CONSUMER MORTGAGE COALITION

May 7, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room
Mail Stop 1-5
Washington, DC 20219
RE: Docket No. 2007-3005
regs.comments@occ.treas.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
RE: Docket No. 2007-09
regs.comments@ots.treas.gov

Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RE: Statement on Subprime Mortgage Lending
comments@fdic.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave, NW
Washington, DC 20551
RE: Docket No. OP-1278
regs.comments@federalreserve.gov

Mary Rupp
Secretary for the Board
National Credit Union Administration
1775 Duke St.
Alexandria, VA 22314-3428
RE: Comments on Statement on Subprime Mortgage Lending
regcomments@ncua.gov

Re: Docket No. 2007-3005, 72 Fed. Reg. 10533 (Mar. 8, 2007)

Dear Sir or Madam:

The Consumer Mortgage Coalition (the "CMC"), a trade association of national residential mortgage lenders, servicers, and service-providers, appreciates the opportunity to submit these comments on the Statement on Subprime Mortgage Lending proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (the "Agencies"). The

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proposed Statement would address risk management practices and underwriting standards, consumer protection principles, and control systems related to subprime lending.

The CMC supports many aspects of the Statement. We support the decision to provide this statement on an interagency basis, although we believe that any new disclosure or other consumer-protection requirements should apply to all lenders, including those that are not affiliated with regulated entities, in order to be effective and as a matter of competitive equity. We support the issuance of these requirements as a statement rather than regulations and the decision to seek public comments, both of which should be helpful in ensuring that the Statement meets its goals while minimizing the burden on industry and consumers.

As to the substance of the proposed Statement, the CMC agrees with the Agencies' predatory lending considerations, including that (1) a mortgage loan should be based on a borrower's ability to repay rather than on the foreclosure value of the property; (2) consumers should not be induced to repeatedly "flip" a loan; and (3) lenders and mortgage brokers must not engage in fraud or deception to conceal the true nature of the mortgage loan obligation. We also agree that underwriting standards should evaluate the borrower's ability to service the debt, but we urge the Agencies not to require that all loans be underwritten at the long-term rate or assuming fully-amortized payments, regardless of the period to which the initial rate applies. We agree that "layering" of risks demands more conservative underwriting, although we note that not all loans with more than one risk factor truly involve "layered" risk. We also agree that the added risk that may be created by risk-layering features should be balanced by features that mitigate risk such as better debt-to-income and loan-to-value ratios. Such weighing of factors is already the practice of responsible lenders.

At the same time, however, we are concerned that some aspects of the Guidance would have a negative effect on both regulated institutions and consumers. Among other things:

- The Statement could be viewed as a move toward implementation of a "suitability" requirement analogous to requirements for broker-dealers for subprime mortgage products, in which lenders would be expected, for these products only, to undertake a comprehensive review of the borrower's financial situation and to refuse to make a loan to a consumer if the lender found that the loan was not in the consumer's best interest. Although we strongly support efforts to improve consumer understanding, once the consumer understands the available options, the consumer should be allowed to decide which product best meets his or her needs. A suitability requirement would require lenders to elevate economic factors over the *consumer's* priorities. For example, if a consumer wanted to obtain a mortgage loan to pay for a child's education, a lender saddled with a suitability requirement may not be able to make that loan if the mortgage loan increased the consumer's monthly payment. Even if a lender could properly evaluate a consumer's non-economic priorities, gathering non-economic information about consumers would be unjustifiably intrusive. For example, for a lender to understand non-economic priorities of a consumer that is a single child

with aging parents, a lender would have to gather information about the parents' health, the consumer's relationship with his or her parents, the consumer's plans to assist the aging parents, etc. And, once the lender gathers this information, a suitability requirement would force the lender to impose its own judgment of these factors over the consumer's judgment. The Agencies should not require lenders to assume a paternalistic position in deciding what is most suitable for consumers. Instead, consumers should be given accurate information about who, if anyone, is working in their behalf. For example, mortgage brokers should be required to disclose their role in the mortgage transaction (i.e., whether they are acting as an agent for the borrower or in some other capacity) and how the broker is compensated.

- Although we agree that consumer comprehension is essential, we do not believe that safety-and-soundness guidance for regulated institutions is the appropriate location for detailed disclosure requirements. If additional disclosures are to be required, they should apply to all lenders, not only institutions and their affiliates that are subject to examination by the Agencies, and they should protect all consumers. Moreover, the new proposed disclosures would be superimposed on the extensive existing framework of required consumer disclosures for mortgage products. These extensive disclosures, which would not be required for other products, would bias consumers against these products, even when they are advantageous for them. The disclosures could cause "information overload" that confuses rather than helps consumers. Only the incorporation of the disclosures within the federal regulatory scheme that applies to nearly all loans under the Truth in Lending Act ("TILA") and the Real Estate Settlement Procedures Act ("RESPA") can ensure that all consumers receive the disclosures that are warranted and that the Agencies, rather than lenders, make the necessary decisions about the relative prominence and conspicuousness of the different disclosures. Alternatively, the disclosure rules could be promulgated under the authority of the Alternative Mortgage Transaction Parity Act (the "Parity Act"), although, as discussed below, the applicability of those rules could be more limited.

- Like the guidance on nontraditional mortgage products, the Statement departs from earlier interagency guidance in the level of detail of the proposed requirements and the lack of consideration of best practices in portfolio management. We believe that the Statement should be just that: a statement providing suggestions that can be tailored to each lender's—and each borrower's—situation, rather than a series of rigid rules.

BACKGROUND

The CMC suggests that any action taken by the Agencies regarding subprime credit must be based on a clear picture of the subprime credit market. In particular, the CMC recommends that the content of the Statement reflect (1) the important benefits subprime mortgage credit confers on consumers, and (2) an accurate assessment of foreclosures

and delinquencies resulting from subprime credit products. Before commenting on specific portions of the Statement, the CMC believes a review of the subprime market, its benefits, and foreclosure/delinquency issues is appropriate.

Subprime Mortgage Products Can Provide Substantial Benefits to Consumers

Although the Statement recognizes that subprime loans may be riskier, both to borrowers and lenders, the Statement does not acknowledge the substantial benefits consumers receive as a result of the availability of subprime credit. Subprime credit has both increased the number of homeowners—particularly among minority groups—and allowed many consumers to repair their credit and qualify for prime loans.

Subprime Credit Expands Homeownership Opportunity

Homeownership has long been an integral part of the American dream. It not only benefits the individual homeowners, but also benefits communities and our nation generally. Practices which make the dream of homeownership more widely available and more affordable to consumers should be applauded, not limited.

As the Agencies are aware, mortgage credit has not always been as available and affordable as it is today.[1] Prior to the 1990s, the vast majority of lenders would make only prime loans (i.e., loans to the lender's most creditworthy customers). Additionally, the number of mortgage products available to consumers was limited. Either the consumer met fairly rigid, conventional lending standards and received a prime loan or the consumer could not get a loan. And even when the consumer met those conventional lending standards, the products available to the borrower were limited.

If the consumer could not meet the conventional lending standards, the only market alternative was a finance company, which made mortgage loans with very high rates (often at double or more the rate on prime loans). Finance company lending standards were focused primarily on the value of the collateral (*i.e.*, the loan amount was not a high percentage of the value of the property serving as collateral for the loan) and on the borrower's income. Loans were typically second mortgages for smaller amounts (under $50,000).

As technology improved and underwriting tools became more sophisticated, lenders (and investors in the secondary market) were able to assess the risk of different borrower and transaction characteristics. Lenders were not only able to offer a wider range of products better tailored to borrowers' varying circumstances, but could tailor the price of the product to the risk level of the individual borrower. The combination of innovative mortgage products and "risk-based pricing" benefits consumers generally. Consumers with good credit can obtain credit products at lower prices than ever before. Consumers that pose greater credit risk benefit not only by having greater access to mortgage credit

[1] For a more detailed discussion of the development of the market for subprime mortgage credit, see Souphala Chomsisengphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Jan./Feb. 2006, at 31.

than ever before, but also in having access to credit products that are more affordable than ever before.

Recent statistics show that the mortgage lending industry is furthering the American dream of homeownership. In recent years, homeownership has been at unprecedented highs. In the fourth quarter of 2006, the U.S. Census Bureau reported that U.S. homeownership was at a near-record level of 68.9%, up from 65.4% from the same quarter in 1996—meaning approximately 9.7 million more people own homes today than in 1996.[2] This time period roughly correlates with the development of the secondary market for subprime mortgages and consequent expansion of the availability of subprime mortgages. Homeownership among minorities also continues at near-record levels.[3]

The increased availability and affordability of subprime mortgage credit—resulting in large part from innovative mortgage products and risk-based pricing—is an important factor leading to the increased homeownership in recent years.[4] Limiting the products available to subprime borrowers will only decrease the availability of mortgage credit to subprime borrowers, and will deprive many of these consumers from owning or maintaining a home.

Subprime Credit Helps Consumers Repair Credit Scores and Overcome Financial Setbacks

The CMC agrees with the Agencies that the impact of subprime lending on consumers should be a component of any guidance regarding subprime lending. When considering the effect of subprime lending on consumers, the CMC urges the Agencies to consider that, for many borrowers, a subprime loan often is an important bridge allowing the consumer to overcome temporary financial setbacks and return to the "prime" borrowing market.

