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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

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[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).
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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.

[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.