Statement of David G. Kittle, CMB

Vice Chairman of the Mortgage Bankers Association,
Washington, D.C.

before the

National Conference of State Legislators
Committee on Labor and Economic Development

Public Hearing

on

The Future of the Nation’s Middle Class
“Subprime Lending and Foreclosures”

August 6, 2007
My name is David Kittle and I am Vice Chairman of the Mortgage Bankers Association (MBA)\(^1\) and President and CEO of Principle Wholesale Lending located in Louisville, KY. I appreciate the opportunity to testify before you today about a topic that has been in the headlines and is on the mind of many middle class families who own their own homes or who are thinking about purchasing their first home. Those middle class families are today facing a greater challenge of finding affordable home mortgage credit as a result of the increasing legislative and regulatory actions being taken by both federal and state policy makers in response to the rising number of foreclosures being reported in many states and their relationship to more prevalent use of non-traditional and subprime mortgage products. These are issues that are of central concern to the MBA and, I am pleased to share my thoughts with you this afternoon in these areas.

Today's hearing is being held during a significant transition affecting the mortgage market and borrowers including subprime borrowers. MBA and its members share the commitment of the members of the National Conference of State Legislators to assuring protections for consumers against abusive lending and foreclosures and assuring that borrowers continue to have the financing they need to buy and draw needed equity from their homes, and, most importantly, to stay in them.

The real estate finance industry provides many benefits. It is a driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Our industry has helped our country reach a near 70 percent homeownership rate. Thus, when abusive lending occurs, it is a stain on the mortgage industry just as it is a burden on our borrowers and communities.

Foreclosures, likewise, are harmful and can be ruinous to borrowers and lenders and devastating to communities. We support improved protections for consumers and efforts to stem unnecessary foreclosures.

The challenge for policymakers is to balance consumer protections against the need to assure the availability of credit. This is not a simple equation in a $3 trillion mortgage market. We think the best approach would result in better educated consumers and honest loan originators, a goal that is impossible to accomplish with legislation alone. As we do legislate, we must do our best to anticipate unintended consequences that may be the inevitable companions of our best intentions. As a matter of prudence, any proposed solutions should address the real problems associated with a small section of the subprime mortgage market and be weighed against their impact on the broader mortgage market.

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\(^1\) The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.
Going forward, MBA believes that in order to assure the continued availability of mortgage credit, there are three things the government can do to help protect consumers. First, make financial education a priority in this nation, empowering consumers with knowledge and giving them the tools they need to make good decisions and protect themselves. Second, simplify and make more transparent the mortgage process and the functions and fees of key professionals so that consumers may better understand the details of their transactions and shop more efficiently from mortgage professional to professional. Third, we should achieve a strong and balanced uniform national standard for mortgage lending with increased consumer protections and more accountability for mortgage professionals.

The mortgage market in general has done an outstanding job for consumers and the larger economy. To assure its continued capability, we must guard against any policy that is not based on sound facts and that has the potential to undermine these benefits going forward – particularly for those most in need of credit.

I. STRUCTURE OF THE MORTGAGE MARKET AND KEY PLAYERS

Consumers in today’s mortgage market can choose from among a wide array of lenders and mortgage brokers to obtain a mortgage to purchase a home, to refinance and/or to draw on their home’s equity. In 2005, 8,848 institutions including 3,034 commercial banks, 974 savings institutions, 2,047 credit unions and 1,923 mortgage companies, reported under requirements of the Home Mortgage Disclosure Act (HMDA). The National Association of Mortgage Brokers reports 53,000 mortgage brokerage companies, as of 2004, employing an estimated 418,700 people at the time.

The delivery channels through which borrowers obtain loans from these institutions vary considerably based on the institutions’ particular business models. In many cases, lenders originate mortgages through their own loan officers or correspondents in response to loan applications submitted through the Internet, call centers, by mail or a visit to a lender’s office. Others obtain mortgages originated by mortgage brokers. While there is not definitive data on the breakdown of lender and broker originated loans, it has been estimated that mortgage brokers may originate more than 50 percent of all loans and at least 70 percent of subprime mortgages in any given year.

Some borrowers shop effectively among the range of mortgage originators. Others rely on mortgage brokers to shop for them. As noted by former U.S. Senator Paul Sarbanes following a hearing concerning mortgage broker compensation on January 8, 2002, “a borrower’s relationship with a mortgage broker is clearly different than with a lender. A borrower views the broker as shopping on the borrower’s behalf, which is not the case with a lender.”

2 According to the Office of Thrift Supervision.
3 Letter dated January 14, 2002 to the Honorable Mel Martinez.
While a broker’s functions are limited to facilitating the origination of a loan and receiving compensation for those services, lenders risks and responsibilities respecting loan transactions are much greater. Lenders design loan products for borrowers, originate loans, frequently service them and seek remedies when they fail. They have brick and mortar investments in communities. Significantly, they bear the risk of repurchase from the investor if a loan fails and garner significant reputational as well as financial risk in the community if it does.

Loan originators – lenders and mortgage brokers – are compensated through direct front-end fees paid by borrowers. A mortgage broker may also be compensated by a lender based on the loan rate or yield on the loan to which the borrower agrees, with increased compensation resulting from a greater rate.

Since the early 1990s following the advent of mortgage brokers, the U.S. Department of Housing and Urban Development (HUD) has required the disclosure of yield spread premiums (YSPs) to mortgage brokers in table-funded transactions as settlement costs of the borrower. In its 2002 proposed Real Estate Settlement Procedures Act (RESPA) rule, which was withdrawn in 2004, HUD sought to make the disclosure clearer than the current requirements which permit disclosure as a notation on a list of fees as “YSP POC” or yield spread premium paid outside of closing. The existence of a greater YSP can affect the broker’s and the borrower’s choice of a mortgage.

While a lender also may receive compensation based on a loan’s yield by investors in the secondary mortgage market, HUD has not required the disclosure of these payments to lenders. Where lenders receive such payments, they are not obtained at settlement. Moreover, many lenders hold loans in their own portfolio and do not receive such payments on loans. Also, when consumers shop among lenders, they have a clear sense of what their rates and costs are; disclosure of specific back-end fees to the lender is not necessary to protect consumers.

II. TODAY’S MORTGAGE MARKET

Homeownership today is near its highest level in history – nearly 70 percent overall. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2006, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2006 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2006 it was 49.5 percent.

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4 Properly used an increased rate can help the consumer defray some or all of his settlement costs.
5 HUD has established an exemption under RESPA for secondary market transactions. Notwithstanding assertions by mortgage broker organizations of asymmetry of disclosure requirements, HUD has aggressively pursued improvement of mortgage broker disclosures and has not sought disclosure of secondary market payments to lenders. Considering the differing perceptions of borrowers regarding mortgage brokers and lenders, it is evident that HUD regards payments to mortgage brokers by lenders, and not secondary market payments to lenders, as requiring greater borrower understanding.
As a result of these increases in homeownership, across all demographics, more Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years.

MBA’s data indicate that more than a third of all homeowners own their homes free and clear of any lien. Of the 50 million mortgage holders, or two-thirds of homeowners who do have mortgages, three-quarters have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

<table>
<thead>
<tr>
<th>Household Mortgage Type</th>
<th>Percent</th>
<th>Percent of Those with a Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Mortgage</td>
<td>34.6</td>
<td>75.2</td>
</tr>
<tr>
<td>Fixed Rate</td>
<td>49.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Adjustable Rate</td>
<td>16.2</td>
<td>24.8</td>
</tr>
<tr>
<td>Jumbo</td>
<td>3.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Conforming</td>
<td>12.3</td>
<td>18.8</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: American Housing Survey; Mortgage Bankers Association

According to MBA’s Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt. A, and 19 percent were nonprime, with government loans accounting for the remaining 3 percent.
Based on first half 2006 data, nearly half of nonprime borrowers, or 45 percent, used nonprime loans to buy homes. One in four of these purchases was made by a first-time homebuyer. Also, notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased markedly.

