may be

accustomed to” because of their inexperience with the new mortgage products over time, according to FDIC Director John M. Reich.³⁹

Additionally, because of the intense competition for borrowers after the steep decline in refinancing demand when interest rates rose, lenders have been willing to accept more risk to drive originations. The overcapacity in the lending industry has encouraged the mortgage lenders to weaken their lending standards to compete for borrowers.⁴⁰ Accurate assessment of credit risk of financial institutions is vital, because credit risk has been the leading cause of bank failures and remains the largest risk for most financial institutions.⁴¹

Non-traditional mortgages require much more extensive application of meticulous underwriting standards, especially assessing the borrower’s long-term ability to afford monthly payments.⁴² The concentration of non-traditional mortgages by some lenders and the application of layered risk (notes with more than one non-traditional mortgage characteristic) requires lenders to assess borrower risk more carefully and to monitor the loans over time to ensure that borrowers’ risk profile and underwriting has not worsened. Non-traditional mortgage products combined with loosened underwriting standards pose higher risks for default. There are concerns that lenders are focusing on credit scores

³⁹ Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 4.

⁴⁰ Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 5.

⁴¹ Remarks by Federal Reserve Governor Susan Schmidt Bies, At the National Bankers Association Annual Convention, Beverly Hills, October 12, 2005.

⁴² Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 8.

alone to assess the creditworthiness of borrowers without taking into account the borrower's ability to repay the note over the length of the mortgage.⁴³

Non-Traditional Mortgages Contribute to Affordability Problems and the Housing Bubble

The presence of non-traditional mortgage products has facilitated the escalating cycle of rising home prices over the previous five years. Although non-traditional mortgages have been marketed in part as an affordability tool for borrowers to become homeowners despite record-high housing prices, the ability of borrowers to leverage their purchasing dollars with non-traditional mortgages contributed to the rising housing costs. Buyers with non-traditional mortgages could either purchase larger homes than they might be able to afford with a fixed rate mortgage or bid up the home prices. As these buyers put upward pressure on the price of their home purchases, other home sellers increased their asking price and even more borrowers needed non-traditional mortgages in order to afford their home purchases. *USA Today* editorialized at the end of 2005 that "When exotic loans become routine, the economics of housing becomes anything but. These loans add something new and troubling. One might call it a bubble."⁴⁴

⁴³ Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 6.

⁴⁴ Editorial, "As Risky Home Loans Rise, House-Price 'Bubble' Inflates," *USA Today*, December 28, 2005.

Essentially, wider access to credit, including non-traditional mortgages, created an arms race between the credit and real estate industry. Rising prices stimulated the demand for more complex credit mortgage vehicles, which in turn increased demand for higher-priced homes. As San Francisco Federal Reserve Senior Economist noted:

Rapidly rising stock and house prices, fueled by an accommodative environment of low interest rates and a proliferation of “exotic” mortgage products (loans with little or no down payment, minimal documentation of income, and payments for interest-only or less) have sustained a boom in household spending and provided collateral for record-setting levels of household debt relative to income.⁴⁵

It is unquestionable that the housing and real estate market was extremely strong over the past decade. Between 1997 and 2005, home sale prices nationally rose by 55 percent after adjusting for inflation and these increases have added \$6.5 trillion in household wealth.⁴⁶ In 2005, the number of home sales hit a fifth consecutive record year and home price appreciation was steady across the country, with many metropolitan areas having annual price increases above 10 percent.⁴⁷ Silver Spring, Maryland-based mortgage

⁴⁵ Lansing, Kevin J., “Spendthrift Nation,” *FRBSF Economic Letter*, Federal Reserve Board of San Francisco, No. 2005-30, November 10, 2005.

⁴⁶ Baker, Dean and David Rosnick, “Will a Bursting Bubble Trouble Bernanke? The Evidence for a Housing Bubble,” Center for Economic and Policy Research, November 2005 at 3.

⁴⁷ National Association of Realtors Research Division, “The 2005 National Association of Realtors Profile of Real Estate Markets: The United States of America,” December 2005 at 2.

trainer Christopher Cruise noted that “These types of products have been enablers when it comes to allowing home prices to rise.”⁴⁸

In 2006, there have been signs that the housing market is beginning to cool, with fewer sales and housing prices rising at much lower rates than in previous years. In some markets where non-traditional and hybrid ARMs have become a significant share of the market, housing prices have even begun to fall. The homeowners who will be most severely hurt by any downturn in the housing market are the non-traditional borrowers who have purchased the most recently with the least equity in their homes.

Conclusion: New Consumer Protections Are Needed

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

First, we believe that consumers must receive timely, clear, and balanced loan disclosures to help them make wise choices. Loan disclosures mandated under the Truth in Lending Act (and implemented by Regulation Z) should be revised and made more specific and more comprehensive. Borrowers should be provided with information about the

⁴⁸ Downey, Kirsten, “Regulators to Issue Mortgage Warning,” *Washington Post*, April 7, 2006.

maximum payment permitted under the contract. Yet improved disclosures are only a piece of the puzzle and, in and of themselves, are unlikely to be sufficient for many borrowers.

