Mortgage Lending Reform:
A Comprehensive Review of the Current Mortgage System

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on behalf of the:

Low-income clients of the National Consumer Law Center
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Chairman Gutierrez, Congressman Hensarling, Members of the Committee: thank you for inviting me to testify today on behalf of the low income clients of the **National Consumer Law Center,**[1] and the **National Association of Consumer Advocates.**[2] I am here today expressing the views of the hundreds of legal aid and consumer attorneys who, on a daily basis, are fighting the foreclosures and attempting to assist homeowners across the country maintain their homes in the face of today's mortgage crisis.

At this hearing, we have been asked to discuss the current state of mortgage lending and proposals to reform the system, changes to HR 3915 – as passed by the House, issues of specific concern to low and moderate income homeowners and mortgage applicants, as well as servicing issues. In this testimony, we provide the following information:

- Section I – Principles to be used to create the mortgage regulation for the 21st century.
- Section II – Detailed explanations of how these principles should be translated into explicit regulations of the mortgage industry;
- Section III – Background on the problems in the current marketplace relevant to the recommended principles of reform.

I. Introduction

It is common knowledge that mortgage delinquencies and foreclosures are at higher levels than ever before recorded.[3] Mortgage originations have plummeted to historic lows: issuance of

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[1]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*, (6th ed. 2007), *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 address 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 was written by Alys Cohen and Margot Saunders.

[2]The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[3]National Delinquency Survey from the Mortgage Bankers Association • Fourth Quarter 2008 at 2.

non-prime mortgage securities virtually ceased by the end of 2008, and analysts do not expect it to rebuild anytime soon.[4]

The current mortgage market is a mess. The big question is how the mortgage production system should changed – to encourage *good* credit to be accessible, and to protect homeowners and investors from credit which is neither sustainable nor secure.

We propose today a different orientation to the question: rather than creating a complex set of rules which are enforceable some of the time by some of the players against some of those involved in the process, create a system which creates *incentives* to accomplish sustainable and secure credit.

HR 3915, passed by the House in November, 2007, was an aggressive bill for *its* time. It was an attempt to balance the perceived need to change current laws and regulations while preserving access to credit. The bill essentially maintained the current structure of loose regulation of mortgage origination, while tweaking the obligations of various parties – mostly the originators – to enhance their obligations to consumers. The repeatedly expressed counter-balance to stronger consumer protections was the fear of inhibiting credit: it was believed that too much regulation would impair the ability of the mortgage market to provide loans.

With six million foreclosures looming in the near future and the subprime mortgage market in a complete shambles, now is the time to reevaluate the issues raised by the current mortgage regulatory structure. New approaches should be considered to creating a mortgage regulatory system which will work for everyone in the future. We propose to you an approach which carries the following three key characteristics:

A **Simplicity** – The rules should be fairly easy for most people to understand. Multiple categories of creditors, borrowers, and types of loans result in confusion, without establishing a clear structure designed to facilitate fair, affordable, and safe mortgage lending.

B **Transparency –** The contracts and obligations of the parties should be simple. The rules governing the transaction should not only be clearly disclosed, but also be easy to understand. The disclosures governing today's mortgages have become increasingly complex and technical because they are attempting to describe unbelievably complicated transactions. The disclosures must be correct – but if it is too difficult to describe the transaction, perhaps the transaction is too complex to be permitted?

C **Appropriate Incentives –** The current system rewards originators for making bad loans – because the originators are paid regardless of whether the loan is unfair, fraudulent, or unaffordable. Similarly, mortgage servicers are rewarded for servicing

[4] *Inside B&C Lending* (February 27, 2009)

practices which do not sustain homeownership or home-equity. Both the origination and the servicing systems should be re-tooled so that the originators, the lenders, the investors and the servicers *all profit only from practices which promote sustainable, affordable and safe home mortgages.*

II. Outline of New Mortgage Regulatory Structure

1. Realigning Incentives – Pay Originators from Mortgage Payment Stream Only. Insurance brokers are paid their commissions entirely from the stream of payments made by the consumer for the insurance product. If the consumer can no longer afford the product and the payments stop being made, the broker does not receive payment – so the insurance broker has every incentive to ensure that the consumer is sold a product that is affordable. The insurance company also has an incentive to ensure that the consumer can afford the insurance product: as soon as the commissions are paid, the amount of the premiums that the company receives increases.

The insurance model of compensating brokers should be used for the mortgage industry: require that both originators and lenders receive all of their costs associated with originating, making and servicing the loan from the *payment stream*. A homeowner making payments on the mortgage is the sign of an affordable, sustainable mortgage – the continued affordability of those payments should be incentivized by the mortgage regulatory structure.

Currently, the origination process itself is the major source of profit. In fact, it is the only source of profit for the mortgage broker and a not-insignificant source of profit for the mortgage lender: both parties generally receive substantial up-front fees (almost always paid for from the consumer's home equity) at the origination of the mortgage. The lender, which then generally sells the loan into a security, also receives compensation at that point. Neither party depends on the payment stream to recover either their costs associated with making the loan, or for their profit. The current system encourages loan churning – making new loans to homeowners over and over – because the *making of the loan* is what generates the business and the profits in this market. This is the incentive that needs to be changed.

