February 5, 2007

The Honorable Christopher Dodd
448 Russell Senate Office Building
United States Senate
Washington, D.C. 20510-0702

The Honorable Jack Reed
728 Hart Senate Office Building
United States Senate
Washington, D.C. 20510- 3903

The Honorable Wayne Allard
521 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510-0605

The Honorable Jim Bunning
316 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-1703

The Honorable Charles Schumer
313 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-3203

Dear Senators,

On January 2nd, the Consumer Mortgage Coalition (CMC) wrote a letter to Senators Sarbanes, Allard, Dodd, Bunning, Reed, and Schumer arguing that it would be inappropriate to apply the October 4th Interagency Guidance on Nontraditional Mortgage Product Risks to subprime 2-28 ARM loans. On January 25th, the Coalition for Fair & Affordable Lending (CFAL) wrote a letter to similar effect to the heads of the federal banking regulators. Their arguments are similar in many respects, and, we respectfully submit, both are equally without merit. Subprime 2-28 mortgages (and other hybrid ARMs with similar characteristics such as subprime 3-27 mortgages) present the full array of risks that drove regulators to issue the Guidance, and should be covered. We address CMC's arguments below, and then, to the extent CFAL has raised any further points meriting response, we address those briefly as well.

Although the CMC tries to link 2-28 subprime ARMs to more established prime hybrid ARMs, the reality remains that 2-28 subprime ARMs present a radically different risk to borrowers and can be covered under the Guidance without introducing new standards on lower-risk prime ARMs. Indeed, the most recent Mortgage Bankers Association *National Delinquency Survey* found that subprime ARMs are starting foreclosure at more than seven times the rate of prime ARMs in the third quarter of 2006.[1]

Many subprime lenders still find such lending profitable, however, because of two factors. First, the advent of risk-based pricing allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Second, the ability to securitize mortgages and transfer credit risk to investors has largely removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have

[1] Mortgage Bankers Association, *National Delinquency Survey, Third Quarter 2006*, (Sept. 30, 2006).

simply become a cost of business that is passed onto borrowers and, sometimes, investors.

One of the primary purposes of the Guidance is to protect borrowers against payment shock. 2-28s almost invariably entail a substantial payment shock because of the way they are designed, underwritten and marketed today. Typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance. This virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two, or when the teaser rate resets.

The harm inflicted by these loans impacts even more borrowers than those affected by the non-traditional mortgages because, first, of the explosion in the subprime market -- from 1994 to 2005, it grew from $35 billion to $665 billion, and from 1998 to 2006, the subprime share of total mortgage originations climbed from 10 percent to 23 percent.[2] The second reason is that 2-28s are by far the most common product in the subprime market today.;[3] through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities.[4]

Moreover, 2-28s and 3-27s are having a particularly damaging impact on communities of color. According to the most recent HMDA data, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[5] while four in ten loans to Latino[6] borrowers were higher-rate, the substantial portion of which are 2-28s and 3-27s. By contrast, approximately 80% of home loans during this time period to white families were conventional loans, the sector clearly protected by the Guidance.[7]

We have seen that borrowers with subprime ARMs were almost never given a choice of products, but were instead automatically steered to an ARM and were given little or no explanation of the ARM's terms. These borrowers should have the same right to receive "information that is designed to help them make informed decisions when selecting and using these products" as recommended by the Guidance.

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[2] Subprime Mortgage Origination Indicators, Inside B&C Lending (November 10, 2006).
[3] Hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector." *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).
[4] *See Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, Fitch Ratings Credit Policy (August 21, 2006). p. 4; Lehman Brothers, *Cause for Al-ARM – A Comprehensive Tool for Understanding the Recent Development of the Adjustable Rate Mortgage and Determining the Implications on Credit Risk of its Growing Popularity*, (June 15, 2005) at 9.
[5] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.
[6] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.
[7] *See e.g.*, Debbie Gruenstein Bocian, *Center for Responsible Lending Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data* (September 28, 2006).

CMC & CFAL Assertions Answered

ASSERTION: 2-28 subprime ARMs are "well-established" with "default rates that are comparable to or sometimes better than those on 30-year fixed rate loans."