III. SUBPRIME MARKET TROUBLES IN PERSPECTIVE

Among current homeowners, 4.9 percent are subprime borrowers with adjustable rate mortgages. Of these subprime ARMs, 10.13 percent are seriously delinquent or in foreclosure. To put this in proper perspective, this is 10 percent of 4.9 percent of homeowners with mortgages or approximately 250,000 homeowners. Importantly, based on experience, fully half of those borrowers will find a solution that avoids a foreclosure sale. In other words, 99.75 percent of homeowners are not at risk of foreclosure. The current foreclosure rate, while important, is not out of line with rates in the past and does not characterize a macroeconomic event for the U.S. economy.

Notably, the problems associated with the subprime market were driven by a number of factors: over-capacity of capital, deceleration or drop in home price appreciation and an increase in unemployment in specific regions in the country.

The issue of over-capacity is being addressed both by market participants who are tightening underwriting standards or have left the market altogether and by federal regulators. For example, today the percentage of banks reporting tighter underwriting standards is the highest in 15 years and those who most abused the system are out of business. In fact, over 40 companies have closed due to being overly aggressive in their underwriting. Regulatory actions such as the recent comprehensive guidance related to nontraditional products and the expected final statement on subprime lending will further tighten underwriting of many mortgage products.
Most importantly, unemployment was and continues to be the main factor in the rise of delinquencies and foreclosures across the nation – not mortgage products. According to Freddie Mac, based on a sample of loans in Workout Prospector® from 2006, data demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. The data shows the following chief causes for mortgage delinquency:

<table>
<thead>
<tr>
<th>Cause</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment or Loss of Income</td>
<td>36.3%</td>
</tr>
<tr>
<td>Illness in the Family</td>
<td>21.1%</td>
</tr>
<tr>
<td>Excessive Obligation</td>
<td>13.6%</td>
</tr>
<tr>
<td>Marital Difficulties</td>
<td>6.0%</td>
</tr>
<tr>
<td>Death in the Family</td>
<td>3.9%</td>
</tr>
<tr>
<td>Property Problems or Casualty Loss</td>
<td>2.8%</td>
</tr>
<tr>
<td>Extreme Hardship</td>
<td>0.9%</td>
</tr>
<tr>
<td>Inability To Sell Or Rent Property</td>
<td>1.4%</td>
</tr>
<tr>
<td>Employment transfer or military service</td>
<td>0.6%</td>
</tr>
<tr>
<td>All other reasons</td>
<td>13.3%</td>
</tr>
</tbody>
</table>

An examination of MBA's National Delinquency Survey (NDS) for the first quarter of 2007 also confirms the causal relationship between unemployment and delinquencies. For example, the chart below shows the top five states that have the highest delinquencies across all loan categories (including subprime ARM, subprime fixed, FHA, prime ARM and prime fixed) including three that have the highest rates of unemployment – Ohio, Michigan, and Indiana.

**Seriously Delinquent Loans - 2007 Q1**

<table>
<thead>
<tr>
<th>Subprime ARM</th>
<th>Subprime Fixed</th>
<th>FHA</th>
<th>Prime ARM</th>
<th>Prime Fixed</th>
<th>All Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGHEST FIVE STATES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ohio</td>
<td>19.86</td>
<td>Mississippi</td>
<td>14.06</td>
<td>Michigan</td>
<td>10.01</td>
</tr>
<tr>
<td>Michigan</td>
<td>18.98</td>
<td>Ohio</td>
<td>12.70</td>
<td>Ohio</td>
<td>8.72</td>
</tr>
<tr>
<td>Louisiana</td>
<td>18.27</td>
<td>Louisiana</td>
<td>11.48</td>
<td>Louisiana</td>
<td>7.82</td>
</tr>
<tr>
<td>Mississippi</td>
<td>17.93</td>
<td>Michigan</td>
<td>10.51</td>
<td>Indiana</td>
<td>7.58</td>
</tr>
<tr>
<td>Indiana</td>
<td>17.26</td>
<td>Indiana</td>
<td>9.90</td>
<td>South Carolina</td>
<td>7.14</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US Average</td>
<td>10.13</td>
<td>US Average</td>
<td>5.89</td>
<td>US Average</td>
<td>5.26</td>
</tr>
<tr>
<td>California</td>
<td>7.57</td>
<td>California</td>
<td>2.92</td>
<td>California</td>
<td>1.96</td>
</tr>
</tbody>
</table>

| LOWEST FIVE STATES |                |           |            |             |           |
| Idaho          | 5.40           | Utah      | 2.53       | Idaho       | 1.91      |
| Washington     | 4.72           | Oregon    | 2.23       | Montana     | 1.67      |
| Oregon         | 4.17           | Hawaii    | 2.16       | North Dakota | 1.61     |
| Arizona        | 4.10           | Arizona   | 2.07       | Alaska      | 1.35      |
| Utah           | 3.99           | Alaska    | 1.38       | Wyoming     | 1.22      |

 Seriously delinquent loans are those 90 days or more past due or in foreclosure.

Source: Mortgage Bankers Association National Delinquency Survey

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6 Excludes delinquent loans in Louisiana and Mississippi due to the effects of the 2005 hurricanes. Note, Freddie Mac also published a summary of causes for mortgage delinquency based on data from 1999-2005, which essentially tracked these results.
All three of these states have suffered large declines in manufacturing employment. While there has been some pickup in service sector employment in those states, that employment is not often in the areas where job losses occurred and the wages are often lower in the service sector. For example, while we have seen increases in employment in places like Cincinnati, Columbus, Ann Arbor, and Indianapolis, we have seen job losses in Detroit, Flint, Cleveland, Dayton and Muncie.

While Ohio, Indiana and Michigan account for 8.7 percent of the mortgage loans in the country, those three states account for 19.9 percent of the nation's loans in foreclosure and 15 percent of all of the foreclosures started in the country during the first quarter. Without these three states, the percent of loans in foreclosure would be below the national average over the last 10 years, 1.12 percent versus an average of 1.19 percent.

To put these numbers in further perspective, the level of foreclosures and foreclosure starts for those three states has exceeded what occurred in Texas during the oil bust of the mid-1980s, and Ohio has the highest level ever seen in the MBA survey for a large state.

In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of technology, induced cost reduction and efficiency gains by the industry as well as the appetites of borrowers for credit, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that nonprime loans have always had higher delinquency and foreclosure rates, and lenders factor in these risks when lending to nonprime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates.