If instead the originator received a percentage of each payment for the first – say two – years – of the loan, that originator would have a strong business incentive to ensure that the homeowner would both be able to make the first two years' payments, and that the homeowner would *want to* continue making the first two years's payments.

Even if the loan were affordable, if the homeowner refinanced it after the first few months – say to obtain a lower interest rate – the originator would lose that part of the commission left unpaid. To avoid this refinancing, at the time loan was first made, both the originator and the lender would want to ensure that the loan were the best possible loan available at the time for the homeowner.

This proposal would be structurally simple to implement: simply pass a federal law which requires that all compensation to the mortgage broker, the originating lender, and the holder, be recovered entirely through the regularly scheduled payment stream of the loan. Third party fees necessarily incurred to close the loan would still be paid by the consumer at closing.

2. Making Simple, Fair Mortgages the Default Mortgage – Mandating the Offer of a *Uniform Mortgage*. Originators should be required to offer every homeowner applicant for a mortgage loan a Uniform Mortgage product. The Uniform Mortgage would be defined as a fixed rate, fully amortizing 30 year mortgage at a rate set by the lender in response to the perceived credit risk of the borrower, with no prepayment penalties.

Alternatives to the uniform loan can also be provided by the mortgage originator – but the costs, risks and benefits would always have to be compared to the uniform mortgage that would be offered. These comparisons – to be provided contemporaneously with the offer of the alternative product would have to be provided at the same time as the alternatives are offered, and would be provided via a simple format developed by the federal agency – presumably the Federal Reserve Board – charged with developing the details of the new disclosure and transparency regulations.

These two changes – requiring that all profits from the origination process be paid through the payment stream, plus requiring that homeowners always be offered the uniform fixed rate, fully amortizing 30 year mortgage, with no prepayment penalty – would be relatively simple to mandate, simple to implement, simple to comply with, and simple for consumers to understand.

There would essentially be just one variable in the uniform mortgage that would change in response to the homeowner's particular circumstances – the fixed rate applicable for the full term. These changes would make the process of obtaining a mortgage, as well as the mortgage itself, transparent.

3. Common Sense Rules Should Be Required. Deregulation of the mortgage origination and servicing process has produced some strikingly absurd situations: lenders making loans without determining the borrowers' ability to make the scheduled mortgage payments, who then find that those homeowners cannot in fact afford the increasing payments; foreclosures on homes when the investors, the communities, as well as the homeowners would benefit from loan modifications instead.

Common sense rules for sustainable long-term home ownership help not only homeowners but also investors. Federal law should require that those making the decisions about the origination and foreclosure of home mortgages must include some basic, common-sense requirements. For example, the following rules should be applicable to all home mortgages made in the future:

- **Mandate that Originators Find that the Homeowners Can Afford All Payments Due on Loan**. Originators must be required to determine that the homeowners' income will be sufficient to afford all of the payments due on the loan.

This includes separate components:

- All scheduled payments due under the terms of the loan, including any potential increases in the interest rate or principal, must be found to be affordable.
- All other housing debt, as well as monthly contribution requirements for property insurance and taxes, must be included in the sum of housing debt.
- All income must be verified through independent means, either using wage statements, bank account and deposit records, or tax information.

- **Mortgage Loans Above Value of Home Should be Prohibited**. Originators should be prohibited from making a mortgage loan for more than the home is worth at the time the loan is made. Similarly, the terms of the mortgage loan should not contemplate that the principal of the loan will climb to an amount over the value of the home. In the current marketplace lenders have made hundreds of thousands of Payment Option Arm Loans (see next section for more discussion about the dangers of these loans) which included basic loan terms contemplating that the principal of the loans would climb above the home's value at origination. This is a recipe for foreclosure – which is exactly what we are seeing. Similarly, inflated appraisals have become commonplace in states which did not experience the steep increases in real estate values – and homeowners and investors are both suffering. To counter these inflated appraisals, originators should be held fully responsible.

- **No Foreclosures Permitted without Modification of Loans.** Federal law should impose one critical requirement before lenders are permitted to foreclose on a primary residence: the servicer must evaluate the homeowner's situation and offer an affordable loan modification where it will produce more income for the investor than a foreclosure. Currently servicers make more money from a foreclosure than a loan modification. Moreover, the income structure for servicer fees encourages them to pad loans with high servicer fees, pushing more homeowners into foreclosure. The servicer fee structure also needs to be changed.

4. Full Enforcement Should be Incentivized – While relying on enforcement of the rules through government administrative action or private litigation is not a sufficient means of making the market successful, public and private enforcement are essential back-ups which serve two essential purposes: 1) they ensure compliance with the rules, and 2) they allow the individuals actually harmed by the violations of the rules to use those rules to protect themselves.