The predominant causes of consumer financial difficulties are the same as they were before the availability of subprime credit: job loss, divorce, and major health care expenses.[5] These life events often make it difficult, if not impossible, for consumers to continue to make timely payments on all of their existing obligations—and sometimes to make those payments at all. Additionally, the financial distress resulting from these life

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[2] *See* U.S. Department of Commerce, *Census Bureau Reports on Residential Vacancies and Homeownership*, at 4 (Jan. 29, 2007), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr406/q406press.pdf.

[3] *See id.* at 8.

[4] *See, e.g.*, Mark Doms & Meryl Motika, *The Rise in Homeownership*, FRBSF Economic Letter 2006-30, at 2-3 (Nov. 3, 2006), *available at* http://www.frbsf.org/publications/economics/letter/2006/el2006-30.pdf; Austan Goolsbee, *Economic View: The Upside of Subprime Lending is Increased Homeownership*, INT'L HERALD TRIB., Mar. 29, 2007.

[5] Freddie Mac recently reported that over 70% of delinquencies in its portfolio in 2006 were due to such life events, with an additional 13.3% ascribed to unspecified "other" reasons. *See* http://www.freddiemac.com/news/archives/servicing/2007/20070425_singlefamily.html (Apr. 25, 2007).

events may make the consumer ineligible for many forms of credit. Even if the consumer has wealth in the form of home equity, the consumer will be unable to access that wealth to weather a financial difficulty without access to mortgage credit. And, if a financial setback causes the consumer's credit score to decrease, a consumer may find it very difficult to repair that credit score without access to new credit.

The experience of CMC and its members is that subprime credit—including the oft-criticized hybrid ARM—helps consumers withstand financial difficulties and repair previously damaged credit. This is supported by others in the industry. One national lender recently testified to Congress that 80% of its borrowers who obtained a hybrid ARM between 2000 and 2006 refinanced within 36 months of origination. Of those borrowers who refinanced with that lender, 50% refinanced into a prime loan and 25% refinanced into a subprime fixed-rate loan. The borrowers who refinanced into a prime loan had improved their FICO scores by an average of almost 50 points and benefited from lower interest rates on their new loans.[6] Thus, subprime loans—including hybrid ARMs—frequently allow consumers to reestablish their credit as well as meet their immediate financial needs. Limitations on the availability of subprime credit would deprive significant numbers of these borrowers of that benefit.

Problems Regarding Subprime Foreclosures and Delinquencies Are Greatly Exaggerated

Recent negative portrayals of the subprime mortgage market by advocacy groups—and, in particular, a recent foreclosure forecast -- have created considerable concern and confusion.[7] In the experience of the CMC and its members, these negative portrayals grossly exaggerate the true scope of the problem. Indeed, the recent advocate forecast claims that 2.2 million subprime loans will end in foreclosures costing borrowers $164 billion. If this were correct, this forecast would mean that each such borrower would lose an average of approximately $75,000 -- an amount greater than the usual experience of CMC's members. While CMC's members have observed a recent up-tick in mortgage foreclosure rates, given the cyclical nature of the mortgage market this up-tick was not unexpected -- nor is it inconsistent with historical foreclosure rates. A great deal of attention has been paid to the fact that the nationwide foreclosure rate in the fourth quarter of 2006 increased 20 percent from the previous year. Very little attention has been paid, however, to the Mortgage Bankers Association's statistics that show that the 1.19% foreclosure rate for the fourth quarter of 2006 is 18% below the foreclosure rates of 2001 and 2002 -- and is less than the average foreclosure rate of 1.22% for the last 10 years. The CMC has urged Congress to have the Government Accountability Office ("GAO") conduct an independent study of foreclosure rates to ensure that Congress make any determinations based on reliable data. The CMC applauds Congressmen Barney

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[6] Testimony of Sandor Samuels, Executive Managing Director, Countrywide Financial Corporation, before the Senate Committee on Banking, Housing and Urban Affairs, Mar. 22, 2007.

[7] *See, e.g.*, Ellen Schloemer, et al., *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Consumers* (Dec. 2006).

Frank and Spencer Bachus for requesting that the GAO conduct such a study.[8] Similarly, the CMC urges the Agencies to ensure that any determinations relating to foreclosure and delinquency rates are based on reliable data. One advocacy-driven forecast should not be the basis for important public policy decisions.

Moreover, even though foreclosures have increased slightly, the evidence shows that the market is working. When delinquency and foreclosure rates ticked up in recent months, investors in the secondary mortgage market responded quickly by tightening their investment guidelines. In turn, this almost immediately led to lenders tightening their credit and underwriting requirements. A few lenders experiencing larger up-ticks were even forced to shut their doors. While this resulted in a significant amount of media attention, there are indications that the market is correcting -- and possibly has corrected -- the problem. For example, according to ForeclosureS.com, a California-based provider of foreclosure property information, foreclosures decreased nationally in February, down 3.4 percent from January and 6.5 percent from December.[9] Alexis McGee, president of ForeclosureS.com, stated that "The foreclosure numbers finally are beginning to reflect the stabilization in housing markets that we've been talking about for the last few months. . . . Of course time will tell for sure whether we've seen the bottom or not. However, other economic indicators reflect a leveling off between housing supply and demand and reinforce the opinion that the worst really is behind us."[10] The CMC and its members do not have a crystal ball -- we do not know for sure whether the foreclosure rate is heading up or down. Still, we believe that, at a minimum, the ForeclosureS.com report indicates that the Agencies should carefully scrutinize the accuracy of the advocates' dire predictions.

Furthermore, it is the experience of the CMC and its members that the vast majority of delinquencies and foreclosures -- including those during the recent up-tick -- are not related to particular loan terms or products, but are due largely to the same factors that have led to delinquencies and foreclosures historically: job losses, divorce, and medical problems. The Mortgage Bankers Association of America recently observed:

> Mortgage delinquencies are still caused by the same things that have historically caused mortgage delinquencies: "life events," such as job loss, illness, divorce or some other unexpected challenge. Foreclosures following

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[8] *See* Letter from Reps. Barney Frank and Spencer Bachus to David M. Walker, Comptroller General, Government Accountabiilty Office, (Apr. 25, 2007), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/press042507b.shtml.

[9] *Foreclosures Down Nationwide, but not in Southeast*, BIRMINGHAM BUS. J., Mar. 5, 2007, *available at* http://birmingham.bizjournals.com/birmingham/stories/2007/03/05/daily3.html.

[10] *Id.* However, another report indicates that some of the recent reductions in foreclosure filings may be caused by an increase in loan investors' willingness to allow a "short sale" of the property to avoid the foreclosure. *Homeowners, Lenders Skirt Default, May Curb U.S. Housing Slump*, Bloomberg.com, March 21, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=an4wlQaDRorE&refer=news. This, too, would indicate that the market is appropriately reacting to the changing market conditions.

> delinquencies may be caused by the inability to sell a house due to local market conditions after one of the above items has occurred.[11]

It has also been the experience of the CMC and its members that when poor job markets and other negative economic factors prevail in an area, foreclosure rates tend to rise. For example, the consumer advocacy group North Carolina Justice Center has shown that while the numbers of foreclosures (not just the rates of foreclosure) decreased state-wide in North Carolina in both 2004 and 2005, the changes in foreclosure numbers in particular counties varied widely.[12] Such variances are much more likely to be a result of local economic factors than the result of any particular lender practices, products, or loan terms. Indeed, the Senate Joint Economic Committee acknowledged in a recent report that "[l]ocal economies, housing market conditions, and regulatory environments can help explain why particular regions are getting hit the hardest by subprime troubles."[13] This is consistent with recent statistics reported by the Mortgage Bankers Association, which show that while states with the worst economies comprise only 10 percent of the mortgage market, they account for approximately 30 percent of the foreclosures.[14] For example, Ohio -- a state struggling with severe economic difficulties -- has the highest delinquency rates across almost all product types, while Arizona -- a state with a stronger economy -- has far fewer delinquencies regardless of product type. Similarly, while housing values have increased nationally (and, in some states dramatically)[15] and foreclosure rates have decreased nationally,[16] in Detroit property values have decreased and foreclosure rates have increased, due largely to "a slumping local economy."[17]

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[11] Mortgage Bankers Association, *The Residential Mortgage Market and Its Economic Context in 2007*, at 31, *available at* http://www.mortgagebankers.org/files/News/InternalResource/48215_TheResidentialMortgageMarketandItsEconomicContextin2007.pdf.

[12] *See* http://www.ncjustice.org/media/library/668_freclsrestatsncadminoffcts.pdf. While the numbers of foreclosures increased in some years, these numbers can only be understood properly in the context of the total new homes, which also increased.

[13] U.S. Senate Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, at 4 (Apr. 11, 2007), *available at* http://jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf.

[14] Mortgage Bankers Association, *National Delinquency Survey for* (Q4 2006).

[15] *See U.S. House Price Appreciation Rate Steadies*, http://www.ofheo.gov/media/pdf/4q06hpi.pdf (Mar. 1, 2007).

[16] *See, e.g.*, *Foreclosures Down Nationwide, but not in Southeast*, BIRMINGHAM BUS. J., Mar. 5, 2007, *available at* http://birmingham.bizjournals.com/birmingham/stories/2007/03/05/daily3.html.

[17] *See, e.g.*, Kevin Krolicki, *Houses Cheaper Than Cars in Detroit*, http://www.reuters.com/article/topNews/idUSN1927997820070319 (Mar. 19, 2007); *see also* U.S. Senate Joint Economic Committee, *supra*, at 7 ("Detroit's depressed automotive industry has no doubt contributed to increased high foreclosure rates."); *id.* ("In Ohio and Indiana sagging job markets may also be responsible for recent foreclosure spikes.").