According to MBA's NDS, delinquencies overall dropped in the first quarter of 2007 from the fourth quarter of 2006. Assertions that delinquency or foreclosure rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates have remained relatively low with some increases over the last year. The chart below traces delinquencies from 1998 through the first quarter of 2007. It reveals the fact that delinquencies were higher in the subprime market at the end of 2000 as well as during 2002 than they were in the first quarter of 2007.
The delinquency rate for mortgage loans on one-to-four unit residential properties stood at 4.84 percent of all loans outstanding in the first quarter of 2007 on a seasonally adjusted basis, down 11 basis points from the fourth quarter and up 43 basis points from one year ago, according to MBA’s NDS. Both prime and subprime ARM loans had higher delinquency rates as compared to the fourth quarter of 2006. Delinquency rates for the fourth quarter increased 30 basis points for prime ARM loans (from 3.39 percent to 3.69 percent) and increased 131 basis points for subprime ARMs (from 14.44 percent to 15.75 percent). The delinquency rate for prime fixed loans decreased 8 basis points (from 2.27 to 2.19 percent), while the rate increased 16 basis points for subprime fixed rate loans (from 10.09 percent to 10.25 percent).^7^ 

MBA's first quarter 2007 NDS found that the percentage of loans in the foreclosure process was 1.28 percent, an increase of nine basis points from the fourth quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.58 percent, four basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the first quarter of 2007 was 5.10 percent, up from 4.53 percent in the fourth quarter of 2006 but still well below historic high points in the early 2000s. The foreclosure inventory rate for prime ARMs went from 0.92 percent in the fourth quarter up to 1.09 percent in the first quarter, for nonprime ARMs from 5.62

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^7^ These figures are based on MBA data. MBA defines “delinquency” as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers and the borrowers actually losing their homes are approximately a fourth of that group.
percent to 6.46. The foreclosure inventory rate increased for subprime fixed rate mortgage loans it went from 3.19 percent to 3.29 percent.

IV. MORTGAGE PRODUCT INNOVATION – Creating Access and Affordability

The mortgage industry takes pride in its innovations in developing mortgage products. Innovation in combination with the liquidity provided by the secondary market has dramatically expanded the opportunity for consumers to become homeowners, particularly for traditionally underserved borrowers.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. In fact, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance.

In addition to ARMs, some lenders at the forefront of responding to consumer demand for product diversity, particularly in high cost markets, began to offer interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without threatening their safety and soundness. It is therefore prudent to look to the practices of lenders regarding nontraditional mortgage products rather than imposing overly prescriptive requirements that would force them to change proven standards, disadvantaging institutions from effectively participating in this market.

Over the last decade, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance in response to consumer demand. Through these products, borrowers now can take advantage of hundreds of different financing options based on their individual needs and circumstances. They can also choose among thousands of mortgage originators. MBA supports the opportunity for consumers to make their own choices. Consumers are in the best position to choose which mortgage option is best for them and their families.

A. Nontraditional Mortgage Products

“Nontraditional mortgage products” refer to financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of homebuyers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers’ incomes. Other homeowners have used these products to tap their homes’ increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as “new,” some of them actually predate long term fixed-rate mortgages. Nontraditional mortgage products include fixed- and adjustable-rate loans that permit interest only (IO) payments and payment-option loans including option ARMs.
MBA strongly believes that the market’s success in making these “nontraditional” products available is a positive development. Although these products have been used to finance a relatively small portion of the nation’s housing, they have offered and continue to offer new, useful choices for borrowers.

Notably, however, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch Ratings, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent of dollar volumes, while it was 25 percent of dollar volumes in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and better credit scores than nonprime borrowers who choose other products.

To be sure, as with all mortgage products, nontraditional mortgages must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. As with other products, loan originators must provide consumers necessary information on a product’s terms so a borrower can determine whether the product matches his or her needs and financial abilities.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have good credit scores and relatively low loan-to-value (LTV) ratios. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high ARM share. As the risk of a loan or its features increase, mortgage lenders take appropriate steps to offset the risk by requiring other features like higher credit scores to ensure a borrower’s credit worthiness.

A. Interest-Only and Payment-Option Mortgages:

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest-only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed at their option to make principal payments during the interest-only period.

A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule;
an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10 to 25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

B. ARMs and Hybrid ARMs

ARMs, including hybrid ARMs, significantly differ from interest-only and payment-option products and are not covered by the nontraditional guidance. As explained below, on March 7, 2007, the Federal financial regulators published a Proposed Statement on Subprime Mortgage Lending that, among other things, would cover hybrid ARMs. 8

ARMs, first developed in the 1970s, permit borrowers to lower their payments if they are willing to assume the risk of interest rate changes. Hybrid ARMs, introduced in the mid-1990s, combine the benefits of fixed rate mortgages and adjustable mortgages and allow borrowers to opt for a lower initial interest rate and lower monthly payments, which are fixed for a period of two to ten years (including 2-28 ARMs and ARMs with longer fixed payment periods). After the fixed payment period ends, the hybrid ARM converts to an adjustable rate mortgage with the interest rate and payments adjusting periodically (usually yearly) based on interest rate changes in the capital markets.

ARMs, including hybrid ARMs, are not simply refinancing tools; these mortgages are affordable financing and for some borrowers credit repair options that have helped millions of borrowers achieve the dream of homeownership. Hybrid ARMs offer a lower monthly payment during the fixed payment period than a fixed rate mortgage. Nearly half, or 45 percent, of nonprime loans are purchase loans, with 25 percent of nonprime purchase mortgages originated for first-time homebuyers indicating that a significant portion of the recent gains in homeownership are likely attributable to hybrid ARMs. In the first half of 2006, 67 percent of new subprime loans were ARMs.

Data available to MBA from large member companies indicate that for the 30 percent of hybrid ARM loans that borrowers refinance with their companies, 50 percent of these hybrid ARM borrowers refinance into a prime loan, half of which are fixed, half of which are ARMs. Of the remaining 50 percent of borrowers, 25 percent refinance into fixed rate subprime products and 25 percent refinance into other ARMs.

Hybrid ARMs are frequently underwritten using more flexible guidelines based on reasonable repayment expectations, allowing many more borrowers to qualify for these

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8 Proposed Statement on Subprime Mortgage Lending, 72 Federal Register 10533 (March 7, 2007)
loans. Flexible underwriting for hybrid ARMs is appropriate. Relatively few hybrid ARMs experience any adjustment at all; hybrid ARMs are usually refinanced very early in their terms. Data from Fitch Ratings indicate that of the prime loans originated in 2003; only 44 percent remained outstanding as of the second quarter of 2006. For subprime loans originated in 2003, only 22 percent remain outstanding as of that time.

If ARMs and hybrid ARMs are required to be underwritten at the fully-indexed rate, as the guidance proposes (see below) then we must face the fact that many hybrid ARM borrowers simply will not qualify for mortgages to buy homes or to get needed credit. For many borrowers, the choice is not between an ARM and a fixed rate mortgage to finance the property they want; it is an ARM or no mortgage at all.

Hybrid ARMs are not “exploding mortgages.” Payment increases are generally much smaller than alleged and by virtue of borrowers moving or refinancing, frequently never come due. The rates and payments under hybrid ARMs do not normally increase by 40-50 percent, after the option period has expired, as has been alleged. In fact, whether there are any payment increases depends on the structure of the ARM and what happens to interest rates during the fixed period of the loan. Data from lenders demonstrate that today, on average, the change between the average start rate and the average fully indexed rate under these mortgages is generally no more than 2-3 percentage points. To protect borrowers from unmanageable payment increases, lenders structure hybrid ARMs so that there is a cap on the periodic adjustment. Also, as indicated, most subprime borrowers do not remain in their mortgages for more than three years. In any event, the potential increase in payments for borrowers later in the life of a hybrid ARM pales by comparison to the initial up-front savings to these borrowers.

C. Federal and State Guidance

1. Nontraditional Guidance

On September 29, 2006, the federal financial regulators including the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) jointly issued Final Guidance on Nontraditional Mortgage Products (the Guidance). Key aspects of the guidance are the same as the proposed guidance issued for comment by the regulators, with a few significant clarifications.

The Guidance addresses risks posed to federally regulated financial institutions by the growing use of mortgage products that allow borrowers to defer payments of principal and, sometimes, interest. The guidance specifically covers interest only (IO) and payment-option adjustable rate mortgages (Option ARMs). It specifically excludes home equity lines of credit (HELOCs) and reverse mortgages.