All rules should be enforceable by federal regulators and state attorneys general, as well as by private lawyers. Attorneys' fees and costs should be recoverable by prevailing homeowners. Additionally there should be a general prohibition against unfair, unconscionable or deceptive acts and practices applicable to all involved in the loan origination, servicing and holding. Statutory damages, along with actual damages should be awardable for violation of these rules, up to the value of the combination of the amount remaining due on the loan, plus what has been paid.

5. Full Responsibility – No one involved in the creation, the funding of, or the enforcement of a mortgage loan which violates the rules should be permitted to profit from a loan made in violation of the established rules. Here, again, the complexity and negative incentives in the current mortgage marketplace have allowed too many entities to make money from activities which support fraudulent practices, faulty underwriting, and anti-homeowner practices. This needs to be changed, so that everyone in the process profits from practices which sustain homeownership and home equity.

6. No preemption – In the current mortgage debacle, it has become clear that the state laws protecting consumers are the last bastion of redress for those homeowners who are fortunate enough to find an attorney able to protect them from foreclosure. State laws on fraud, unfair trade practices, unconscionability, foreclosure defenses, good faith and fair dealing, conspiracy, joint venture, as well as other torts and contract defenses, have been the primary way many individual homes have been saved. The rich and textured common law in the states has been particularly useful to the courts as they craft appropriate responses to the new and complex set of problems that have arisen in recent years.

III. Rationale – The Problems of the Current Mortgage Market and the Lessons from the Past

This section will provide a brief discussion of three issues:

A. **Payment Option Arm Loans** ("POARMS") – Much has been written about subprime adjustable rate mortgages and their dangers,[5] but less is known about the equally toxic mortgages known as Payment Option ARM loans. These are some of the most problematic loans in the marketplace, and their prevalence – among both middle and low income homeowners – serve to illustrate the serious failures in underwriting allowed by today's mortgage regulatory structure.

B. **Problems in the Loan Servicing Industry** – The mortgage servicing industry has itself contributed substantially to the current foreclosure crisis. The rules governing this industry need to be changed.

C. **The Role of Preemption and Private Rights of Action Against Enforcers of Illegal Mortgage Instruments** – The last bastion of hope for individual homeowners when faced with illegal mortgages or improper servicing is the private attorney seeking to stop a foreclosure using state law remedies: these must be preserved.

[5] *See generally,* National Consumer Law Center's website on predatory mortgage lending: http://www.consumerlaw.org/issues/predatory_mortgage/index.shtml and the website of the Center for Responsible Lending: http://www.responsiblelending.org/issues/mortgage/.

A. Payment Option Arm Loans – Danger in the Loan.

In the past few years, payment option ARM loans ("POA"s) became a popular type of mortgage offered to many homeowners. Nearly $750 billion in these loans were issued between 2004 and 2007, and they are a substantial cause of the foreclosure crisis facing the United States.[6] Yet they were largely issued to prime borrowers, and for that reason, they are still considered prime loans.[7] **These loans exemplify the essential basis to cover *all* mortgages in the mortgage regulation for the 21st century.**

Like the adjustable rate mortgages that were common in the subprime market since the early part of this decade, POAs include a variable rate component as part of a systematic shifting of risk from lenders to borrowers. The signal factor in POA loans is a set period of time during which the minimum payment is fixed – such as one to several years – but the interest rate varies, which leads to negative amortization and a steady increase in the principal owed on the loan.

Under a payment option ARM a borrower has, in theory, a choice of three payments: a minimum payment based on an initial, low teaser interest rate; an interest only payment that covers the actual interest accruing; and a fully amortizing payment. Three-quarters of all borrowers pay only the minimum payment.[8] The minimum payment is generally sold as a "fixed rate" payment, although the interest rate is usually not fixed for more than a month and may be fixed for only a day.[9] Given the low initial teaser rates (1% to 2%), negative amortization occurs whenever minimum payments are made beyond the initial fixed rate period and the rate becomes adjustable. Most payment option ARM loans limit the negative amortization that can accrue to an amount between 110% and 125% of the original principal.

Once the negative amortization cap is reached, the monthly payments regime is completely changed. There is no longer a choice of payments. Now the borrower must pay an amount sufficient to pay off the loan in the remaining time of the loan term. This means that if the original loan term was 30 years, and the remaining term is now twenty-five years, the – now swollen – principal will be amortized over the remaining twenty-five years of the loan. The combination of negative amortization and low teaser rates results in significant payment shock, often a doubling or tripling of the borrower's payment obligations thirty to sixty months after loan consummation, generally with no more than thirty days notice.

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[6] Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, January 30, 2009.

[7] *Id.*

[8] Joint Ctr. for Hous. Studies, *State of the Nation's Housing 2007*, at 17.

[9] *See, e.g.*, Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007) (describing payment option ARM sold as "fixed rate" when interest only fixed for one month, although payments fixed for a year).