Additionally, while foreclosure rates decreased nationally in January and February, the Southeast experienced an increase.[18]

This is supported by the economics report, "Explaining the Higher Default Rates of the 2005 Origination Year" by Michael Youngblood, Managing Director of Asset-Backed Securities Research at Friedman Billings Ramsey & Co., published in June 2006 in The MarketPulse by LoanPerformance, a copy of which is attached. The report notes that while the default rate at 20 months of adjustable rate mortgage (ARM) subprime securities was higher in 2005 than in 2003 or 2004, it was lower than the default rate at 20 months on similar securities originated from the years 2000 through 2002.[19] Moreover, the report concluded that the increase in the default rate on these securities in 2005, compared to 2003 or 2004, was attributable not to increases in short-term interest rates, nor to the erosion of underwriting criteria, but to weak economic factors in specific metropolitan statistical areas (MSAs) of the country. The study noted, for example, weak labor market conditions in areas where subprime borrowers depend on employment by automobile manufacturers and related companies, particularly, but not exclusively, in the Midwest; weak labor markets in New England; and the impact of Hurricanes Katrina and Rita on Louisiana and Mississippi.

Additionally, significant numbers of delinquencies and foreclosures are the result of mortgage fraud perpetrated against lenders rather than the financial distress of borrowers. While mortgage fraud schemes take many forms, the Federal Bureau of Investigation reports that some types of fraud schemes -- in particular, property flipping schemes -- end in "the properties [being] foreclosed on by victim lenders."[20] In one prominent case, three mortgage fraud schemes orchestrated by one person over a three-year period in only

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18 *See Foreclosures Down Nationwide*, *supra*.

19 Additionally, in the experience of CMC and its members, subprime hybrid ARM loans remain a small fraction of residential mortgage loans made nationwide. *See, e.g.*, Mortgage Bankers Association, *National Delinquency Survey* (Q4 2006) (reporting that approximately 5% of all mortgages are subprime ARM loans). Indeed, the total number of ARMs made during the last three years that are scheduled to reset in the near future are very low relative to the total number of loans originated during this period. The following chart shows the number of loans that were originated during 2004-2006 that are set to reset in the next 10 years, with the dollar total of those loans:

	Number of Loans Originated	**Millions**
2007	1,724,211	$368,579
2008	1,172,714	$267,603
2009	969,538	$256,485
2010+	2,308,414	$701,614

Source: Christopher L. Cagan, *Mortgage Payment Reset: The Issue and the Impact* (Mar. 19, 2007) (published by First American CoreLogic).

20 Federal Bureau of Investigation, *Financial Crimes Report to the Public*, at 21 (Mar. 2007), *available at* http://www.fbi.gov/publications/financial/fcs_report2006/publicrpt06.pdf; *see also* Federal Bureau of Investigation, *The Rise of Mortgage Fraud and How It Impacts You*, *available at* http://www.fbi.gov/page2/dec05/mortgagefraud121405.htm (Dec. 14, 2005).

one metropolitan area (Atlanta) resulted in over $80 million in foreclosures.[21] It is no coincidence that with instances of mortgage fraud rising dramatically in recent years,[22] foreclosure rates also have risen.

Another reason that advocates' projections overstate likely foreclosure rates is that many delinquencies will not result in foreclosure because of loss-mitigation techniques employed by mortgage servicers. In recent years, mortgage servicers, recognizing the high costs of foreclosure to the lender as well as the borrower, have come to view foreclosure as a last resort. Servicers, including CMC members, now try to keep the borrower in the home as long as there is any reasonable possibility of repayment.

Many servicers call all borrowers several months before a scheduled reset if the reset is likely to result in a significantly increased payment, to determine if the borrower is likely to be able to handle the payment. Although many borrowers either will be able to carry the increased payment or have already made plans to refinance, when that is not the case, servicers are in a position to offer either temporary forbearance or repayment plans – where the borrower will eventually catch up on the payment – or permanent loan modification, in which the legal terms of the loan are permanently changed.

Available loan-modification options often include, for example:

- Adding delinquent payments to the balance and calculating a new monthly payment;
- Providing for a balloon payment at the end of the term; or
- Permanently or temporarily reducing the rate. A recent trend is to offer a temporary or permanent "payment-shock modification" in which the rate is maintained at the initial rate or some other rate that is lower than the scheduled, indexed-based rate.

In our experience, most agreements between servicers and investors that apply to pools containing 2/28 hybrid ARMs allow loan modifications. Because of restrictions such as a requirement that either the loan is in default or the lender reasonably anticipates that it will be in default, as well as limitations in some agreements on the percentage of loans that may be modified, loan modification may not always be a complete solution, but it, along with other loss-mitigation techniques, should significantly reduce the number of foreclosures during the current downturn.

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[21] *See* R. Robin McDonald, *Athletes Caught Up in Mortgage Fraud Case*, FULTON COUNTY DAILY REP., Jan. 23, 2007, at 1.

[22] The federal Financial Crimes Enforcement Network (FinCEN) has reported that the number of mortgage-related Suspicious Activity Reports (SARs) filed in the first six months of 2006 rose 51% over the same period in 2005, which follows a 33% increase from 2004 to 2005, and a 150% increase from 2003 to 2004. *See* FinCEN, *The SAR Activity Review – By the Numbers*, Issue 7, at 6 (Nov. 2006), *available at* http://www.fincen.gov/sar_review_by_the_numbers_issue7.pdf; Mortgage Asset Research Institute, *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, at 1 (Apr. 2006), *available at* http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf.

In this regard, the CMC commends the Agencies for their recent Statement on Working with Mortgage Borrowers.[23] Lenders, servicers, and investors lose substantial amounts of money on each foreclosure. A Federal Reserve study has noted that

> When a borrower defaults on a home mortgage, the lender may attempt to recover its losses by repossessing and selling the property. However, estimated losses on these foreclosures range from 30 percent to 60 percent of the outstanding loan balances because of legal fees, foregone interest, and property expenses.[24]

Because a failed loan transaction is costly to all concerned, lenders design their underwriting criteria to avoid foreclosures. Lenders monitor closely the performance of loans and adjust their underwriting standards to avoid making loans that will default. Lenders and servicers also have developed programs to help borrowers through financial difficulty where possible, including encouraging customers to work with HUD-approved credit counseling agencies and offering flexible repayment plans. Lenders and servicers are better off if they can find ways to help the borrower avoid default. And, to the extent foreclosures increase, market forces compel lenders and servicers to tighten underwriting criteria and take steps to assist borrowers in avoiding default and foreclosure. From the perspective of lenders and servicers, foreclosure is a highly undesirable, but occasionally necessary, last resort. The CMC applauds the Agencies' efforts to encourage institutions to work with borrowers to avoid foreclosure.

In summary, the CMC believes the foreclosure picture to be very complicated in terms of severity, causation, and geographic dispersion, and not susceptible to glib generalizations about particular loan products or the direction of property values nationally.[25] Indeed, one senior policy maker familiar with the situation has stated he believes the news media have "overreacted" to the correction in the mortgage lending market. In a recent speech, HUD Deputy Secretary Roy Bernardi stated that while "[s]ome of the concerns are justified because of the cooling in the housing market," in his view, the recent housing boom was unsustainable and no one should be surprised by the market correction. Nevertheless, Secretary Bernardi emphasized that he believes "this cooling-off period will be a short-term adjustment, and it will eventually be healthy for our economy."[26]

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[23] *See, e.g.*, http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417/attachment.pdf.

[24] Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, at 2 (May 13, 2003), *available at* http://www.federalreserve.gov/pubs/feds/2003/200316/200316pap.pdf.

[25] The CMC agrees with Congressmen Barney Frank and Spencer Bachus, who recently wrote that "there is no reason to conclude that [the type of loan] is the only factor [in higher foreclosure rates]." *See* Letter from Reps. Frank & Bachus, *supra* note 8.

[26] Roy Bernardi, Deputy Secretary, Department of Housing and Urban Affairs, Remarks at the 2007 Legislative and Regulatory Conference of the National Association of Mortgage Brokers (Mar. 20, 2007), *quoted in National Mortgage News Daily Briefing*, Mar. 21, 2007.

Some advocacy groups have also put forward anecdotal stories to support their calls for government action. Many of these anecdotes, however, involve fraudulent lender or broker practices. Originators who engage in fraudulent practices already ignore currently existing prohibitions on such practices. New limitations on loan products and terms will not deter such bad actors, but will only serve to limit the ability of responsible lenders to provide affordable credit to those who need it.

Such anecdotes are also selected to maximize negative impact. They do not include the millions of stories of consumers who have been able to purchase and retain homes, build equity, and pay emergency expenses as a result of subprime mortgage credit. The sad reality is that there will always be some number of consumers who default on their loans. But that number has been and continues to be relatively small. The misfortunes of a few should not deprive the many of opportunities to own their own homes and to make their own financial choices. The CMC urges the Agencies to consider the many success stories when considering the negative anecdotes.

DISCUSSION

Guiding Principles

Before addressing specific portions of the Statement, the CMC respectfully recommends that any statement or guidance regarding subprime lending be based on the following principles:

1. The Statement should provide a series of suggested best practices that individual lenders can adapt to their particular circumstances, not a set of detailed, mandatory disclosures. The Statement should discuss a range of solutions to the issues presented rather than mandating one particular approach. This is because:

    a. Both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Regulatory action or guidance that limits choices or stymies new product development will reduce the ability of the market to serve consumers. Consumers will be best served if the Statement creates generalized guidelines that then can be applied flexibly by lenders to a variety of products and circumstances.

    b. Although the Statement would not itself create a private right of action, there is a risk that state courts would look to it in interpreting state unfair and deceptive acts or practices ("UDAP") statutes that allow consumers to bring suit against state-chartered institutions. To avoid such a misuse, the Statement should not include specific consumer-protection requirements.