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9 71 Federal Register 58609 (October 4, 2006)
The guidance applies to federally regulated institutions including federally chartered banks, savings and loans and credit unions but it has a “trickle down” effect since it requires such institutions to monitor the quality of third party originations so they reflect the institutions’ lending standards and compliance with laws and regulations.

The Guidance addresses three sets of concerns: (1) Loan Terms and Underwriting Standards; (2) Portfolio and Risk Management Practices; and (3) Consumer Protection Issues.

On November 14, 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) encouraged the states to adopt guidance which generally tracked the Federal Guidance and, to this end, both organizations published their template as CSBS/AARMR Guidance. This guidance is based on the Federal Guidance, and only modified or deleted those provisions dealing with risk management that were inapplicable to non-depository institutions.

In their press announcement, the organizations noted that consistent guidance “will allow the opportunity to gauge the impact on the mortgage market and consumer behavior.” As of this date, 35 states and the District of Columbia have adopted or begun the process of adopting the CSBS/AARMR guidance.

Mortgage lenders have been subject to a patchwork of lending requirements, in areas other than nontraditional products, emanating from the federal, state and even local governments. These diverse standards, while well-intentioned, have lessened competition, increased regulatory costs and, thereby, increased costs to the consumer. Restrictions that vary from locality to locality lessen the number of entrants that are willing to learn and comply with particular requirements. Increased regulatory risks and compliance costs for those who do compete translate into increased costs for consumers.

For these reasons, MBA particularly appreciates the efforts of the regulators to develop guidance that is consistent among federal and state regulated institutions. MBA will continue to advocate such consistency to better serve consumers, increases competition and lowers costs.

2. Statement on Subprime Lending

On June 29, 2007, the federal financial regulators including the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) also jointly issued a Statement on Subprime Mortgage Lending (Statement) that was published in the Federal Register on July 10, 2007. The regulators proposed the Statement for comment on March 7, 2007 and MBA provided extensive comments.
The Statement largely tracks the proposed statement. It is generally directed to subprime ARM products offered to subprime borrowers that can cause “payment shock” and that have one or more of the following characteristics:

- Low initial payments based on a fixed introductory or teaser rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;
- Very high or no limits on how much payment amount or interest rate may increase (“payment or rate caps”) on reset dates;
- Limited or no documentation of borrower’s income;
- Product features likely to result in frequent refinancing to maintain affordable monthly payments; and/or
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate period.

The Statement provides guidance for federally regulated institutions regarding risk management and underwriting, control systems, consumer protection for these loans as well as plans for supervisory review.

Notably, the Statement provides that, in qualifying borrowers for nonprime ARM loans meeting the foregoing criteria, institutions should evaluate the borrower’s ability to repay the debt by final maturity at the fully indexed rate. It also provides that the higher a loan’s risk, either from a loan’s features or borrower characteristics, the more important it is to verify the borrower’s income, assets and liabilities. The Statement reminds institutions of necessary consumer protections including warnings about payment shock, balloon payments, taxes and insurance and prepayment penalties.

MBA appreciates the efforts of the Regulators to provide this guidance concerning underwriting, risk management and consumer protection issues concerning subprime short-term hybrid adjustable rate mortgage (ARM) products, subprime low documentation loans and subprime loans with prepayment penalties and other specified features. These products are not covered by the Regulators’ October 4, 2006 Guidance.\(^\text{10}\) This guidance is timely and appropriate considering the very high demand for these products and recent concerns that these products may present a higher risk of default depending on economic conditions including falling real estate prices.

MBA abhors predatory lending as a stain on the industry. For this reason, MBA appreciates that the Statement made clear that subprime lending is not synonymous with predatory lending.

MBA remains concerned, however, that the Statement may unduly limit credit and homeownership opportunities to credit worthy borrowers and add a new layer of disclosures without a comprehensive revision of the current disclosures that borrowers face and routinely ignore across the entire market.

\(^\text{10}\) Interagency Guidance on Nontraditional Product Risks, 71FR 58609 (October 4, 2006).
While MBA supports provisions of the Statement requiring that lenders underwrite loans based on a finding of a borrower’s ability to repay, MBA does not agree with rigid, one size fits all underwriting standards. Underwriting flexibility in both the prime and subprime mortgage markets is appropriate to address borrowers’ situations and resources and has resulted in increased homeownership. In that vein, MBA appreciates that the Statement did not require use of a rigid debt-to-income ratio to qualify borrowers, even for reduced documentation loans nor did it unduly limit no-documentation or low-documentation loans that remain good options for many borrowers as long as the risks of the loan are appropriately evaluated and the borrower is informed of any increased cost resulting from the loan.

MBA also appreciates and supports the Regulators’ strong encouragement that institutions that impose prepayment penalties structure them in such a way that they do not extend beyond the initial reset period and, further, provide borrowers a sufficient window of time immediately prior to the reset date to refinance without a penalty.

While MBA strongly supports the consumer protection provisions of the Statement requiring new disclosures, MBA also strongly believes that to be truly effective, disclosures and the disclosure process, including disclosures under RESPA, TILA and other laws, must be comprehensively overhauled and greatly simplified, so that the resultant disclosures are read, understood and useful to consumers, increase competition and lower consumers’ costs. MBA also supports improved disclosures by mortgage brokers, along with the other disclosures required under the Statement, to address concerns about steering. In particular, mortgage brokers should provide much better disclosures of whether or not they are the consumer’s agent. Furthermore, brokers should disclose their fees to prevent steering to products that are more lucrative for the broker. MBA would urge regulators to support better licensing and bonding requirements for brokers.

3. Underwriting Standards

The establishment of underwriting standards is ordinarily the responsibility of lenders and mortgage investors who are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Mortgage lenders have successfully offered nontraditional as well as hybrid ARM products using credit reports, credit scores, and sophisticated modeling to ensure that the features of nontraditional loans are mitigated with features that reduce risk. While recent information assumes that some lenders and investors have developed products that have resulted in unsatisfactory delinquency levels, it is far too early to fully assess the extent of this problem. It is clear though that the capital markets have responded through changing the guidelines and underwriting standards of the products in which they will invest. Current credit options have become much more conservative.

While MBA and its members agree that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA has not favored the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers’ ability to repay.
the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We have commented that such an approach is far too prescriptive and forces lenders to apply credit policies that disadvantage products in a manner which is inconsistent with their risks.

The nontraditional guidance expects that interest-only and payment option mortgages be underwritten to the fully indexed rate, a result that will limit the availability of these products. The extension of this requirement to hybrid ARMs will have a similar effect. Moreover, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a 3/1 hybrid ARM with a 27-year amortization starting in year four despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product.

Key risk factors of a hybrid mortgage include the initial length of time during which the interest rate is fixed, where an interest-only payment is required or the fact that the loan does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes.

MBA would caution that if the policy decision is to require underwriting of hybrid ARMs to the fully indexed rate going forward, any such policy must be flexible enough to ensure that all borrowers facing a reset will have access to credit to refinance. To that end, MBA is committed to consultations with Wall Street, the government sponsored enterprises and advocacy organizations to assure that credit is available. We cannot allow the current tightening of credit to strangle borrowers who, previously, could easily refinance.

4. Portfolio and Risk Management Practices

MBA and its' members share the view embodied in the guidance that lenders should pay particular attention to those products in their portfolios that carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there might be a problem.

There is also agreement with the requirement that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate. Lending institutions work internally and with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolios.