Payment option ARM loans are very problematic for borrowers. They are complex, involve concepts that are unfamiliar and confusing to most, even fairly sophisticated, homeowners.[10] Brokers and lenders can easily take advantage of the complex nature of the products and the lack of specific guidance in the regulations governing disclosures to mislead consumers and make abusive loans.[11]

The dangers of adjustable rate loans for borrowers is considerably exacerbated by additional characteristics on these loans such reduced verification of the borrowers' ability to repay the loan.[12] As more risk factors are piled into the same loans – adjustable rates plus reduced documentation – unsurprisingly, the likelihood of foreclosure rises as well.[13] It is well recognized that particularly the failure to adequately underwrite mortgage loans leads to increased foreclosures creating horrible home losses for homeowners and significant losses for investors.[14]

In 2006 and 2007, federal regulators issued guidance and statements addressing the widespread failure of underwriting in POA loans and other adjustable rate loans.[15] These five federal banking regulators specifically challenged the practice of substituting rate increases for underwriting.[16]

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[10] *See e.g.* Consumer Fed'n of Am. press release, Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages 3, July 26, 2004, (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment) available at http:// www.consumerfederation.org/releases.cfm#Consumer%20Literacy.

[11] Fed. Trade Comm'n v. Chase Financial Funding, Inc., No. SACV04-549, Complaint at 4 (C.D. Cal. May 12, 2004), available at www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (describing payment option ARM); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006) (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%, yet interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page), available at www.gao.gov/new.items/d061021.pdf.

[12] *See* Gov't Accountability Office, GAO No. 06-1021, *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved* 3 (2006), available at www.gao.gov/new.items/d061021.pdf.

[13] See Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12* (Apr. 5, 2007) (increase in early payment defaults within four months of origination, particularly for loans with low documentation and a piggyback loan), available at www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf. Thus, balloon payments and ARMs appear to be markers for lack of loan affordability and consequent default risk rather than the cause of default in themselves.

[14] See, e.g., M. Diane Pendley, Glenn Costello & Mary Kelsch, Fitch Ratings, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance* (Nov. 28, 2007), available at www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624 (noting the absence of adequate underwriting contributed significantly to the elevated default rates in 2007).

[15] Statement on Subprime Lending, 72 Fed. Reg. 37,569 (July 10, 2007); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

[16] 71 Fed. Reg. 58,609, 58,614 (Oct. 4, 2006) ("While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.").

They identified three main failures of underwriting typical of these loans:

- the failure to take into account future rate adjustments and negative amortization in determining ability to repay,
- the failure to include tax and insurance payments in determining ability to repay, and
- the widespread prevalence of stated income loans.

The 2006 Interagency Guidance on Nontraditional Mortgage Products issued by these five federal banking regulators focused on the payment shock occasioned by rate resets and periods of negative amortization.[17] The guidance urged lenders to underwrite loans to the fully indexed rate, as opposed to an initial teaser rate.[18] This focus on the fully indexed rate was a large step forward from the practices of many lenders – and one which was vigorously objected to by the mortgage industry.[19]

Despite these statements from federal regulators, the loans written *after* the pronouncements are expected to default <u>at a greater rate</u> than those written before.[20] According to a recent Wall Street Journal article, based on reports issued by Goldman Sachs and Countrywide:

> As of December, 28% of option ARMs were delinquent or in foreclosure, according to LPS Applied Analytics, a data firm that analyzes mortgage performance. . . .
>
> **Nearly 61% of option ARMs originated in 2007 will eventually default**, according to a recent analysis by Goldman Sachs, which assumed a further 10% decline in home prices. That compares with a

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[17] 71 Fed. Reg. 58,609, 58,613-58,614 (Oct. 4, 2006).

[18] The fully indexed rate is the interest rate that would be in effect at the time of origination, based upon the index identified in the loan note plus the listed margin, absent a teaser rate. Even the fully indexed rate does not reflect the possible risk that interest rates will increase; it is not the maximum rate that can be charged under the note. It is only the rate that would be charged on the note had the interest rate calculations under the note been imposed at the outset.

[19] Subprime Mortgage Market Turmoil: Examining the Role of Securitization, Hearings Before the S. Comm. on Banking, Hous., & Urban Dev., 110th Cong. (2007) (statement of Sandor Samuels, Executive Managing Dir., Countrywide Fin. Corp.) (60% of borrowers from Countrywide could not qualify at the fully indexed rate), available at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=256; Steven Sloan & Joe Adler, How Freddie Cutbacks in Hybrids May Reverberate, Am. Banker, Feb. 28, 2007 (quoting Wright Andrews, a lobbyist for nonbank lending institutions, as saying that most subprime borrowers cannot afford the fully indexed rate and requiring underwriting to the fully indexed rate would prevent adjustable rate mortgages from being made).

[20] *See, e.g.*, American Home Mortgage Assets, LLC Prospectus supplement dated August 29, 2006 (to prospectus dated April 21, 2006), American Home Mortgage Assets Trust 2006-4; Issuing Entity: American Home Mortgage Servicing, Inc.; Servicer: American Home Mortgage Corp. showing that the lender *underwrote these POA loans only for the first year's payments* (at 9), also showing the 73% of the loans covered by this prospectus were refinance loans.