2. Consumers must be put in a position to make informed decisions regarding the products that are most appropriate for their particular needs and circumstances. A simplified, understandable disclosure of key information about the loan would

enable consumers to better understand their credit obligations and comparison shop for loans—and create the competition necessary to benefit consumers. While the CMC generally supports improved consumer credit disclosures, any new disclosure requirements must be standardized and uniformly applied to all lenders—including those not subject to the regulatory authority of the Agencies. Otherwise, consumers will receive different disclosures from different lenders, resulting in (1) increased consumer confusion and decreased consumer ability to make informed decisions when comparing various products, and (2) competitive disadvantages between lenders that are required to make certain disclosures and those that are not.

3. In the majority of cases, the mortgage broker is the initial -- and often the principal—contact with the consumer during the consumer's efforts to shop for credit products. The broker is particularly influential with respect to the consumer's understanding of (1) the range of products available; (2) the terms of any particular product; and (3) how any particular product will impact the consumer. Thus, brokers should be responsible for providing clear, meaningful information to consumers about the products available, the role the broker plays in the transaction (i.e., whether the broker is acting as the consumer's agent, the lender's agent, or some other role), and the total compensation the broker will receive in the transaction. Brokers should also be subject to the same mechanisms to protect consumers as are lenders. For example, brokers should (1) be licensed in every jurisdiction; (2) register with a nationwide database that provides information about the broker, such as licensing, disciplinary or legal actions, etc.; (3) have increased minimum net worth requirements and bond/insurance requirements to cover borrower losses or claims; and (4) be required to maintain and submit for approval fair lending plans (similar, for example, to the fair lending plan the New York Banking Department requires for licensed mortgage lenders).

4. The best way to address pricing and other concerns in the subprime market is to encourage more competition and more entry into the market, not less. Only competition will effectively reduce prices and increase consumer choice. To this end, any substantive restrictions on products or practices must be applicable to all lenders equally. Otherwise, lenders subject to the Agencies' authority will be placed at a competitive disadvantage vis-à-vis other lenders -- to the detriment not only of the Agencies' lenders but also of consumers.

5. To the extent additional limitations or restrictions are imposed on subprime lending products or on underwriting or disclosure practices, these limitations and restrictions should be applied only to that segment of the market -- the subprime market -- giving rise to the concerns. There is no need for further restrictions on the prime mortgage market.

6. Additionally, any additional limitations or restrictions on subprime lending products or on underwriting or disclosure practices should be narrowly tailored to address only those subprime products that give rise to the Agencies' concerns.

The CMC believes that the Agencies' concerns are related to subprime products with very low, below-market teaser rates that expire in relatively short time frames. Any restrictions on credit should apply only to these products, and not to other subprime credit products.

7. The statement should not apply to "jumbo" loans. Because they have higher incomes and thus a higher degree of sophistication, borrowers who obtain jumbo loans do not need as much protection as borrowers of lesser amounts. Borrowers eligible for jumbo loans should have the freedom to choose from the widest range of financial options.

8. The Agencies, in partnership with industry and advocacy groups, can play an important role in educating consumers—and helping consumers understand that they must educate themselves—regarding the nature and impact of home-secured credit. Ultimately, the key to minimizing negative impact of subprime credit is helping consumers understand the products available to them.

9. Complaints made and concerns raised by consumers should be provided to the regulatory agency with jurisdiction over the entity that is the subject of the complaint or concern. The Agencies, in cooperation with state regulators, can create a system whereby complaints made to state regulators are routed to the appropriate federal agency, and vice versa.

10. Mortgage fraud involving faulty appraisals causes serious losses and increases foreclosure rates. The Federal Reserve Board can use its authority under the Home Ownership and Equity Protection Act ("HOEPA") (discussed below) to require appraisers to report contemporaneously any instances of pressure from lenders or brokers to inflate appraisals and to prohibit lenders and brokers from pressuring appraisers to inflate values. The Board also should prohibit the inflation of appraisals. Additionally, the process in the Financial Institutions Reform Recovery and Enforcement Act 's ("FIRREA") process should be used to impose insurance requirements to cover losses from inflated appraisals and establish the ability to decertify appraisers involved in fraud or pattern of inflated valuations. FIRREA's requirements for appraisals should be amended to apply only to commercial mortgages, so that AVMs could be used more broadly in connection with residential mortgages. Any inaccuracy in appraisals, or pressure related thereto, should not, however, affect whether a loan is considered an above-threshold loan, as such an after-the-fact recalculation would mean that a lender or investor could never be sure if a loan exceeded a given threshold unless and until the loan became involved in litigation.

Coverage of Only a Portion of the Entire Industry

Because the Statement would apply only to regulated lenders, it would not reach the minority of lightly regulated lenders that have been the main source of abuse in the subprime market -- and would put lenders at a competitive disadvantage compared to other lenders. The proposed Statement does not ensure consistent practices across the industry.

In order to compete in the marketplace and serve their customers, banks need to be able to offer innovative products. If the government decides, as a matter of policy, that certain products are unsuitable or underwriting practices are inappropriate, that decision should apply to all lenders and protect all consumers. This implies that any substantive requirements should be made pursuant to the Board's authority under HOEPA. The Federal Reserve Board has broad authority under HOEPA to establish substantive requirements with respect to subprime loans—and that those requirements would apply to all lenders, not just those subject to the authority of the Agencies. HOEPA provides:

> The Board, by regulation or order, shall prohibit acts or practices in connection with –
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> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
>
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

15 U.S.C. § 1639(l)(2).[27]

In addition, to apply any disclosure requirements broadly across all loan originators in the industry, any disclosure requirements be made through the Board's discretionary authority under TILA, *see* 15 U.S.C. § 1604(a) or through the authority of the OTS, the OCC, and the NCUA under the Parity Act. The Board's TILA authority and these banking agencies' Parity Act authority is discussed in more detail below.

To the extent the Agencies do not currently have the authority to effect all changes recommended herein, the CMC urges the Agencies to join with it and others in working to effect these changes.

Risk Management Practices

Predatory Lending Considerations

The CMC agrees that lenders should not make loans that involve any of the three criteria identified in the proposed Statement. Lenders should not base a decision to make a mortgage loan predominantly on the foreclosure or liquidation value of the property securing the loan. Lenders and brokers should not induce borrowers repeatedly to refinance loans in order to charge high points and fees on each refinancing. And CMC believes there is no justification for lenders or brokers engaging in fraud or deception to

[27] We note that the Board's use of its authority under Section 129(l)(2) would have no impact on the definition of a loan referred to in § 103(aa) or on the thresholds described therein. This is appropriate because the Board's prohibition of unfair and deceptive practices should not be tied to loans that meet the § 103(aa) definition.

conceal the true nature of a mortgage loan or product, whether the borrower is sophisticated or unsophisticated.

While we agree that lenders and brokers should not mislead consumers and should provide full disclosure of the material terms of the transaction, as noted above, we do not believe it would be feasible or good policy to impose on the lender the additional burden of investigating each consumer's specific circumstances -- beyond repayment ability -- and recommending what the lender thinks is the best product. In other words, the CMC believes that a "suitability" standard similar to what broker-dealers must abide by under the securities laws cannot appropriately be applied to lenders. In contrast to a broker-dealer, a lender is advancing funds to, rather than receiving funds from, the consumer, and has a significant incentive to avoid making a loan if the borrower's record does not demonstrate both the capacity and willingness to repay. In addition, a lender is prohibited under various federal laws from asking certain information that could be important in determining the most suitable product, such as information about childbearing plans, and is limited in obtaining information about the consumer's medical condition. *See* Regulation B, 12 C.F.R. § 202.5(d)(3); Fair Credit Reporting Act, 15 U.S.C. § 1681b(g)(3). After the lender provides the consumer with a range of reasonable product offerings, it should be ultimately up to the consumer to select the option that best meets his or her needs.

Underwriting Standards

Underwriting to the Fully-Indexed Rate

The CMC agrees with much of the content of the proposed Statement regarding underwriting standards. Lenders' underwriting standards should be designed in recognition of the effect "payment shock" can have on the borrower's ability to service the debt.

While the CMC generally agrees that underwriting standards should evaluate the borrower's ability to service the debt, we urge the Agencies not to require that all loans be underwritten at the long-term rate, regardless of the period to which the initial rate applies. While underwriting to the fully-indexed rate may be appropriate in some circumstances, it creates an inappropriate limitation on subprime credit in many other circumstances.

Such a global requirement is inappropriate for many reasons. First, this requirement likely would greatly exacerbate default and foreclosure rates by preventing borrowers who have already been successfully carrying a subprime loan, such as a hybrid ARM, from refinancing that loan. Requiring that loans be underwritten at the fully-indexed rate will drastically reduce the maximum debt-to-income ratio for many products -- likely to a level so low that few consumers who currently have subprime loans will be able to qualify. (This would still be true, though to a lesser degree, if the definition of "fully indexed" rate is adopted from the Nontraditional Mortgage Guidance as discussed below.) Many consumers obtain subprime hybrid ARMs fully intending to refinance prior to or upon adjustment. However, if this requirement is imposed, many of these consumers—consumers who otherwise are making their payments on a timely basis ---

will be unable to qualify for refinancing. Indeed, many of these borrowers are seasoned, have demonstrated that they can service a mortgage debt, and have known payment history. Yet, notwithstanding these positive criteria, these borrowers may be unable to refinance their loan, may be unable to make payments after the adjustment period, and may be foreclosed upon. Thus, a requirement to underwrite to a fully-indexed rate will have the perverse effect of increasing, not decreasing, foreclosures.