ANSWER: The first-lien subprime market is less than a decade old and is only now being tested for the first time as waning house price appreciation exposes weaknesses that are projected to lead to 1 in 5 subprime loans ending in foreclosure.[8]

EVIDENCE:

- Using housing price forecasts from Moody's Economy.com, a recent Center for Responsible Lending report, *Losing Ground*, projected that 1 in 5 (19.4%) of subprime loans originated in 2006 will end in foreclosure and that subprime ARM loans have a greater risk of foreclosure than subprime fixed-rate loans.[9] For example, the report found that subprime ARM loans originated in 2002 had a 78% greater risk of foreclosure than subprime fixed-rate loans after controlling for credit score.
- Multivariate regression analysis from the University of North Carolina showed that subprime ARMs had a 49% greater risk of foreclosure than subprime fixed-rate mortgages after controlling for FICO score, loan-to-value ratio, strength of income documentation, and economic conditions.[10]
- According to the Mortgage Bankers Association National Delinquency Survey, subprime ARMs have much higher delinquency rates than prime ARMs and subprime fixed rate loans. The 2006 third quarter data showed that the delinquency rate for subprime ARMs was 13.22 percent, compared to 9.59 percent for subprime fixed rate loans and just 3.06 percent for prime ARMs.[11]

ASSERTION: "[If the Guidance were extended to 2/28 mortgages, [m]any first-time borrowers would lose the opportunity to own a home."

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[8] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[9] We have been pleased to receive informal confirmation of our projections from various sources, including major investment firms. The attached Baltimore Sun article provides a good summary of the paper's findings and perspective from multiple market participants.

[10] Roberto G. Quercia, Michael A. Stegman 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) at 28-9.

[11] Mortgage Bankers Association, *National Delinquency Survey,Third Quarter 2006*, (Sept. 30, 2006) at 7, 9.

ANSWER: Loans that borrowers cannot afford do not lead to lasting homeownership opportunities. Moreover, the loans in the subprime market are typically debt consolidation refinance loans and do not create new homeownership opportunities.

EVIDENCE:

- Assessing subprime lending from 1998-2004, CRL reports in *Losing Ground* that refinance loans were a majority of all subprime originations.[12]
- A survey published in *Housing Policy Debate* in 2004 by staff from Opinion Research Corporation, Freddie Mac, and Equitec revealed that only 14.2% of subprime borrowers reported taking their loan to purchase a first home.[13] Further, with projected default rates of 19.4% for recent subprime loans, subprime lending appears to be on pace to result in a net loss in homeownership in its current form. Finally, most of the borrowers in a cohort of subprime loans refinance into further subprime loans, and many of these will also be foreclosed upon; following the borrower through subsequent loans rather than just looking at that first loan cohort, CRL roughly estimates in *Losing Ground* actual subprime borrower foreclosure rates over 35%.

ASSERTION: "The type of deep discount below the fully-indexed rate that Mr. Calhoun [of CRL] addressed in his testimony is not common." (Referencing testimony before the Senate Banking Committee regarding Nontraditional Mortgages on September 20, 2006)

ANSWER: High payment shock is absolutely typical of 2-28 subprime ARMs.

EVIDENCE:

- A December 11, 2006 presentation by Fannie Mae Chief Economist David Berson at the Office of Thrift Supervision reported that 2006 subprime ARM loans in mortgage-backed securities carried an average initial interest rate of 7.95% and an average fully-indexed rate of 11.29% as of year-end (margins averaged 5.93% over 6-month USD LIBOR)[14]. For a 2-28 subprime ARM this differential represents a payment shock of 32% between the initial rate and the fully-indexed rate.
- A mid-year 2006 analysis from Fitch Ratings similarly reported that 2-28 subprime ARMs carried a built-in payment shock of 29% even if interest rates

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[12] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 46.
[13] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency", Housing Policy Debate 15:3 (2004).
[14] David Berson, VP & Chief Economist at Fannie Mae, *Challenges and Emerging Risks in the Home Mortgage Business*, presented at the National Housing Forum at the Office of Thrift Supervision (December 11, 2006).

remain unchanged, with LIBOR remaining at 4.27%. With year-end LIBOR at 5.36%, the Fitch analysis suggests payment shocks of 48%.[15]

ASSERTION: "We note that both of these features [subprime prepayment penalties and low-documentation loans] can benefit borrowers…. Lenders are able to offer low-documentation loans because the technology of predicting loan performance has improved..."

ANSWER: Both of these features are associated with higher foreclosure risk on subprime loans and should certainly be scrutinized in the context of the Guidance. Limited documentation loans often are used to make loans where it is known that the borrower's income is insufficient to cover the scheduled payments.

EVIDENCE:

- UNC researchers found that prepayment penalties and limited documentation loans in subprime loans nationally were features associated with a 16-20% and a 15% increase in foreclosure risk, respectively, after controlling for credit score, loan-to-value ratio, economic conditions, and several other variables.[16]
- The CRL *Losing Ground* report finds that prepayment penalties and limited documentation on subprime loans nationally were associated with increased foreclosure risk. For example, for loans originated in 2001, controlling for credit score, the increased foreclosure risk for prepayment penalties and limited documentation features on subprime loans were 36% and 26% respectively.[17]
- Similarly, on a set of subprime loans from the Chicago area, OCC researcher Morgan Rose reported that subprime loans with prepayment penalties and low-income documentation were more likely to lead to a foreclosure starts for subprime refinance ARM loans.[18]
- A report from the Mortgage Asset Research Institute (MARI) examined a sample of stated-income loans and found that 90 percent of borrowers had incomes higher than those found in IRS files and "more disturbingly, almost 60 percent of the