5. Borrower Information Concerning Nontraditional Products

MBA and its members strongly believe that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. Many consumers understand the array of products and have used them appropriately to their advantage.
Because there is no single, uniform, mandated disclosure for nontraditional products, lenders have developed their own disclosures to inform borrowers about the characteristics of these products. Many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of nontraditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

MBA recently announced new tools for borrowers to use when they are shopping for a mortgage that we have called the “Simple Facts” and the “Simple Calculator”. These new tools offer consumers in plain English information that all borrowers can use at the earliest possible time when they are shopping for a mortgage. They comprise a comprehensive guide and an accompanying online calculator that will demystify the mortgage process for borrowers.

This new resource for consumers provides the necessary information that will help prospective homebuyers identify the pros and cons of each type of mortgage and choose the best product for their own personal situation. In addition the “Simple Calculator”, offers the borrower the means to estimate the payments for each product, not just today but throughout the mortgage, and compares payments under different types of loans. These new resources can be accessed by consumers at www.SimpleFacts.com.

MBA appreciates the efforts of the federal regulators to issue Proposed Illustrations of Consumer Information on Nontraditional Products published contemporaneously with the federal nontraditional product guidance and we strongly urge the regulators to use the existing authorities under TILA to improve disclosures for nontraditional products nationwide.

The regulators determined that new information as set forth in the Proposed Illustrations could not await a more comprehensive approach to disclosure as suggested by MBA in its comments on the Guidance. The regulators concluded that guidance was needed now, to ensure that consumers get the information they need about nontraditional products. There is a similar point of view respecting the products covered by the
Statement. While MBA supports provision of all necessary information, we urge the regulators to regard the new disclosure illustrations as a temporary approach. MBA recommends that the regulators direct their energies toward a much more comprehensive approach of improving the mortgage disclosure process for consumers and require the provision of these disclosures from all mortgage lenders.

Consumers today confront a pile of disclosures when they apply for and close on a mortgage. Sadly, every new layer of disclosure simply increases the likelihood that the consumer will merely initial all of them without even a cursory reading. For this reason, the number of disclosures need not increase, rather, they need to be combined, streamlined and made much more user friendly.

Efforts at improvement should include all disclosures required by federal law. Because RESPA and TILA apply to regulated and unregulated entities, such an approach is the best means of assuring that virtually all consumers receive high quality information and that a level playing field of disclosure requirements is established for all industry originators. These efforts should also consider the plethora of state disclosures.

MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest. We also believe it is essential that the legislative and regulatory environment foster innovation in the industry to assure that borrowers confront a competitive marketplace offering low cost credit options. Such an environment allows lenders to provide borrowers the widest array of options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives.

V. FORECLOSURE PREVENTION AND SERVICING PRACTICES

Mortgage servicers want to preserve homeownership and, in fact, have economic incentives to get borrowers back on their feet as quickly as possible and avoid foreclosure. Delinquencies and foreclosures are costly both from a hard and soft dollar perspective. Significant staff must be dedicated to handling delinquencies and foreclosures. Servicers also must advance principal and interest payments to investors and pay taxes and insurance premiums even though such payments are not received from the borrower. If the loan becomes seriously delinquent, servicers must hire foreclosure attorneys and pay for property preservation. All these costs can be a significant drain on capital. In the event of foreclosure, noteholders take significant losses on the loans. A 2003 Federal Reserve study notes that “estimated losses on foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses.” 11 From a pure economic basis alone servicers do not desire foreclosures.

It is important to note that servicer profits derive from receiving the servicing fee for administering the loans. Although the servicing fee is small, usually amounting to one fourth of one percent of the loan balance, when a loan is delinquent, that fee is not earned. When a loan is extinguished through foreclosure, the servicing asset represented on the balance sheet is also extinguished. Large numbers of foreclosures are detrimental to a servicer's earnings and net worth. Thus, long-standing claims that lenders knowingly put borrowers into products they cannot afford in order to take the property through foreclosure are simply unfounded.

In reality, everyone loses in a foreclosure – the borrower, the local community, the mortgage insurer, investors and the servicer. Lenders and servicers do not have incentives to cause foreclosures, because profitability rests in keeping loans current and, as such, the interests of borrowers and lenders are aligned.

A. Loss Mitigation Tools

Recognizing the significant downside to foreclosures and with a strong desire to assist their borrowers, servicers have, over the last 15 years, made deliberate and significant strides to provide workout alternatives to foreclosure. These alternatives include both home retention options, such as forbearance, repayment plans and modifications, and home relinquishment options when the borrower can no longer support the debt. Of course, servicers strive to provide home retention solutions whenever possible. The following is a brief overview of the home retention options used by servicers. The availability of these options is dependent on investor agreement.

- **Forbearance Plans:** These plans provide postponements in payments with a typical duration of six months, followed by repayment of the arrearage over time. The plans can be verbal or written.

- **Delinquent Refinances:** Although less common, borrowers that are less than three months behind may be able to refinance to lower rates and capitalize the arrearage.

- **Subordination of Unpaid Debts:** Servicers in some cases can also place the arrearages into a junior lien in order to bring the loan current. The borrower is required to pay both debts, similar to a repayment plan, but this option makes such payments more affordable because the balance owed is amortized over a longer period of time.

- **Temporary Modifications:** These modifications allow for a temporary reduction in interest rate or payments for a period of time, usually lasting about six months.

- **Permanent Loan Modifications:** These modifications result in permanent changes to one or more of the original loan terms, such as the interest rate and/or duration of the loan. A permanent modification is a very effective work out vehicle, because it provides an immediate resolution to the delinquency by taking
the amount of arrearage and adding it to the balance of the modified loan (e.g. “capitalize the arrearage”) and re-amortizing the payments. The duration of the loan can also be extended to reduce monthly payments. While this option gives the borrower and loan servicer additional choices, its availability is limited for those mortgages that have been purchased by investors in the form of mortgage-backed securities. Because the MBS are held in trust, rules restrict servicers and trustees from altering the assets.

Two-thirds of all mortgage loans are placed in trusts to create mortgage-backed securities and then the MBS are sold to investors. Trust documents dictate what the servicer is permitted to do in the way of loss mitigation. In many cases the servicer is prohibited from modifying the loan. In other documents the servicer is permitted to follow standard industry practices—a very vague standard that could create liability for the servicer if there is a subsequent challenge from some investor group. Subprime and other private label servicers have had moderate success in amending the investor documents, but such changes require the approval of all investors. There can be many investors in an MBS trust and locating the beneficial owner investor can be difficult or impossible. Under some circumstances, the MBS trustee has to seek a legal opinion that modification of delinquent loans will not affect the securities’ REMIC tax status. This is costly and there is a risk that the IRS will have a different opinion and terminate the REMIC. Such a result would be financially catastrophic for the MBS investors because the loss of REMIC status results in taxation of the trust as a corporation and not as a pass-through entity. This means that the income from the MBS would be taxed at both the trust entity level and the investor level, rather than just at the investor level.

Non-home retention loss mitigation alternatives are useful when borrowers have no viable means to cure their financial situation. These options offer several benefits that should not be discounted. First, they avoid foreclosure which can severely impact the borrower’s credit. Second, the servicer generally does not seek repayment of the deficiency, which is the difference between the value received for the property and the amount of the debt owed. Third, borrowers are often assisted with moving expenses. These options are most often used when home prices decline below the amount of outstanding debt:

- **Pre-Foreclosure Sales (PFS) or Short Sales:** Proceeds from a third party sale of the borrower’s home are accepted as satisfaction for the mortgage, even though they represent less than the amount owed.