Second, this requirement wrongly assumes that borrowers will keep a loan for the entire term of the loan. In the experience of CMC and its members, the vast majority of subprime borrowers refinance long before the loan term expires. Indeed, thirty-year subprime mortgages have an average duration of around three years. Subprime borrowers access credit and use their home as security in many different ways and for many different reasons. These reasons generally result in restructuring or refinancing the debt over short-term periods. As noted above, subprime loans often serve as a critical bridge over financial setbacks and as a means of repairing credit. Requiring that lenders underwrite to the fully-indexed rate when few borrowers will still be obligated on the loan when the fully-indexed rate applies is a requirement that is not consistent with how borrowers use subprime mortgage products.

Third, this requirement wrongly assumes that a borrower's income at the moment of origination will be the same as the borrower's income when the loan adjusts to the fully-indexed rate. Some of the country's leading housing economists—Kristopher Gerardi and Paul S. Willen of the Federal Reserve Bank of Boston, and Harvey S. Rosen of Princeton University -- recently released a study showing that borrowers frequently base credit decisions on future rather than present income, and that borrowers have been quite rational in making those decisions.[28] As Professor Rosen stated, "Our findings suggest that people make sensible housing decisions in that the size of house they buy today relates to their future income, not just their current income and that innovations in mortgages over 30 years gave many people the opportunity to own a home that they would not have otherwise had, just because they didn't have enough assets in the bank at the moment they needed the house."[29] Professor Rosen further explains that requirements like underwriting to a fully-indexed rate could harm the very people such requirements are intended to protect: "The main thing that innovations in the mortgage market have done over the past 30 years is to let in the excluded: the young, the discriminated against, the people without a lot of money in the bank to use for a down payment."[30] In reviewing this study, Professor Goolsbee of the University of Chicago

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[28] Gerardi, Kristopher et al., *Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market*, NBER Working Paper No. W12967 (Mar. 2007), *available at* http://ssrn.com/abstract=971601.

[29] *Quoted in* Austan Goolsbee, *"Irresponsible" Mortgages Have Opened Doors to Many of the Excluded*, N.Y. TIMES, Mar. 29, 2007.

[30] *Id.*

cautions "that regulators should be mindful of the potential downside in tightening [underwriting requirements] too much."[31]

Finally, the proposal to require underwriting to the fully-indexed rate and fully-amortized payment would, in effect, require that lenders apply a "stress test" to each individual loan, rather than to their entire portfolio. This "loan-level" stress test is unprecedented and, if taken literally, would drastically reduce the availability of subprime mortgage products. If the same approach were applied to traditional lending, it would also significantly reduce the amount of credit available. For example, no lender would make a 30-year fixed-rate loan to a 45-year-old couple if it had to establish that the borrowers would still be both alive and able to make the full payment at age 75. Lenders can prudently make long-term fixed-rate loans, as they can prudently offer subprime mortgage products, because they have sophisticated models that allow them to manage their financial risk on a portfolio basis. Using these models, they can take into account the probability that the vast majority of loans will be paid off before the end of the term. As the Agencies are aware, in subprime loans as in other mortgage loans, borrowers have the option of paying off the loan at any time, and they do so for a variety of reasons, including sale of the residence, cashing-out equity, moving from a variable to a fixed rate, or moving from a subprime to a prime loan.

Instead of imposing a rigid requirement that lenders underwrite to the fully-indexed rate, the Statement should provide that lenders should underwrite using prudent underwriting guidelines that, among other things, allow reasonable projections of an applicant's income to meet future payment increases, manage risk at the portfolio level, and thus allow lenders the flexibility to offer consumers products that meet their needs. Such flexibility is essential for lenders to be able to meet not only the needs of borrowers, but also the needs of communities -- particularly communities with large immigrant populations.[32]

If the Agencies decide to implement an underwriting requirement based on a "fully indexed" rate, the CMC urges the Agencies to be consistent and incorporate in the Statement the definition of "fully indexed rate" from the Interagency Guidance on Nontraditional Mortgage Products ("Nontraditional Mortgage Guidance"). The Nontraditional Mortgage Guidance provides:

> The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District

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[31] *Id.*

[32] *See, e.g.*, Edward L. Yingling, *Viewpoint: Subprime Loans Helping a Texas Town*, AM. BANKER, May 4, 2007 (describing how a bank used flexible criteria to help many borrowers in the small town of Van Horn, Texas buy homes who likely would not otherwise have been able to do so).

> Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. *In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.*[33]

Thus, in the Nontraditional Mortgage Guidance, the Agencies appropriately gave lenders the flexibility to use a "credible market rate" when qualifying borrowers. As the text italicized above makes clear, the Agencies correctly recognized that in many interest rate environments, the difference between an ARM's margin plus index and the rate of a 30-year fixed-rate loan can be substantial. Unless lenders are permitted to use a "credible market rate," as they are under the Nontraditional Mortgage Guidance, when such substantial rate differences exist many consumers would be able to qualify for a 30-year fixed-rate mortgage but could not qualify for an ARM. Thus, the consumers could qualify for a loan with a higher monthly payment but not a loan with a lower monthly payment. Additionally, when rates are low, underwriting to a fully-indexed rate would result in loose underwriting standards -- and underwriting to a rate that likely can only increase.[34] Such results are arbitrary and absurd, and do not benefit consumers. If a consumer has demonstrated an ability to service a long-term debt -- such as by qualifying for a 30-year fixed-rate loan at the same risk class -- the consumer should not be prevented from choosing loan products that the consumer prefers, including ARM products that provide the benefit of lower monthly payments.

Additionally, under the Nontraditional Mortgage Guidance, a fully indexed rate is used only after an "introductory interest rate" expires. However, the Guidance does not define what constitutes an "introductory interest rate." If the Agencies decide to require that

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[33] 71 Fed. Reg. 58609, 58614 n.5 (Oct. 4, 2006) (emphasis added).

[34] For example, in the testimony of FDIC Chairman Sheila Bair before the House Subcommitte on Financial Institutions and Consumer Credit, she used the example of a 2/28 ARM with an introductory rate of 8.30% and a margin at reset of 6.99%. The fully-indexed rate used in her example, based on an index of 5.375% was 12.365%. *See* Sheila C. Bair, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, at 10 (Mar. 27, 2007), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbair032707.pdf. However, if that same 8.30% loan with a 6.99% margin had been made in 2003, the fully-indexed rate could have been as low as 7.97%, because the low point for the index was 0.98%. Additionally, a recent UBS study indicates that the average original weighted-average coupon for subprime ARMS originated in 2003 was 7.5%, with an average margin of 6.036%. *See* UBS, *Servicing in a Subprime Meltdown: Loan Modifications and Servicing Transfers* (Apr. 17, 2007). On a simple daily average basis the index was 1.23%, so the average fully indexed rate was 7.27% for 2003. Thus, in 2003 the initial rate could have been, and often was, higher than the fully-indexed rate—a premium rate, rather than a teaser.

lenders underwrite to a "fully indexed" rate, the CMC urges the Agencies to clarify that only a rate that lasts 36 months or less is an "introductory interest rate." The CMC believes a rate is not truly "introductory" if its duration is greater than 36 months. Indeed, any longer period would create even greater inconsistency with the FHA's guidelines, which allow lenders to underwrite to the initial rate (or to the initial rate plus 1% if the loan is a 1-year arm and the LTV is greater than 95%).[35]

As discussed above, the CMC opposes any requirement that lenders underwrite to a fully-indexed rate. However, if the Agencies decide to impose such a requirement, to maintain both flexibility and consistency CMC urges the Agencies to adopt the definition of fully-indexed rate from the Nontraditional Mortgage Guidance and permit a lender to qualify a consumer for an ARM loan of a particular risk class if the consumer qualifies for a 30-year fixed-rate mortgage of the same risk class. To benefit consumers, lender flexibility in qualifying borrowers must be maintained.

Lower-Documentation Loans and Risk-Layering

The CMC continues to believe that stated income and low-documentation loans serve an important purpose and provide important benefits to certain populations. For example, for some borrowers, W-2s may not accurately reflect significant portions of earnings, such as tips, bonuses or raises. Additionally, members of immigrant populations often have income from sources not reportable on a W-2.

Although we agree with the general concept that there should be mitigating factors when a lender accepts a lesser level of documentation or makes a simultaneous-second lien mortgage, we are concerned that the DTI example -- mentioned as "*one* widely accepted approach" (emphasis added) -- could be misunderstood by examiners as a requirement. Examiners should be directed to evaluate the whole range of a lender's criteria, and to accept criteria other than DTI (e.g., higher credit scores, lower loan-to-value, credit enhancements, mortgage insurance, etc.), in determining whether a specific program feature such as a relaxed documentation requirement is justified under the circumstances. The Statement should require prudent underwriting standards without imposing any particular mitigation factor or setting any particular threshold for any factor.

Loss Mitigation and Loan Modification

As noted, CMC strongly endorses the recent interagency Statement on Working with Mortgage Borrowers.[36] In particular, we appreciate the confirmation in that Statement that "Financial institutions may receive favorable Community Reinvestment Act (CRA) consideration for programs that transition low and moderate income borrowers from higher cost loans to lower cost loans, provided the loans are made in a safe and sound manner." As described above, CMC members and other large servicers currently follow

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[35] *See* HUD Mortgagee Letter 2004-10 (Mar. 19, 2004).