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[15] *Structured Finance: U.S. RMBS Criteria for Subprime Interest-Only ARMs* , Fitch Ratings Credit Policy (New York, N.Y), October 4, 2006.
[16] Roberto G. Quercia, Michael A. Stegman 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)
[17] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 22.
[18] Morgan Rose, OCC Working Paper #2006-1, "Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices."

stated income amounts were exaggerated by more than 50 percent."[19] Similarly, a survey of 2,140 mortgage brokers (constituting a national sample) found that 43 percent of brokers who use low documentation loan products know that their borrowers "can't qualify under standard [debt-to-income] ratios" because they did not have enough income for the loan.[20]

ASSERTION: "Investors set limits on the extent to which loan underwriting can take this initial "teaser" rate into account. They sometimes … [require] that loans with an aggressive initial discount be underwritten at the fully-indexed rate."

ANSWER: To protect both borrowers and responsible lenders who require underwriting at the fully indexed rate, it is important that regulators level the playing field by making this standard applicable to <u>all</u> 2-28 subprime ARMs. It is clear that major subprime lenders do not underwrite to the fully-indexed rate.

EVIDENCE:

- A 2005 Option One prospectus shows that the lender underwrote loans to the lesser of one percentage point over the start rate or the fully-indexed rate.[21] Yet, under this "lesser of" formulation, the latter would typically never apply to 2-28 subprime ARMs.
- As summarized in a November 2006 release, 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 <u>minus</u> one percentage point. Other borrowers have their ability to repay screened at the initial interest rate.[22]

Additional Assertions By CFAL Answered

ASSERTION: The Guidance "does not take into account an individual's income growth over the years."

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[19] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

[20] "How Mortgage Brokers View the Booming Alt A Market," survey conducted by Campbell Communications cited in Inside Mortgage Finance , Volume 23, Number 42 (November 3, 2006 available at http://www.imfpubs.com/issues/imfpubs_imf/23_42/news/1000004789-1.html and cited in Harney, Kenneth, *"The Lowdown on Low-Doc Loans,"* The Washington Post 11/25/2006 page F-1 (November 25, 2006), available at http://www.washingtonpost.com/wp-dyn/content/article/2006/11/24/AR2006112400503_pf.html

[21] *See* Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

[22] ***See Adoption of Additional Lending Best Practices,*** included in "New Century Financial Corporation Reports Third Quarter 2006 Results and Provides Outlook for 2007," (November 2, 2006) *available at* http://news.moneycentral.msn.com/ticker/article.aspx?Symbol=US:NEW&Feed=PR&Date=20061102&ID=6163344.

ANSWER: Subprime lenders' public filings make clear that the lenders do not consider whether the borrower is likely to experience any income growth whatever, but rather qualify the borrower with a focus on the initial years of payment.[23] In the vast majority of cases, the lenders have no reasonable basis for assuming that the borrowers receiving subprime 2-28s and 3-27s will experience any increase in income.

ASSERTION: The Guidance "does not appear to recognize that market forces, including secondary market purchasers' requirements, generally do a better job than regulators at managing nontraditional risks."

ANSWER: This proposition is negated by industry leaders' own statements. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, William D. Dallas, who "acknowledges that [underwriting] standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[24]

ASSERTION: "Traditional hybrid ARMs offer a significantly lower monthly payment for the initial fixed–rate period than an equivalent traditional fixed-rate loan. The rate difference is commonly in the 50 to 80 basis point range."

ANSWER: This assertion reveals a great tragedy confronting many of the families currently losing their homes in foreclosure: for an additional 50 – 80 basis points at the outset, they could have been holding sustainable 30-year fixed rate loans. Gaining little more than a 50 basis point short-term discount, borrowers are being lured into loans that will increase by up to 3% at the beginning of the 25th month, cost them substantial equity stripped through refinancing costs and fees, or force them to lose their home altogether.

Compare the fixed rate cost with the 50 – 100 basis point bump up that roughly half of borrowers pay for not documenting their income, even though most are employees fully able to provide W-2's. Or compare it with the extra interest borrowers pay to give their mortgage brokers, who originate 71% of subprime loans,[25] a yield-spread premium/kickback. For example, for brokers who increase a borrower's interest rate beyond what they qualify for by an extra 1.25%, a recent New Century rate sheet rewards the broker with 2% of the loan amount as a yield-spread premium.

ASSERTION: "The traditional hybrid ARM structure is especially well suited to the needs of nonprime consumers who are looking for a more affordable transitional product as they reestablish their credit and financial footing."