> 63% default rate for subprime loans originated in 2007. Goldman estimates more than half of all option ARMs outstanding will default. (Emphasis added.)[21]

Unfortunately, this only makes clear that guidances and statements from federal regulators are not sufficient to change the marketplace. Instead the basic incentives governing the mortgage origination process have to be changed. There should be clear rules that only permit originators, lenders and holders to profit from the *payment stream* of the loan, the borrower's ability to repay the actual payments that will be required by the loan must be verified to be sufficient before the loan can be made; loans made in violation of these basic rules should not be permitted to be enforced.

B. Problems in the Loan Servicing Industry Substantially Contribute to Foreclosures

While the servicing industry stands at the center of the foreclosure crisis, and thus is in the best position to turn the situation around, the basic structure of the servicing business requires a recognition that this industry will not lead the way out of this foreclosure nightmare – Congressional action is needed.

Mortgage servicers are the link between mortgage borrowers and the mortgage owners. Since the 1990s, mortgage servicing has become an increasingly specialized and lucrative industry, driven in part by the need for one party to coordinate the distribution of mortgage revenues to the investors in securitized loans. Despite the important functions of mortgage servicers, borrowers have few market mechanisms to employ to ensure that their needs are met. Rather, in the interest of maximizing profits, servicers have engaged in a laundry list of bad behaviors, which has considerably exacerbated foreclosure rates.[22] The most common abuses in loan servicing include misapplication of payments, use of suspense accounts, failure to make timely escrow disbursements, and cascading fees imposed upon homeowners in default.[23] These abuses exist because there are market incentives rather than deterrents for this type of behavior.[24] Any new regulation of the mortgage marketplace must account for these dynamics and move beyond them.

1. Servicers – Cutting Cost, Cutting Service.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs. Servicers have cut costs by relying more on voicemail systems and less on people to assist borrowers, by refusing to respond to borrowers' inquires and by failing to resolve borrower disputes. Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate. As a

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[21]Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, January 30, 2009.

[22]See National Consumer Law Center, *Foreclosures*, Ch. 6 (2d ed. 2007)(describing the most common mortgage servicing abuses).

[23]*Id.*

[24]*See* Kurt Eggert, Comment on Michael A. Stegman *et al.'s "Preventive Servicing Is Good Business and Affordable Homeownership Policy": What Prevents Loan Modifications*?, 18 Housing Pol'y Debate 279 (2007).

result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead borrowers are being pushed into short-term modifications and unaffordable repayment plans.

These "kick the can" approaches to solving the foreclosure crisis do not provide real solutions for those affected borrowers. Instead, they merely postpone the day of reckoning. As is evident from the most recent analysis of the loan modifications currently being made – in most cases the modifications only provide very temporary band-aids to situation that need major surgery:

> Modifications increasing loan balances still dominate, with 89% of modifications involving some capitalization of arrears, and only 12% involving any write-offs of principal, interest or fees . . . . Monthly payment reductions accounted for 49% of all modifications, essentially unchanged from November and December, while 13% of modifications did not change the payment and 38% increased the payment.[25]

The single-minded pursuit of foreclosures is costing investors far more than affordable loan modifications would:

> Investors lost $3.8 billion from foreclosure sales, compared with $73 million from write-downs in connection with mortgage modifications. Looking only at the 12% of modified loans with write-offs, the average write-off was $26,000, or about 13.5% of the original loan amount. For liquidated foreclosures, the average loss was $130,000, representing about 61% of the original loan amount.[26]

Creating affordable and sustainable loan modifications for distressed borrowers on a loan-by-loan basis is labor intensive.[27] Under many current pooling and servicing agreements, additional labor costs incurred by servicer's engaged this process are not compensated by the loan owner. By contrast, most servicers are paid a fee to foreclose on a borrower. Under this cost and incentive structure, it is no surprise that servicers continue to push borrowers into less labor-intensive repayment plans or towards foreclosure.

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[25]Alan White, Update - January's Subprime Mortgage Modifications. Consumer Law & Policy Blog, Feb. 13, 2009. Available at: http://pubcit.typepad.com/clpblog/2009/02/update-januarys-subprime-mortgage-modifications.html.

[26]*Id.*

[27]Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls, at 7(Oct. 3, 2007), available from SSRN at papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

2. Servicers Maximize Income in ways that Hurt Borrowers and Investors.

Customarily, the servicer collects a monthly fee in return for the services provided to the trust (or investors). The servicing fee provides the largest income stream for servicers. The fee is based on the unpaid principal loan balance and typically ranges from 25 basis points (prime loans) to 50 basis points (subprime loans). In addition, ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events. The most common ancillary fee is a late fee, although a variety of other "servicer" fees exist. Such fees are a crucial part of the servicers' income because servicers are typically permitted under Pooling and Servicing Agreements to retain such fees. This behavior may benefit the servicers, but it hurts the investor, the homeowner, and communities.