[36] Available at, *e.g.,* http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417/attachment.pdf.

the practices recommended in that Statement, and we strongly support the concept of providing forbearance and loan modifications where appropriate.

To avoid any confusion, the Statement on Subprime Mortgage Lending should make clear that it is should be interpreted in a manner consistent with the Statement on Working with Mortgage Borrowers. In particular, the Statement on Subprime Mortgage Lending should explicitly state that it does not apply to loan modifications or other loss-mitigation practices. Rigid underwriting requirements are particularly inappropriate and unhelpful to the borrower when the alternative is foreclosure. For example, a servicer should be able to offer to a distressed borrower a loan modification in which an initial discounted rate is extended for a limited period during which the lender anticipates that the borrower will find alternative financing or sell the property. The Statement should make it clear that this type of relief is permissible even when the servicer does not establish that the borrower is capable of repaying the loan over its full remaining term.

Consumer Protection Principles

Substantive Protections

The first consumer protection principle provided by the Agencies in the proposed Statement is the principle of "[a]pproving loans based on the borrower's ability to repay the loan according to its terms." For the reasons stated above, CMC believes it is inappropriate to require underwriting to a fully-indexed rate. However, CMC supports underwriting standards based on the borrower's ability to service the loan—and not based on the foreclosure value of the property. In this vein, CMC recommends rephrasing this consumer protection principle as follows: "Approving loans based on the borrower's ability to service the debt, rather than on the foreclosure or liquidation value of the property."

As the CMC discusses above, imposing substantive requirements only on lenders subject to the Agencies—and not to all lenders—places lenders under the Agencies' authority at a competitive disadvantage. We recommend that if the Agencies wish to impose substantive requirements on subprime loans, such as a requirement that prepayment penalties not extend beyond the initial reset period of an ARM, that the Board use its rulemaking authority under HOEPA to propose such a requirement applicable to the entire industry, obtain feedback from the wider group of commenters, and potentially proceed with the rulemaking.

Informing and Educating Consumers

Both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Regulatory action or guidance that limits choices or stymies new product development reduces the ability of the market to serve consumers. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation. And, consumers must be able to choose financial products that meet their goals and needs, consistent with their ability to repay and with safety and soundness concerns. Instead of imposing external limitations on lenders activities or products, the CMC

suggests that improved methods of educating consumers about their loans is a preferable means of minimizing delinquency and foreclosure.

1. Improving Disclosures

The CMC agrees with the Agencies that consumers will benefit by improved disclosures regarding the terms of subprime mortgage products. The best way to address pricing or other concerns in the subprime market is to encourage more competition and more entry into the market, not less. Only competition will be able to reduce prices and increase consumer choices in this market.

A simplified, understandable disclosure of key information about the loan would enable consumers to better understand their credit obligations and comparison shop for loans—and create the competition necessary to benefit consumers. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about key features of the loan. If the borrower receives a clear disclosure of these key features early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable. While two economists recently concluded, after reviewing studies on mortgage disclosures, that "[c]urrent mortgage disclosures fail to convey key mortgage costs to many consumers," these economists also concluded that "[i]t is possible to design better disclosures that significantly improve consumer recognition of mortgage costs."[37]

It is critical that lenders be able to comply with a uniform set of disclosure and other substantive requirements that will consistently and adequately protect consumers across the nation. The CMC agrees with the Agencies that new or modified disclosures must (1) be short and in a form consumers can digest so as to avoid both "information overload;" (2) clearly describe changes in payments or interest rates to minimize instances of "payment shock;" (3) the existence and calculation of any prepayment penalty and when such a penalty may be imposed; (4) the existence of any balloon payment; (5) the cost of any stated income or low-documentation loan; and (6) the requirement to pay taxes and insurance, if not escrowed. Such a disclosure could be patterned on, or at least informed by, the successful "Nutritional Facts" disclosures, as some officials at the Agencies have suggested.[38] However, the CMC urges the Agencies to recognize the operational difficulties that would arise from a requirement to provide comprehensive disclosures at or before the time of application. If the Agencies wish to create such a timing

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[37] James M. Lacko & Janis K. Pappalardo, Bureau of Economics, Federal Trade Commission, *Information Regulation is Tricky: Lessons from Mortgage Disclosure Research*, presentation before the Behavioral Economics and Consumer Conference, Federal Trade Commission, Washington, D.C. (Apr. 20, 2007); *see also* James M. Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Federal Trade Commission Bureau of Economics Staff Report (2004), *available at* http://www.ftc.gov/os/2004/01/0301/030123mortgagefullrpt.pdf.

[38] *See, e.g.*, Julie L. Williams, Acting Comptroller of the Currency, Remarks Before an EGRPRA Outreach Meeting (May 12, 2005), *available at* http://www.occ.treas.gov/ftp/release/2005-47a.pdf.

requirement, the CMC recommends that lenders be permitted to provide a very short pre-application disclosure orally (limited to a few sentences), and follow up with written disclosures before the consumer pays any non-refundable fee or at the time the consumer receives the Good Faith Estimate.

For any new or modified disclosures to be effective for consumers and fair to the Agencies' lenders, they must be offered by all lenders, not just those subject to the Agencies' authority. The CMC recommends one of two approaches. One approach is for the Federal Reserve Board to exercise its authority under TILA to create a disclosure requirement that would apply to the entire mortgage industry. Section 105 of TILA, codified at 15 U.S.C. § 1604, gives the Board broad authority to require disclosures to "effectuate the purposes" of TILA. Historically, the Board has interpreted its authority under Section 105 broadly. For example, Section 105 is the only statutory provision cited as authority for the Board to promulgate rules requiring use of the Consumer Handbook on Adjustable Rate Mortgages (the "CHARM" booklet).[39] The CMC believes that if Section 105 gives the Board the authority to require use of the CHARM booklet, it similarly gives the Board authority to require all lenders to disclose the information described in the proposed Statement. The CMC also continues to believe that a reconciliation and rationalization of TILA and RESPA would better enable lenders to provide the information to consumers that would benefit consumers most.

A second approach is for the banking agencies to adopt new disclosures as regulations and for the OTS, OCC and NCUA to promulgate their rules under their Parity Act authority. Such rules would then apply to all federal chartered banks and credit unions as well as to any state chartered bank, credit union, or housing creditor that choose to make loans that would be considered "alternative mortgage transactions" under the Parity Act.[40] We note that a drawback to this approach is that the application of the Parity Act to state-chartered institutions is optional, not mandatory. That is, state-chartered institutions are free to choose whether to make alternative mortgage transactions under the Parity Act, and thereby take advantage of the Parity's Act's preemptive authority, or to comply with state law.[41] If, for example, new Parity Act regulations required a disclosure relating to the borrower's ability to repay a subprime loan that is not required

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[39] *See, e.g.*, 50 Fed. Reg. 20221 (May 15, 1985).

[40] The Parity Act was enacted "to eliminate the discriminatory impact that those regulations have upon nonfederally chartered housing creditors and provide them with parity with federally chartered institutions by authorizing all housing creditors to make, purchase, and enforce alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by the Federal agencies." 12 U.S.C. § 3801(b). Under the Parity Act, the OCC is authorized to promulgate rules applicable to banks, the NCUA is authorized to promulgate rules applicable to credit unions, and the OTS is authorized to promulgate rules applicable to savings associations and other "housing creditors." *Id.* § 3803(a). "Housing creditors" include nonbank state-licensed mortgage lenders. The Parity Act does not give the Board authority to promulgate rules applicable to state-chartered banks. "Alternative mortgage transaction" includes ARMs, which the CMC understands are the loan products that are the central focus of the proposed Statement. *See id.* § 3802(1). The term "alternative mortgage transaction" also includes balloon loans. *Id.*

[41] *See* 12 U.S.C. § 3803; 12 C.F.R. § 560.220(a).

under state law, a state housing creditor may choose simply to follow the state law, and not use the Parity Act.[42] However, the inclusion of the new disclosure in Parity Act regulations would send a signal to the states that any similar disclosure they adopt could not be avoided by a state-chartered lender through use of the Parity Act.

Additionally, it is vitally important that consumers understand the mortgage broker's role in the transaction. In the majority of cases, the mortgage broker is the initial and often principal contact with the consumer in the process of shopping for and understanding the range of loans available and the potential impact of a loan on the consumer's financial situation. The broker is particularly influential with respect to the consumer's understanding of (1) the range of products available; (2) the terms of any particular product; and (3) how any particular product will impact the consumer. Consumers would benefit greatly if brokers were required to provide clear, meaningful and timely information to the consumer about the products available, the role the broker is playing (i.e., consumer's agent, lender's agent or other role), and the total compensation the broker will receive in the transaction. Furthermore, the CMC believes that such disclosures by brokers must be accompanied by making brokers subject to similar consumer protection mechanisms as are lenders. For example, brokers should (1) be licensed in every jurisdiction; (2) register with a nationwide database that provides information about the broker, such as licensing, disciplinary or legal actions, etc.; (3) have minimum net worth requirements and bond/insurance requirements to cover borrower losses or claims; and (4) be required to maintain and submit for approval fair lending plans (such as New York requires for mortgage lenders licensed in that state) which would be made available to consumers and would include steps to ensure the broker or lender does not engage in illegal discrimination in making loan decisions or in the pricing of loans.