- **Deeds-in-Lieu of Foreclosure (DIL):** The borrower voluntarily deeds the property to the servicer as satisfaction for the mortgage even though the value of the property is less than the amount owed.
B. Servicer Practices

Before borrowers ever reach the point of being seriously delinquent, servicers attempt to cure the delinquency. Experience has shown that early intervention is the key to curing delinquencies. As a result, servicers make significant attempts to contact borrowers early in the delinquency or even before a delinquency occurs. In fact, prime lenders have adopted some techniques from subprime lenders that have proven effective, including: providing welcome calls to new customers ensuring that they have important contact information; initiating reminder calls prior to the expiration of the grace period for at-risk borrowers; using automation to determine when a borrower’s failure to make a payment is outside of their normal pay-behavior; and prioritizing out-bound assistance calls to the highest risk delinquent borrowers first. This allows servicing staff to focus their resources where they are most needed. These techniques have proven to be beneficial for consumers. In addition to personal contact, servicers send numerous notices to borrowers informing them of their delinquency, offering loss mitigation and providing helpful information on how to avoid foreclosure. Property preservation personnel in some cases also leave discrete information at the property address.¹²

Some servicers are also using telecommunication tools to streamline contact with delinquent borrowers. Through automation, the delinquency status of in-bound callers can be determined very quickly and calls routed automatically to workout staff thus bypassing the company’s standard customer service line. The process is seamless to the consumer and avoids wait times. Other companies provide dedicated toll-free numbers that go directly to the loss mitigation teams trained to address more complex borrower needs.

Servicers have also developed Web sites that allow borrowers to access loss mitigation information obtain and submit required documents and in some cases apply for online.

Unfortunately, despite all this technology and effort, over half of borrowers in foreclosure proceedings have had no contact with their servicer.¹³ This lack of contact is one of the biggest challenges servicers face in trying to cure delinquencies.

¹² The following are the notices/solicitations typically provided by servicers: a payment reminder that payment is past due (from 2-16th) (this is typically for high risk borrowers); late charge notice notifying the customer that payment is past due and late charge has been assessed; monthly account statement reflecting either the current and/or total amount past due; notice of availability of counseling and state/local payment assistance programs at 45 days (Federal Law); mail “How to Save Your Home” pamphlet at 60 days (Federal Law for FHA loans); mail internally created documents on how to save the home for non-FHA loans; separate letters soliciting for loss mitigation; multiple calls each month to solicit alternative collection/loss mitigation. Additional notifications are sent pursuant to state statutory requirements or preconditions to foreclosure including the breach (or demand letter); letter announcing acceleration of the debt; service of process notices, and foreclosure sale date.

¹³ Foreclosure Avoidance Research, Freddie Mac, 2005.
One situation that MBA believes contributes to this low contact rate is a provision in the Fair Debt Collection Practices Act (FDCPA). Under FDCPA, a lender who purchases servicing on a delinquent loan is required to announce itself as a “debt collector” prior to discussions with that customer. A servicer who purchases current servicing that subsequently becomes delinquent, however, is not required to make this announcement. This so-called “mini Miranda warning” effectively drives borrowers away by creating a misleading and conflicting message with loss mitigation efforts (especially when servicers request financial information from the borrower for purposes of structuring the loss mitigation plan). Servicers that purchase delinquent servicing should be treated like other servicers and not have to provide this statement.

Even with these obstacles, servicers are not just throwing in the towel. They are proactive in exploring new options that bring borrowers to the table -- ways that create approachable environments for borrowers who might be embarrassed or not trusting of the lender. This includes teaming up with non-profit and for-profit agencies to assist in locating borrowers and providing homeownership counseling.

Counselors work with borrowers and their servicers to achieve and execute loss mitigation arrangements. The hope is that homeowners who are hesitant to call their servicers will be more likely to contact a non-profit organization or other reputable intermediary to discuss alternatives.

Recognizing the value of third-party groups in helping connect borrowers with servicers and work out problems, MBA has partnered with NeighborWorks America, the Homeownership Preservation Foundation and the Ad Council in a campaign to prevent foreclosure that includes free mortgage counseling. Borrowers seeking assistance should call 1-888-995-HOPE or visit http://www.995hope.org/. Through this service, counselors are currently receiving 650 calls a day. About half of those callers enter into counseling sessions and 42 percent of those result in positive final outcomes, avoiding foreclosure.

MBA also makes valuable information available to borrowers in every stage and status of the mortgage process, including delinquency, on the Home Loan Learning Center Web site at http://www.homeloanlearningcenter.com/.

The paradigm has shifted from a decade ago. Borrowers need to know that lenders can help. A direct call to the lender or to a reputable housing counselor can save a borrower’s home. We hope to convey that message whenever possible.

VI. THE IMPOSITION OF A SUITABILITY STANDARD WOULD HURT THOSE IT IS MEANT TO HELP

As indicated, the data does not show that unsuitable products or predatory lending are the cause of delinquencies and foreclosures. The foreclosure problem is based on economic difficulties that confront borrowers.
Notwithstanding, a number of advocacy organizations have urged that a “suitability standard” be imposed on mortgage lenders as a means of making the lender responsible for assuring the borrower is in the right loan to prevent foreclosure later. These organizations assert that a “suitability standard” applies to securities brokers and that there is no reason why a similar standard should not be imposed on mortgage lenders. MBA disagrees.

While a specific proposal for a “suitability standard” for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement. While many of these points might sound good at first, on closer examination of the facts, they each raise very significant concerns for consumers.

Earlier this year, MBA published a paper that explains why the imposition of a “suitability standard” on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. The New York State Assembly should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard. A uniform national standard would be the best approach to addressing the current mortgage market challenges.

A. Rigid Hard Wired Underwriting Standards Deny Credit Options to Borrowers

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA), on loans made in 2004 and 2005, demonstrate the greatest and widest availability of mortgage finance in our nation’s history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

It is important to remember how we got to this point. The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as “nontraditional.”

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has
enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the growth of risk-based pricing. As shown in the chart below, according to the Federal Housing Finance Board’s data from their Monthly Interest Rate Survey, the costs of originating a mortgage have declined tremendously both measured as a percentage of the loan balance and in nominal dollars.

Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers “who have difficulty in meeting the underwriting criteria of ‘prime’ lenders because of blemished credit histories or other aspects of their profile.”

Rigid new underwriting standards, no matter how well intentioned – even as seemingly innocuous as requiring a particular debt-to-income ratio, for example – will result in denying some borrowers’ credit who would otherwise qualify in today’s market. Some of these borrowers will even be denied homeownership although they would qualify today. The magic of today’s market is that the widest range of borrowers can get the widest spectrum of loans.

Similarly, while it might sound reasonable to require that all borrowers contending for a hybrid adjustable rate mortgage (ARM) that allow lower fixed payments for an initial period and higher payments after that be qualified at the fully indexed rate, such an approach will lock some borrowers out of the home of their dreams and deprive them of

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lower payments. It would also have the consequence of failing to allow these borrowers an opportunity to repair their credit so they can refinance into a lower priced prime loan before the rate adjusts. Moreover, ARMs allow borrowers to allocate more of their cash flow to other uses. For example, a borrower who saves on their mortgage payment can put more funds towards financial investments, potentially diversifying their overall portfolio.

Some insist that a borrower who can not meet fixed ratios should be denied credit if they don’t satisfy a particular test. Such a result is unnecessary in today’s financing world. Also, respectfully, MBA wonders if that opportunity should be withheld from 87 percent of borrowers, including those who qualified for nonprime loans who are making their payments and achieving the dream of homeownership.