3. The Rules Governing Mortgage Servicers Need to be Changed: Servicers Interests Should be Aligned to those of Homeowners

Getting to Affordable Loan Modifications Takes Work. Creating affordable and sustainable loan modifications for distressed borrowers is labor intensive. It is no surprise, then, that servicers continue to push borrowers into less costly repayment plans and short-term modifications. While the current government loan modifications at least promise better outcomes, these measures are voluntary and temporary.

New legislation should prioritize loan modifications where they are more profitable to investors than foreclosure, and should value loss mitigation in general over foreclosure. Loan modifications must be based on an affordability analysis centered on the debt to income ratio with some consideration of a homeowner's residual income and the person's full debt profile, including junior liens on the property.

Mandating Borrower Access to a Decision Maker. From the homeowner's perspective one of the biggest obstacles to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. Federal law should require that mortgage servicers provide borrowers with contact information for a real person with the information and authority to answer questions and fully resolve issues related to loss mitigation activities for the loan.

Requiring Information and Dispute Resolution Prior to Foreclosure. While the Real Estate Settlement Procedures Act currently requires servicers to respond to borrowers' request for information and disputes within 60 days, in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure.

Essential changes to this law governing servicers would ensure that borrowers facing foreclosure should no longer be at the mercy of their servicer. There should be transparency in the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. Servicers should be prohibited from initiating or continuing a foreclosure proceeding during the period in which and outstanding request for information or dispute is pending.

Most importantly – foreclosures should be prohibited unless an analysis of the comparative costs between an affordable loan modification and foreclosure shows that the investor will reap more income from the foreclosure.

C. The Role of Preemption and Private Rights of Action Against Enforcers of Illegal Mortgage Instruments

Homeowners who have been victimized by predatory mortgages routinely bring actions against the holders of their loans under common law and statutory theories such as unfairness, unconscionability, and breach of duty of good faith and fair dealing. These claims generally are used to challenge the overall damaging nature of the loan, sometimes known as a "net tangible benefit" claim, or to challenge the lender's failure to determine the homeowner's ability to pay the loan. Courts regularly allow these claims to go forward, and these claims are routinely the basis for saving homes around the nation. These claims are often the main claim used to protect against foreclosure—both because they encapsulate the predominant market abuses of today—unaffordable loans and loans grossly mismatched with the borrower's circumstances—and because, unlike fraud claims, they do not require proof of a series of specific elements.

Such challenges are couched in different terms, determined by the rules and requirements of state law and by the facts of the individual cases. They boil down to the same problems: bad loans made with no real analysis of the homeowners' ability to repay or with no material benefit to the borrower.

1. Don't Repeat the Preemption Problems in HR 3915.

One serious problem with HR 3915 as passed by the House in 2007 was the preemption of claims against holders. Section 208 would preempt all claims against assignees and holders when net tangible benefit or ability to pay issues are involved. While there are some exceptions to this wholesale preemption, important claims that are currently saving homes all over the nation would be eliminated. *This is a serious problem which must not be repeated in any upcoming legislation.*[28]

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[28]SEC. 208. EFFECT ON STATE LAWS –

(a) In General- Section 129B(d) of the Truth in Lending Act (as added by section 204) shall supersede any State law or application thereof that provides additional remedies against any assignee, securitizer, or securitization vehicle, and the remedies described in such section shall constitute the sole remedies against any assignee, securitizer, or securitization vehicle, for a violation of subsection (a) or (b) of section 129B of such Act or any other State law the terms of which address the specific subject matter of subsection (a) (determination of ability to repay) or (b) (requirement of a net tangible benefit) of such section 129B.

(b) Rules of Construction- No provision of this section shall be construed as limiting--

(1) the application of any State law against a creditor;

(2) the availability of remedies based upon fraud, misrepresentation, deception, false advertising, or civil rights laws–

(A) against any assignee, securitizer, or securitization vehicle for its own conduct relating to the making of a residential mortgage loan to a consumer; or

(B) against any assignee, securitizer, or securitization vehicle in the sale or purchase of residential mortgage loans or securities; or

(3) the application of any other State law against any assignee, securitizer, or securitization

The preemption would apply whether the claims were made for the assignee's own conduct or for the conduct of the originator for which the assignee is liable as an assignee of the law. This preemption of essential claims against assignees would eradicate the ability of homeowners to stop foreclosures, to void bad loans, or even to modify their loans, when the basis for their claim against the originator is grounded in an analysis similar to "net tangible benefit" or failure to determine the borrower's ability to repay the terms of the loan. Including the holder in the case is critical for the relief needed to address the problem: only the holder has the power to modify the loan. Lawyers who represent homeowners in most states—both defensively against and affirmatively—routinely use non-fraud consumer claims to challenge the predatory nature of the loans.[29] Moreover, these claims are routinely raised against holders of the loans – which is generally essential to do to stop threatened foreclosures.[30]

2. History is Instructive: Making Holders of Bad Loans Responsible Does Not Reduce Credit Availability.

All players involved in a bad mortgage loan must be part of the solution, just as they are now part of the problem. Wall Street's investment in subprime lending transformed the industry from a modest player into a significant portion of the market. The securitization process also resulted in product development aimed at secondary market sales, rather than at homeowners. Moreover, homeowners facing default and foreclosure must contend with rules set by the trusts holding pools of securitized loans.