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[23] *See* discussion of Option One and New Century underwriting standards, above.
[24] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.
[25] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

ANSWER: This observation relates to the hybrid ARMs in the prime market, where the introductory rate typically lasts at least 5 years, where lenders escrow for taxes and insurance, and where borrowers are not subject to prepayment penalties. It is directly contrary to the facts associated with subprime 2-28 and 3-27 loans, as shown in the data discussed above.

ASSERTION: "[Pre-payment] penalties, in fact, generally terminate automatically when the loan adjusts to the fully-indexed rate. This allows most consumers to achieve a substantial savings through two or three years of the lower rate, rebuild their credit and then to move promptly to a new lower rate loan without incurring a penalty or having to pay the higher adjusted rates for any extended period."

ANSWER: The experience of most 2-28 and 3-27 borrowers is contrary to the circumstances alleged by CFAL. As CFAL acknowledges, the loans are designed so that the pre-payment penalty remains in effect until the time that the rate resets. This means that the borrower can almost *never* avoid both the pre-payment penalty and the increased rate. As described above, these loans are typically underwritten to so that a substantial proportion of 2-28 and 3-27 borrowers predictably will not be able to afford the loan when the rate resets, and so must choose between paying the penalty and defaulting when the payment shock hits. The latter most definitely does not improve the borrower's credit rating and increases the pressure on the borrower to refinance on the lender's terms.

ASSERTION: "[F]oreclosures for nonprime loans, including hybrid ARMs, are dramatically less than the grossly inaccurate 20% rate ('1 in 5' loans) that some consumer groups have been claiming. Industry data indicate, for example, that the foreclosure inventory rate during the third quarter of 2006 for subprime loans was about 3.9% and the percent of new nonprime loan foreclosures was around 1.8%"

ANSWER: The CFAL figure is misleading in that it represents reflects the percentage of outstanding loans that are in foreclosure at a specific point in time, while the 20% rate is a cumulative rate that reflects the percentage of loans originated during a year that will eventually end in foreclosure over time. Further, the 20% anticipated foreclosure rate on subprime 2-28 loans is in fact a conservative estimate based on conservative assumptions applied to objective loan-level data, and corresponds to data compiled from industry sources, as detailed in our *Losing Ground* report, described above. In fact, the numbers are hardly inconsistent. If 1.8% of subprime loans foreclose each quarter over three years, that would be 21.6% cumulative foreclosure starts. And the 20% number increases substantially when one tracks the subprime borrower through subsequent subprime refinancings, each of which has its own risk of foreclosure.

Conclusion

The steep payment shocks on 2-28 subprime ARMs that follow from dramatic scheduled increases in the interest charges just two years into the loan represent precisely the sort of "deferral of interest" on loans to "a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages" addressed by the Guidance. In the case of 2-28 subprime ARMs, the change in interest rates is typically so large at year two that they may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[26] The magnitude of this deferral is significantly larger than typically found in prime ARM loans.

Federal Reserve Board Governor Susan Bies reached a similar conclusion, recently stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[27] In addition to being consistent with the notion that these subprime hybrid ARMs present a deferral of interest, this quote also illustrates a second dimension on which subprime ARMs tend to differ from their prime counterparts. Specifically, low introductory rates on subprime ARMs are typically associated with high up-front financed fees whereas fees on prime ARMs tend to be much lower.[28] In other words, subprime ARMs routinely find borrowers trading equity in exchange for dramatically lower interest payments—thereby producing the same result as negative amortization.

In addition, this deferral of interest is being presented to borrowers with weaker credit histories who have not traditionally been faced with such large payment shocks. For these reasons, it remains critical that regulators clarify that the Guidance applies to 2-28 and 3-27 subprime ARMs.[29]

We recognize that this issue is emblematic of the widespread abuses in the mortgage market that require Congressional action. We look forward to working with you all on a response to these problems.

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[26] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[27] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[28] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[29] While some have pointed to a reference in footnote 1 in the guidance as evidence that these loans should not be included, that footnote does not clearly address 2-28 subprime ARMs. In it, the regulators explicitly exclude "fully amortizing residential mortgage loan products." However, in the Appendix to the Guidance they also make clear that "fully amortizing" refers both to principal and interest. They use an example where they specifically qualify the term as follows: "a fully amortizing principal and interest payment."

Sincerely,

Center for Responsible Lending
National Consumer Law Center
Consumer Federation of America
Consumer Action
National Lawyers Committee for Civil Rights Under the Law
Rainbow Push
Opportunity Finance Network
National Fair Housing Alliance
U.S. PIRG
National Community Reinvestment Coalition
National Association for the Advancement of Colored People
Acorn
NACA

CC:

The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation
The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
The Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency
The Honorable JoAnn Johnson, Chairman, National Credit Union Administration
The Honorable Neil Milner, President and CEO, Conference of State Banking Supervisors
The Honorable John M. Reich, Director, Office of Thrift Supervision