Today, borrowers at nearly all points on the credit spectrum qualify for loans. The imposition of new rigid standards would change that.

B. The Imposition of a Suitability Standard Risks Unintended Consequences

While certainly not intended to promote or authorize discrimination or reignite redlining, MBA is extremely concerned that the injection of subjective standards into the mortgage process would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains particularly for first time homeowners and minorities.

The reason this would happen is not because anyone has bad motives but because new subjectivity would be injected into the market, the risks would increase markedly, driving many lenders to be much more cautious or even to withdraw from the market. Lessened competition and increased risks will decrease financing options and increase costs.

Since the 1990’s, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.15

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. If a subjective suitability standard is imposed, in the first instance, lenders will be required to assure that a loan is suited for the borrower. If such a standard is imposed, a lender facing a mortgage applicant who is a member of a protected class, and for whom a loan product may be “unsuitable,” might deny the

15 1992 and 2004 HMDA data.
borrower credit options to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. Conversely, if credit is extended, the lender risks violating a suitability requirement.

Either way, by injecting subjective standards into the process, there will be much greater caution by lenders and less competition in the market as lenders shy away from these risks. There is real concern that subjectivity and even caution will disproportionately affect first-time homeowners, minorities and those with less wealth where suitability and fair lending concerns intersect.

Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was “unsuitable.” This new cause of action will also drive lenders out of markets, lessening the availability of credit and driving up costs for consumers. It would seem that only the lawyers will benefit.

Although as indicated, advocacy organizations point to the securities industry as a model for a suitability standard, on examination, the industries are not analogous. Their business models differ and so do the policy imperatives that govern them.

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to underserved persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As far as their business models are concerned, securities broker-dealers function as intermediaries between their customer and the market to invest their customers’ money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among mortgage lenders when seeking a mortgage.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower’s personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to “decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender.”

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a lawsuit alleging that the program amounts to “state-sanctioned redlining.”\textsuperscript{17} Governor Blagojevich suspended this law on Friday, January 19, recognizing that it was hurting the people it was designed to protect, according to \textit{The Chicago-Sun Times}.\textsuperscript{18}

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they might qualify. For this reason, it pays for consumers to see lenders early in the home buying process, not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their own companies.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. Let us assure you, the fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

State Legislatures, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current “arms length” transaction model in the mortgage lending industry works best.

\textbf{VII. STEPS STATE LEGISLATURES CAN TAKE TO PROTECT CONSUMERS}

There are at least three things State Legislatures can do to help consumers become better informed through the mortgage process, protect themselves and help them make the best choice for themselves.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including this important subject into general educational programs and increasing access to transaction-specific borrower counseling. It would be a worthy undertaking to conduct a review of total government efforts in the area of financial literacy to see what is working is what is not. This study could also include the amount of resources expended for this purpose. MBA believes

\begin{itemize}
  \item \textsuperscript{17} See Mary Umberger, “Home Buyer Counseling Challenged,” Chicago Tribune, Nov. 2, 2006.
\end{itemize}
that better financial education would empower all borrowers to shop effectively among
the array of competitors in the marketplace.

Second, MBA believes simplification of the mortgage process and all necessary
consumer information would make it much easier for an empowered consumer to
navigate the market, and such improvements are long overdue. We commend to the
Committee the fact that Federal Trade Commission staff just issued a comprehensive
study that strongly supports this view.\textsuperscript{19} Consumers today face a pile of disclosures
when they apply for and close on a mortgage. Efforts at improvement need to
streamline the existing mandated disclosures and information, and must be
comprehensive and well considered. A successful effort would result in much more
effective information on the benefits, costs and features of the loan options presented
by lenders. This approach would also go a long way to help borrowers shop for
mortgages among loan providers, increasing their ability to make an apples-to-apples
comparison.

In particular, MBA believes that many abuses could be prevented and costs lowered if
there were much better borrower information on the function and fees of the mortgage
broker in each borrower’s loan transaction, and if there were stronger licensing and a
registry of mortgage brokers and other loan originators. For almost a decade, MBA has
advocated a clear disclosure to the consumer concerning the functions and
compensation of mortgage brokers that would advise the consumer of whether the
broker is or is not the borrower’s agent and of the total compensation that the broker
receives. Such a disclosure would alert the borrower in cases where the broker is not
an agent that the borrower should either shop for himself or risk higher mortgage costs.
Moreover, if a mortgage broker holds himself out as an agent, MBA believes it is
appropriate to consider him an agent as a legal matter. In MBA’s view, disclosures
along these lines are a much better approach than imposing an undefined standard or
standards on the industry, again increasing liability and greater costs to borrowers.

Notably, MBA does not believe that a disclosure of function and fees is warranted for
mortgage lenders. Unlike a broker whose role may be uncertain – agent or loan
provider – a lender’s role is clear. A lender underwrites, approves and funds the loan.
The lender does not hold himself out as an agent of the borrower. While a lender must
serve its customers fairly, and the industry has done much to assure high professional
standards, a lender owes a duty to its shareholders and investors. A borrower knows a
lender offers its own products and does not offer to shop for borrowers. In MBA’s view,
the fact that the lender may sell the loan into the secondary market and receive
compensation for the sale does not change our view that a broker, and not a lender,
need disclose its fees. A lender offers a loan to a borrower at a price and rate and
points which are fully disclosed and there is no additional payment which a borrower
needs to consider in light of the lender’s functions.

\textsuperscript{19} Improving Consumer Mortgage Disclosures, An Empirical Assessment of Current and Prototype Disclosure
Also, as has been pointed out, in some states, the standards for licensing a hair dresser are more rigorous than those applicable to mortgage brokers. MBA supports national, uniform regulation of mortgage brokers including a national database of approved brokers. A clear, fair national regulatory standard for mortgage brokers is an essential step to establishing much better mortgage lending protections for borrowers.

Third, State Legislatures could support the creation of uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings. MBA would support the expansion of the types to loans to be covered in a uniform national standard to include purchase money loans and open-ended lines of credit.

MBA supports the framework for a national standard that includes the following principles and components.

Broad Principles of a National Standard:

- **Uniform National Standard.** A national law should recognize a national mortgage market by including broad preemption that facilitates competition and market efficiencies leading to low cost mortgage lending. It should apply to all lenders creating uniformity in the market. It should not change the current regulatory oversight, preemption or enforcement regime of those regulated by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC).

- **Protect Financing Options.** The innovation of lenders to make mortgage credit more widely available through a variety of products and financing tools should be protected. Unduly limiting or outlawing finance options could put homeownership out of borrowers’ reach, particularly underserved borrowers.

- **Risk-based Pricing.** Lenders’ ability to efficiently price loans based on the risk of non-payment presented by a borrower has revolutionized and expanded the availability of mortgage credit. Through risk-based pricing, mortgage credit is more widely available to borrowers, especially to traditionally underserved communities. A national standard should recognize and protect the benefits of risk-based pricing.

- **A Suitability Standard Should Not Be Imposed.** Certain groups have suggested imposing a suitability standard on mortgage lenders. Lenders already make a “suitability” determination through assessing affordability when underwriting a consumer’s ability to repay a loan. A suitability standard beyond that threatens progress made in fair lending as well as the availability and affordability of credit to homeowners by reintroducing a subjective determination into a loan officer’s work. Further, the imposition of a suitability standard exposes lenders to
significant liability and will increase the cost of mortgage credit since it could affect the mortgage-backed security marketplace.

- **Objective Standards.** The provisions of any national standard should include clear, objective standards so that consumers understand their rights and protections and lenders understand compliance requirements.

- **Added Consumer Protections:** MBA supports increased protections for consumers in a national standard.