Borrowers deserve direct access to the party who can save their home. This can only be ensured through applying assignee liability to every mortgage loan. Market incentives and interests must be aligned with those of the homeowners. Opponents of assignee liability claim that a series of terrible events will befall the mortgage industry if full assignee liability is applied. This "sky is falling" list includes: a dramatic decrease in the availability of credit, particularly affecting 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 nearly impossible and would dramatically increase the cost of credit.

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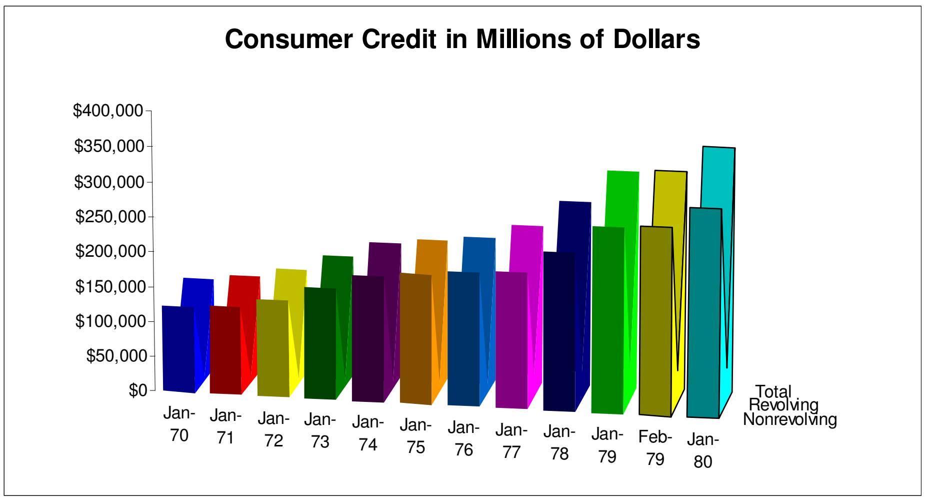
vehicle except as specifically provided in subsection (a) of this section.

[29]In judicial foreclosure states, these claims can be raised as a defense against the foreclosure. In a nonjudicial foreclosure state, it often is necessary to file bankruptcy to have these claims heard, because to stop a foreclosure in a non-judicial foreclosure state requires the filing of an independent, affirmative action, and the issuance of an injunction. In some of these states the bond requirements are prohibitively expensive, so that the only way to stop a foreclosure is to file a bankruptcy.

[30]Our report issued a few months after HR 3915 passed the House, details this analysis and provides extensive examples of real life claims brought to save homes from foreclosure against holders which would be preempted if HR 3915 passed the Congress. *See*, National Consumer Law Center, *Key Home-Saving Measures at Risk: The Threat of H.R. 3915's Preemption Rule*, March 14, 2008. Available at http://www.consumerlaw.org/issues/predatory_mortgage/content/HR_3915_Preemption_Analysis.pdf.

A key perspective in analyzing these concerns is to look at what happened after the Federal Trade Commission passed the Preservation of Consumers Claims and Defenses Rule (commonly referred to as the "Holder Rule") in 1975.[31] The Holder Rule applies liability for all claims and defenses that could be brought against the seller to assignees of loans used to purchase goods and services.[32] The rule reallocates the cost of seller misconduct from the consumer to the creditor,[33] so that a consumer who has been harmed may obtain a remedy by abrogating the Holder in Due Course doctrine.[34]

At the time the rule was proposed, the automobile dealers and other sellers of goods argued that, if the rule passed, 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.[35] The finance companies and the banks argued that they did not want the responsibility of policing sellers, sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and the rule would interfere with free competition.[36] These nightmare scenarios did not materialize.



There was no reduction in available consumer credit; there were no indications that sellers were hurt in any way; there was no discernable

[31]16 C.F.R. 433, 40 Fed Reg. 53506 (November 18, 1975).

[32]The transaction must involve a consumer credit contract and the seller must be in the business of selling goods or services to consumers. The assignee's liability is limited to the amounts paid by the consumer.

[33] Maberry v. Said, 911 F. Supp. 1393 , 1402 (D. Kan. 1995).

[34]An assignee is a holder in due course only if it can show that a) the mortgage is a negotiable instrument as defined by Article 3 of the Uniform Commercial Code, b) the note was properly endorsed to the holder, c) the holder paid value for the mortgage, and d) the holder purchased it without notice that it is overdue and without notice that there is a defense about any nonpayment. See National Consumer Law Center, Cost of Credit (3rd ed. 2005), § 10.6.

[35]40 Fed. Reg. 53506 (November 18, 1975) at 53517.