Nor do we believe that enhanced financial literacy alone is an adequate answer – the system is too complex and the bargaining power too diverse. Further compounding the problem is that many borrowers over-rely on loan originators to judge mortgage products for them even though mortgage brokers and lenders typically are not obligated to provide borrowers with the best loan. Industry best practices also are not an adequate answer. To the extent that some best practices can be agreed to, they are not enforceable by consumers and regulators cannot examine for them since they are not binding. Rogue lenders can simply ignore them.⁴⁹ Regulation plays the important role of creating a level playing field for consumers and responsible lenders which does not countenance rogue players.

Second, adoption without further delay of the Proposed Federal Guidance on Non-Traditional Mortgage Products⁵⁰ would help to send the message that depository lenders, such as banks, thrifts, and their lending affiliates should place sufficient emphasis on the borrower's debt repayment capacity over the life of the mortgage. The guidance was first published for comment in December 2005, but has yet to be finalized by the banking

⁴⁹ Just one example of a set of the industry best practices which have been resoundingly ignored are those entered into by Ameriquest Mortgage Corp., which is the subject of a multi-district litigation proceeding in the Northern District federal court in Illinois. *See, e.g.* In re Ameriquest Mortgage Co., 2006 WL 1525661 (N.D.Ill.) May 30, 2006).

⁵⁰ *See*, Interagency Guidance on Nontraditional Mortgage Products, 70 Federal Register, 77249, December 29, 2005.

regulatory agencies. While adoption of strong new federal agency policy in this area would help, it will not apply to the many independent mortgage lenders, Wall Street investment houses, and other important actors that are active in the non-traditional mortgage market. Nor does the guidance alone provide consumers with any new rights and protections to ensure that lenders adhere to the principles adopted. Moreover, the guidance should encompass hybrid ARMs, such as the 2/28 product.

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

1. To maintain homeownership and to maintain the strength of home equity as a primary savings tool, the mortgage industry must be required to underwrite subprime mortgage loans to ensure that the loan is an appropriate loan for this household. To accomplish this, we need strong but flexible standards, like suitability, to apply to all mortgage loans. Congress should adopt a duty of good faith and fair dealing applicable to the non-traditional, hybrid adjustable rate and subprime market.⁵¹ This duty would:

⁵¹ A suggested definition of a subprime or “covered home loan” is provided in Section II of these comments.

CFA/NCLC Senate Testimony on Non-Traditional Mortgages

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

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

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

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

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

- C) Prohibit steering borrowers into costlier loans than the borrower's qualification would require.
2. All players involved in the mortgage loan must be part of the solution – just as they are now part of the problem – and there must be full assignee liability applied to mortgage loans. The industry and the secondary market all argue strenuously against assignee liability of any sort, citing, among other things, a series of terrible events that will befall the mortgage industry if full assignee liability is applied.⁵² The best answer to all of these concerns is to look at what happened after 1975 when the Federal Trade Commission passed the *Preservation of Consumers Claims and Defenses Rule*.⁵³ That rule applies full liability in most circumstances to assignees of loans used to purchase goods and services. The automobile dealers and other sellers of goods, among others, argued that if the rule passed that the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.⁵⁴ The finance companies and the banks argued that they did not want the responsibility of policing sellers and that sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and that the rule would interfere with free

⁵² This “sky is falling” list includes – a dramatic decrease in the availability of credit, particularly effecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans as the process is so routinized and involves so many loans at any one time, that a careful review of each loan would be near impossible and would dramatically increase the cost of credit.

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

⁵⁴ 40 Fed Reg. 53506, 53517 (Nov. 18, 1975).

competition.⁵⁵ However, there are absolutely no indications that the passage of this FTC rule has had any impact whatsoever on the availability of or cost of credit. Indeed, it appears that credit availability has continued to expand since the passage of this rule.⁵⁶

3. Congress should enact a duty of good faith and fair dealing in the making of appraisals to support home loans, requiring appraiser's bonds, and the prohibition of communication to the appraiser about the desired appraised value, and a procedure to rewrite the loan amount if a retrospective appraisal shows the original appraisal was inflated.
4. Congress should establish a requirement of good faith and fair dealing in loan servicing, providing, among other things –
 - Limits on fees and charges that can be assessed a homeowner after loan closing;
 - Strict protections against the use of forced-placed insurance;
 - A comprehensive right to cure defaults – to avoid foreclosures;

⁵⁵ *Id* at 53518.

⁵⁶ In 1970, the total non-revolving credit in the US was approximately \$124 billion; growth continued steadily through the 1970s and by December 1980, the total non-revolving credit in the US was approximately \$297 billion. This growth continued notwithstanding the announcement and final promulgation of the holder rule. Source: Federal Reserve Statistical Release G.19 1970 through 1980.

- The requirement that alternatives to default (“work-out options”) be evaluated before a foreclosure can be initiated.
5. Congress should establish a Home Preservation Loan Fund to be implemented by state housing finance agencies, which would provide money to homeowners for whom the payment of the mortgage arrearage would avoid a foreclosure, but who have the wherewithal to maintain their mortgage payments once the mortgage arrearage is paid. The funds for the payment of these arrearages would operate as “silent seconds,” only required to be repaid once the first mortgage is paid off.

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

CFA/NCLC Senate Testimony on Non-Traditional Mortgages

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