2. Improving Consumer Education

In addition to advocating improved disclosures, the CMC has long advocated a robust three-step program to increase public awareness and improve consumers' understanding of their loan obligation:

a. Public Service Campaign

Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

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[42] *See, e.g.*, 12 C.F.R. § 560.220.

b. Public Awareness Infrastructure

Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

c. "Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators

Over 9 years ago, the Federal Reserve Board and the Department of Housing and Urban Development issued a *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* ("Joint Fed/HUD Report") recommending, among other things, that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Obviously, great strides in technology have occurred since then, with many mortgage calculators or "smart" computers available online. Since these computer programs have been already developed by the private sector and are widely available, a more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products.

We note that this proposed Statement was issued just a few weeks after National Consumer Protection Week (NCPW) (observed this year February 4-10). The theme of NCPW for this year was "Read Up and Reach Out: Be an Informed Consumer," and it aims to encourage people to take advantage of the wealth of information available from government agencies and national and local consumer organizations that can help individuals make smart buying decisions and avoid frauds. We also note that this letter is submitted just days after Financial Literacy Month (April 2007), which recognizes that "personal financial literacy is essential to ensure that individuals are prepared to manage money, credit, and debt, and become responsible workers, heads of households, investors, entrepreneurs, business leaders, and citizens."[43] These two events could not be more apropos to the issues being addressed in the proposed Statement. The CMC takes consumer education very seriously and believes it is the best way to enable people to protect themselves. In the words of FDIC Chairman Sheila Bair, "We know that when

[43] *See* H. Res. 273; S. Res. 426.

people learn how to make smart financial decisions and guard against fraud, they are protecting themselves and their family as well as their local community."[44]

CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

Control Systems

The CMC generally agrees with the provisions of the proposed Statement indicating that institutions should develop strong control systems to monitor compliance, consistency with internal policies and procedures, and safety and soundness.

However, the Statement would require lenders to monitor the marketing activities of brokers and correspondents. Although the CMC agrees that a lender should not encourage or acquiesce in deceptive or abusive practices by brokers and correspondents, it is not realistic to expect wholesale lenders to be able to monitor the marketing practices of their retail counterparties. The wholesale players in the mortgage market generally have little or no information, other than copies of the disclosures that would allow them to understand how retail brokers and correspondents marketed a loan that the lender funded or purchased. Moreover, the monitoring requirement is not, on its face, limited to the originator or first purchaser but could apply to subsequent purchasers and investors, including securitizers, who are not equipped for this complex task.

Congress recognized this difficulty and generally limited the responsibility of assignees under TILA to violations apparent on the face of the documents. *See* 15 U.S.C. § 1641(a). Additionally, Regulation Z's advertising requirements apply only to the "advertisement" rather than to the creditor on the note. *See* 12 C.F.R. § 226.24. Accordingly, the FTC generally has proceeded against the entity that placed an advertisement that allegedly violated these requirements rather than against the creditor, which is often unaware that an advertisement was even placed. In appearing to mandate a direct role for lenders in ensuring that brokers and correspondents comply with the law, the Standard would deviate from this pattern.

Supervisory Review

The CMC agrees that supervisory review of risk management and consumer compliance processes is appropriate. However, as discussed above, the CMC urges the Agencies to clarify that the content of the Statement is in the form of guidance, not rules, and that institutions have flexibility in implementing these guidelines and adapting them to particular circumstances.

[44] Federal Deposit Insurance Corporation, *Simple Strategies for Managing Money: New How-to Guide from the FDIC Issued for National Consumer Protection Week*, http://www.fdic.gov/news/news/press/2007/pr07011.html (Feb. 5, 2007).

Answers to Specific Questions

Although we have addressed the substance of the specific questions in the discussion above, we are also answering the specific questions raised in the request for comments.

1. **The proposed qualification standards are likely to result in fewer borrowers qualifying for the type of subprime loans addressed in this Statement, with no guarantee that such borrowers will qualify for alternative loans in the same amount. Do such loans always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances are they appropriate?**

As discussed above, the answer to this question is "no": the types of subprime loans addressed in this statement frequently do not present inappropriate risks to lenders or borrowers. The data show that the vast majority of borrowers who have received these loans make their payments on a timely basis. The data also strongly suggest that reports of a foreclosure crisis -- particularly one of the magnitude forecast by certain advocates -- are greatly exaggerated. The CMC believes these loans are appropriate in a wide variety of circumstances and provide significant benefits to consumers. We strongly urge the Agencies not to discourage such loans.

Any limitations or restrictions on subprime lending products or on underwriting or disclosure practices should be narrowly tailored to address only those subprime products that give rise to the Agencies' concerns: products with very low, below-market teaser rates that expire in relatively short time frames. Any restrictions on credit should apply only to these products, and not to other subprime credit products.

Additionally, any limitations or restrictions the Agencies impose on subprime lending products should not apply to "jumbo" loans. Borrowers who obtain "jumbo" loans possess higher incomes and thus a greater degree of financial sophistication—and consequently are less in need of protection—than other consumers. This is been recognized by many states and is reflected in the express exclusion for jumbo loans from the provisions of many state high cost loan laws. *See, e.g.*, N.M. Stat. Ann. § 58-21A-1 et seq.; N.Y. Banking Law §6L et seq., N.C. Gen. Stat. 24-1.1E (a)(4). Similarly, TILA excludes from its coverage credit transactions (not secured by real estate) over $25,000. *See* 15 U.S.C. § 1603(3). Sophisticated borrowers, like those who obtain "jumbo" loans, should be free to choose from the widest variety of financial products available.

2. **Will the proposed Statement unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock? The Agencies also are specifically interested in the availability of mortgage products that would not present the risk of payment shock.**

As discussed above, the proposed Statement -- and, in particular, the requirement to underwrite loans at a "fully indexed" rate -- will severely and unduly restrict the ability of many existing subprime borrowers to refinance their loans and avoid payment shock. Requiring that loans be underwritten at a "fully indexed" is particularly inappropriate for

existing borrowers. Such borrowers are seasoned, have serviced a mortgage debt, and have a known payment history. Consideration of such factors should be permitted in underwriting. For this and other reasons discussed above, the CMC strongly urges the Agencies not to require that loans be underwritten at the fully-indexed rate. We note that the Agencies should encourage lenders to make available ARMs that cap annual payment changes to ensure that the borrower is protected.

3. **Should the principles of this proposed Statement be applied beyond the subprime ARM market?**

No. As discussed above, the CMC urges the Agencies not to apply all of these principles to the subprime ARM market, let alone beyond that market.

If the Agencies should decide to apply these principles to the subprime ARM market, they should not extend these principles beyond that market. As discussed above, several of these principles will limit the availability of credit and stymie innovation. The availability of credit and the tremendous innovation of the past decades have conferred and continue to confer many benefits on consumers. The CMC urges the Agencies not to take any action to limit the availability of credit or inhibit innovation.

4. **We seek comment on the practice of institutions that limit prepayment penalties to the initial fixed rate period. Additionally, we seek comment on how this practice, if adopted, would assist consumers and impact institutions, by providing borrowers with a timely opportunity to determine appropriate actions relating to their mortgages. We also seek comment on whether an institution's limiting of the expiration of prepayment penalties such that they occur within the final 90 days of the fixed rate period is a practice that would help meet borrower needs.**

The CMC supports limiting prepayment penalties to the initial fixed rate period. We believe such a limitation is consistent with the purpose of many subprime hybrid ARMs and will allow consumers to freely refinance to avoid payment shock. However, imposing this requirement only on lenders subject to the authority of the Agencies will place such institutions at a competitive disadvantage vis-à-vis other lenders, and will not benefit all consumers. The CMC recommends that any such requirement be implemented by the Board through its authority under HOEPA.

The CMC does not believe that prepayment penalties must expire 90 days before the expiration of the fixed-rate period. If the consumer is informed of the date on which the fixed-rate period ends, the consumer can take the steps necessary to refinance the loan prior to experiencing any significant "payment shock" but without incurring a prepayment penalty. If the Agencies choose to require expiration of prepayment penalties in advance of an adjustment date, the CMC suggests that 30 days is sufficient time to allow the consumer to avoid any significant "payment shock."

*   *   *

We appreciate the opportunity to present our views. Please do not hesitate to call (202) 742-4366 with any questions.

Sincerely,

Anne C. Canfield
Executive Director

Attachment

LOANPERFORMANCE

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June 2006 Data

RiskView

Explaining the Higher Default Rates of the 2005 Origination Year

Author: Michael Youngblood, Managing Director, Asset-Backed Securities Research, Friedman Billings Ramsey & CO.