[36] *Id.*.at 53518.

increase in defaults. This is a chart that illustrates that there was simply no effect on credit availability from passage of the Holder Rule by the FTC. The level of "non-revolving credit" is indicated in the last column and includes auto loans, loans for mobile homes, education, boats, trailers and vacations but excludes all credit card loans. In 1970, total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s, with not even a blip in 1975 and 1976 when the FTC rule was announced. By December 1980, total non-revolving credit in the United States was approximately $297 billion. In the space of ten years, consumer credit – notwithstanding the announcement and final promulgation of the holder rule halfway through that decade – had more than doubled.[37] The amount of outstanding consumer credit has continued to climb unabated since then: the outstanding amount of non-revolving debt increased over 500% during the seventeen years from January 1980 to December 2007.[38] In the area of auto loans, this FTC rule has not interfered whatsoever with the securitization of auto credit.[39] Auto ABS volume for 2005 for prime and subprime loans combined exceeded $75 billion.[40]

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[37]Federal Reserve Statistical Release G.19, 1970 to 1980.

[38]The amount of non-revolving debt (in millions of dollars) was $295,524.23 in 1980 and grew to $1,580,039.43 (in millions of dollars) by December 2007. Federal Reserve Statistical Release G.19, 1980 & 2007, available at http://www.federalreserve.gov/Releases/g19/hist/cc_hist_nr.html.

[39] Letter from Vernon H.C. Wright, Chairman, American Securitization Forum, to Financial Accounting Standards Board (May 10, 2004), available at http://www.americansecuritization.com/uploadedFiles/FAS_140_Setoff_Isolation_letter_51004.pdf. The letter in part describes the FTC Holder Rule and its importance and describes the assessment used in the regular course of business to incorporate such liability into deals. It also states that buyers are willing to assume such risks and purchase such assets –

> For decades, a rule of the Federal Trade Commission (the "FTC Rule") has required every consumer credit contract (for instance, retail automobile installment loans) to include a legend to the effect that any purchaser of the contract is subject to all claims and defenses which the debtor could assert against the seller of the goods financed under the contract. This is to assure that consumers are not deprived of important defenses relating to payments owed on defective goods merely because their initial creditor sells the contract.
>
> The Uniform Commercial Code (the "UCC") provides that a buyer of many common types of receivables (for instance, credit card receivables, short term trade receivables and lease receivables) may be subject to all defenses or claims of the debtor against the seller… . Notwithstanding these risks, buyers are willing to purchase these types of assets. For instance, most retail auto installment paper is originated by auto dealers, who assign the paper to a finance company or bank. The finance company or bank may in turn transfer the paper into a securitization.
>
> The FTC and UCC rules about setoff are the same for both the initial purchase from the auto dealer and any subsequent transfer into a securitization. Banks and finance companies that buy this paper analyze potential setoff risks as analogous to other ordinary course seller risks that a buyer of any asset takes.

[40]ASF 2006 Retail Auto ABS Sector Review, available at http://www.americansecuritization.com/uploadedFiles/Retail%20Auto%20Loan%20ABS%20Sector%20Panel%204pm.ppt#646,1,ASF 2006 Retail Auto ABS Sector Review.

C. The Answer – Simply Prohibit Enforcement of Illegal Loans.

The complexities of assignee liability are confusing and nonsensical. The goal of avoiding liability for the bad acts of those who came earlier in the origination chain simply encourages irresponsible behavior – just the sort of behavior which has brought us to where we are today. An alternative approach, which would further simplicity, transparency and responsibility, would be simply to prohibit the enforcement of a mortgage which violates the simple rules governing the making and servicing of the home loan.

This rule would create incentives for everyone involved in the process to ensure that the rules are followed, rather than ignored. It would also provide an easily determinable degree of risk to those who might purchase the loan: the amount at risk would be the total loan amount. This certainty is all that the ratings agencies have ever said they need.

D. Private enforcement is essential.

We firmly believe that the key to make systemic, meaningful changes in the structure of the mortgage market is to change the incentives, as we have described above. The incentives are established by new rules. The rules we propose are simple, straightforward, and will result in a transparent structure governing mortgage origination and servicing. However, when there are violations of these rules, someone must enforce these violations.

Federal and state regulators are essential ingredients to the enforcement of these rules: Federal regulators must be motivated to keep the nation's lending appropriately flowing and appropriate safe for homeowners and investors. State enforcement agents are essential to be able to respond nimbly to the problems evident in their area.

Private enforcement by lawyers who will be paid by the defendants if the case prevails are also an indispensable part of protecting homeowners. Only private lawyers are able to stop individual foreclosures. Only private lawyers are able to articulate the particular problems with a specific homeowner's situation. Only private lawyers are likely to be able to assist the homeowner in the design of the most appropriate loan modification if the servicer fails to follow those requirements. These attorneys – generally legal services and *pro bono* attorneys – must be able to recover their fees from the defendants when they prevail on their claims. Without this fee shifting, attorneys will not be available, as defaulting homeowners will not have the funds to pay attorneys.

Conclusion

Thank you for providing me the opportunity to testify today on behalf of the low income clients of the National Consumer Law Center, as well as the National Association of Consumer Advocates. I will be happy to answer any questions.