**Components of a National Standard:**

A. **HOEPA Triggers:**

- **Reasonable High Cost Loan Triggers.** Almost no lenders will make loans that meet the HOEPA high cost loan triggers because of the significant liability that attaches. Investors will not buy high cost loans because of the liability, which dried up liquidity for these loans. The triggers, therefore, act as a de facto usury ceiling in that lenders won’t make loans above the triggers. Therefore, the APR and point and fee triggers should be maintained at their current levels so that legitimate lending is not cut off. MBA would support the setting of triggers at a reasonable level to help assure that mortgage credit continues to be available to credit-worthy borrowers.

- **Point and Fee Definition Should Not Be Overly Broad.** A national standard should maintain the items included in HOEPA for making the point and fee calculation. Neither prepayment penalties, nor yield spread premiums should be included in the definition because doing so would threaten the use of these finance options and because the value of those items is already reflected in the interest rate and APR. Thus, including those items in a points and fees test would result in double counting. Lowering the point and fee trigger by excessively expanding the point and fee definition will invariably cut off legitimate credit to our neediest borrowers.

B. **HOEPA Protections:**

- **Refinancing a Loan Should Provide a Benefit to a Borrower.** Existing loans should not be refinanced into a high cost mortgage loan unless doing so provides a benefit to a borrower. A national standard should allow regulators to establish objective safe harbors for determining when the benefit threshold is met.

- **No Asset Based Lending.** Evaluating a borrower’s ability to repay a loan is fundamental to a lender in underwriting a mortgage application. A lender has every incentive to ensure a loan is properly underwritten since the lender takes the risk of loss on a defaulting loan and, through agreements with investors, can be forced to repurchase a loan from the secondary market. A borrower’s ability to repay a high cost loan should not be solely based on the collateral value of the property.

- **Assignee Liability.** MBA supports the maintenance of the existing assignee liability regime provided in the Truth in Lending Act (TILA) and HOEPA.
C. Consumer Protections for All Loans:

- **Prepayment Penalties Should Be Limited to Three Years.** Prepayment penalties reflect an agreement between the lender and borrower whereby the borrower agrees to stay in a mortgage for a period of time in exchange for a lower rate or a significant reduction in fees. If a prepayment penalty is offered, it should be limited to three years and clearly disclosed to the borrower.

- **Yield Spread Premiums Are a Valuable Financing Option.** A yield spread premium (YSP) is a very good mortgage financing option that allows borrowers to pay closing costs through the rate. The inability to use yield spread premiums could bar creditworthy borrowers from homeownership. Where RESPA requires it, MBA would support improved YSP disclosures.

- **Borrowers Should be Given Choice to State Income.** Stated income loans are important to certain borrowers, especially in the emerging markets, because documenting their income in connection with a mortgage application can be difficult. Further, interested borrowers should be given the option of choosing a stated income loan versus a fully documented income loan if the borrower so chooses and if the lender has disclosed any cost difference.

- **Home Improvement Contracts.** Lenders should disburse loan proceeds to the borrower or jointly to the borrower and the contractor, or through a third-party escrow agent. Lenders must not disburse loan proceeds until the payment is approved in writing by the borrower, the contractor has signed a certificate of completion or the contract, and the property has been made available to the lender for inspection.

D. Standards for All Loans:

- **Right to Cure.** A national standard should permit lenders reasonable time to “cure” any unintended errors in the mortgage transaction without incurring any further or punitive liability.

- **Accurate Appraisals.** When formal valuation methods are required, lenders must evaluate properties through real estate appraisal professionals and/or through automated valuation models. Participants to the transaction must be careful not to either pressure or be pressured. Lenders must ensure that the appraiser is licensed as required by law and make a good faith effort to ensure the appraiser is in good standing.

Finally, while any increases in delinquencies and foreclosures are an important concern, prohibition of particular products is not a solution – because they are not the cause. Many borrowers have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.
VIII. INDUSTRY EFFORTS TO HELP CONSUMERS

While working with policymakers to address the transformation in the mortgage market, MBA and its partners are leading the way to help stabilize and preserve the subprime mortgage credit system, provide assistance for homeowners facing foreclosure, and finally, prevent this from ever occurring again.

MBA has met with Fannie Mae and Freddie Mac, with FHA, with our largest servicers, consumer groups and civil rights leaders to search for solutions. We did so both separately and as a participant in a housing summit convened by Senate Banking Committee Chairman Christopher Dodd where an agreement was reached on principles for mortgage lenders and servicers to assist troubled borrowers.

MBA also has partnered with NeighborWorks America, a national nonprofit organization created by Congress, to help troubled borrowers. Specifically, MBA has dedicated financial and staff resources to help promote a free counseling hotline, 888-995-HOPE, which is staffed by the Homeownership Preservation Foundation and provides a helpful place for troubled borrowers to turn. In addition, through the partnership, we hope to establish foreclosure intervention programs in cities with high rates of foreclosure and to conduct a national public education campaign with the National Ad Council to improve contact rates for homeowners in financial distress. The partnership also seeks to improve counseling capacity and provide certified training programs for foreclosure counselors through the NeighborWorks Center for Homeownership Education and Counseling (NCHEC).

MBA is also seeking to arm consumers with good information so that they can make intelligent choices. That’s why MBA recently announced a new resource for borrowers to use when they are shopping for a mortgage that we have called the “Simple Facts” and the “Simple Calculator". These new tools offer consumers in plain English information that all borrowers can use at the earliest possible time when they are shopping for a mortgage. They comprise a comprehensive guide and an accompanying online calculator that will demystify the mortgage process for borrowers.

This new resource for consumers provides the necessary information that will help prospective homebuyers identify the pros and cons of each type of mortgage and choose the best product for their own personal situation. In addition the “Simple Calculator”, offers the borrower the means to estimate the payments for each product, not just today but throughout the mortgage, and compares payments under different types of loans. These new resources can be accessed by consumers at www.SimpleFacts.com.

And finally, as part of MBA’s ongoing financial literacy effort, we have re-tooled and re-launched our consumer Web site,20 which is also available in Spanish.

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20 http://www.homeloanlearningcenter.com/
Conclusion

MBA members have worked hard to put Americans in homes, facilitating the development of communities, increasing consumer wealth and improving the stability of families across the nation. The transitioning of the subprime mortgage market and the affect it is having and will likely continue to have on access to mortgage credit, is a challenge for us all. MBA implores State Legislatures not to act hastily but to partner with industry and consumer groups to develop new approaches to assure that borrowers continue to get mortgage credit to fulfill their dreams of homeownership while effectively protecting them against abuse.

MBA has been long committed to fighting predatory lending and we would welcome the opportunity to work with State Legislatures to develop solutions that weed out bad actors and allow the mortgage industry to continue to serve borrowers. Better financial literacy, mortgage simplification and establishment of a uniform national standard are steps that should be taken.

MBA wants to underscore the importance of innovation in making credit opportunities available to consumers. MBA believes that borrower choice should be protected. The imposition of a suitability standard risks undermining our hard won gains in the areas of homeownership and reaching underserved borrowers. It will take away consumer choice as well as access to affordable mortgage credit.

Lenders and consumers alike have every incentive to keep borrowers in homes. Foreclosure is a loss for everyone. Foreclosures are caused in large measure by life events like job loss, divorce and illness. Lenders work very hard to offset foreclosure and work with delinquent borrowers to try to keep them in their homes.

MBA looks forward to continuing to work with the National Conference of State Legislators and State Legislatures all across the nation to address these challenges in the housing market and we stand ready to assist you however we can.

Thank you.