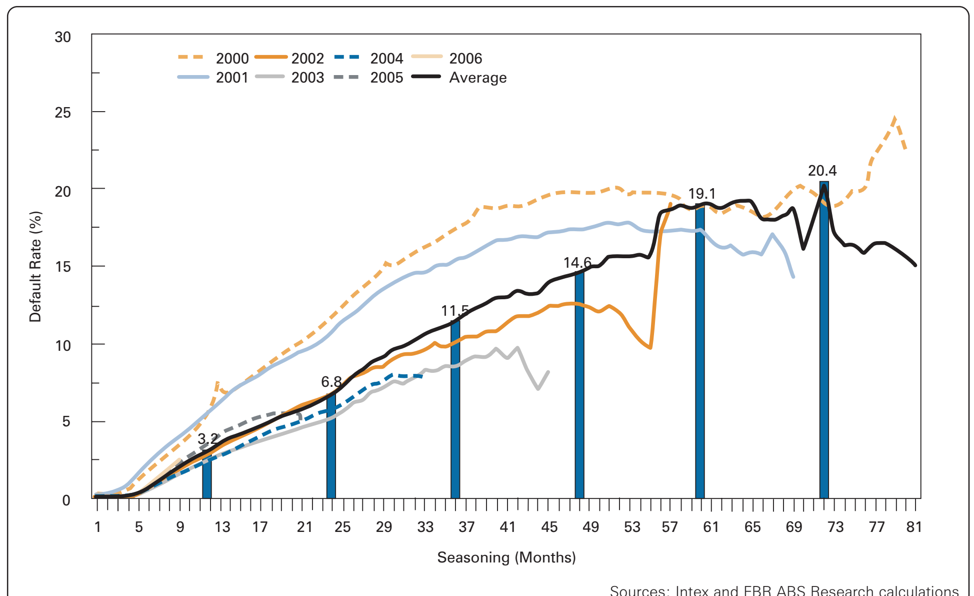
Market participants are concerned about the credit performance of adjustable-rate subprime residential mortgage-backed securities (RMBS) originated in 2005. We present in Figure 1 the default rates of adjustable-rate subprime securities originated in 2000-2006 by age. We observe that the default rate of subprime securities originated in 2005 rose to 5.1% in August 2006, at 20 months of age. In contrast, the default rates of adjustable-rate subprime securities originated in 2003 and 2004 were 4.4% and 4.8%, respectively, at the same age. Thus, the default rate of adjustable-rate subprime securities originated in 2005 is 15.4% and 6.3% higher than the default rates of those originated in 2003 and 2004, respectively.

However, we should compare the default rates of the adjustable-rate subprime securities originated in 2005 to the default rates of those originated every year since 2000, when subprime lenders generally adopted current underwriting policies. The default rates of adjustable-rate subprime securities originated in 2000, 2001, and 2002 were 5.7%, 9.2%, and 9.7%, respectively, at 20 months of age. They exceed the default rate of the adjustable-rate subprime securities originated in 2005 by 47.6%, 44.7%, and 10.7%, respectively. Furthermore, the default rates of the 2000-2005 origination years at 20 months of age average 6.5%, which exceeds the default rate of the 2005 origination year by 27.4%. Therefore, the default rate of the adjustable-rate subprime securities originated in 2005 is lower than those originated in 2000-2002 and lower than the average of those originated in 2000-2005. We may describe the default rates of the 2005 origination year as lower-than-average.

Inside News

- Prime Delinquencies & Prepayments pages 6 & 7
- Subprime Delinquencies & Prepayments pages 8 & 9
- HELOC/Seconds Market Data pages 10 & 11
- Non-Agency MBS Market pages 12 & 13
- ABS Market pages 14 & 15

Figure 1: Default Rates of Adjustable-Rate Subprime RMBS by Origination Year (% Unpaid Principal Balance)



Sources: Intex and FBR ABS Research calculations

Continued on pg. 14

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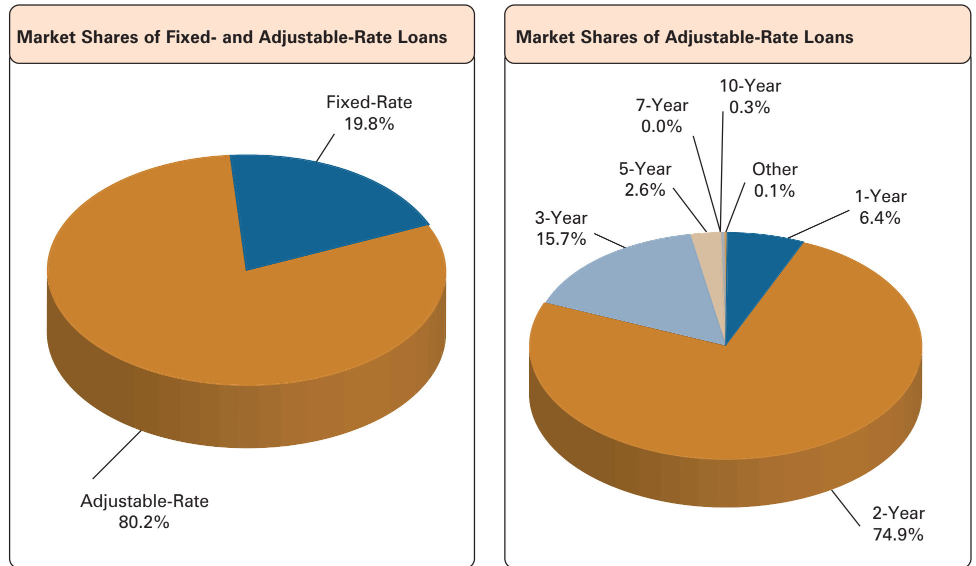
Nevertheless, we cannot ignore the concerns of market participants about the higher default rate of the adjustable-rate subprime RMBS originated in 2005 at 20 months of age. Why is the default rate of this origination year higher than those of the two prior origination years at the same age? We cannot accept the popular explanation that it reflects the influence of rising short-term interest rates, to which adjustable-rate subprime loans generally are indexed. The great majority of adjustable-rate subprime loans originated in 2005 were hybrid adjustable-rate loans (HARMs); only 6.4% adjust at one-year or shorter intervals. (We show in Figure 2 the composition of subprime mortgage loans originated in 2005.) For 2/28 HARMs, which represent 74.9% of the adjustable-rate subprime loans originated in 2005, the mortgage rate is fixed for the first two years after origination, and begins to reset periodically afterwards, subject to initial, periodic, and lifetime caps. Hence, most of the adjustable-rate subprime loans originated in January 2005 will not reset at the earliest until January 2007.

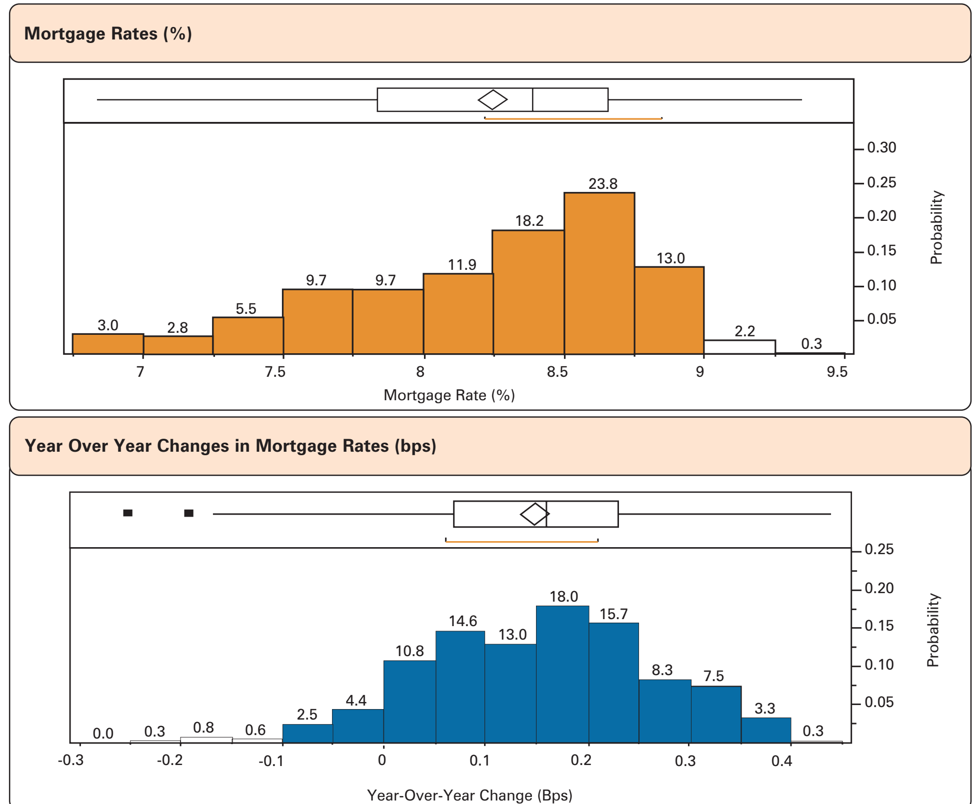
Furthermore, we have calculated the weighted-average mortgage rates as of July 2005 and July 2006 of all adjustable-rate subprime loans (ARMs and HARMs) in each of the 361 metropolitan statistical areas (MSAs) in the United States. The weighted-average mortgage rate fell by 35 bps from 7.47% in July 2005 to 7.12% in July 2006. In the 361 MSAs, the mortgage rates rose by as much as 44 bps (Barnstable, Massachusetts) and fell by as much as 25 bps (Valdosta, Georgia) over this interval. We show in Figure 3 the distribution of the mortgage rates and the year over year changes in mortgage rates of the adjustable-rate subprime loans as of July 2006 in all MSAs. Therefore, rising short-

Figure 2. Composition of Securitized Subprime Mortgage Loans Originated in 2005 (% Unpaid Principal Balance)



Sources: LoanPerformance and FBR ABS Research calculations

Figure 3. Distribution of Mortgage Rates and Year over Year Changes in Adjustable Mortgage Rates in 331 MSAs, July 2006 – July 2005



Sources: LoanPerformance and FBR ABS Research calculations

Note: The box plot shows outliers as dots beyond the whiskers, which extend 1.5 times the interquartile range. The box itself spans the interquartile range. The vertical line that dissects the box identifies the median, whereas the diamond indicates the mean and its 95% confidence interval. The red bracket identifies the shortest half, which is the densest 50% of observations. The histogram shows quantiles of the distribution.

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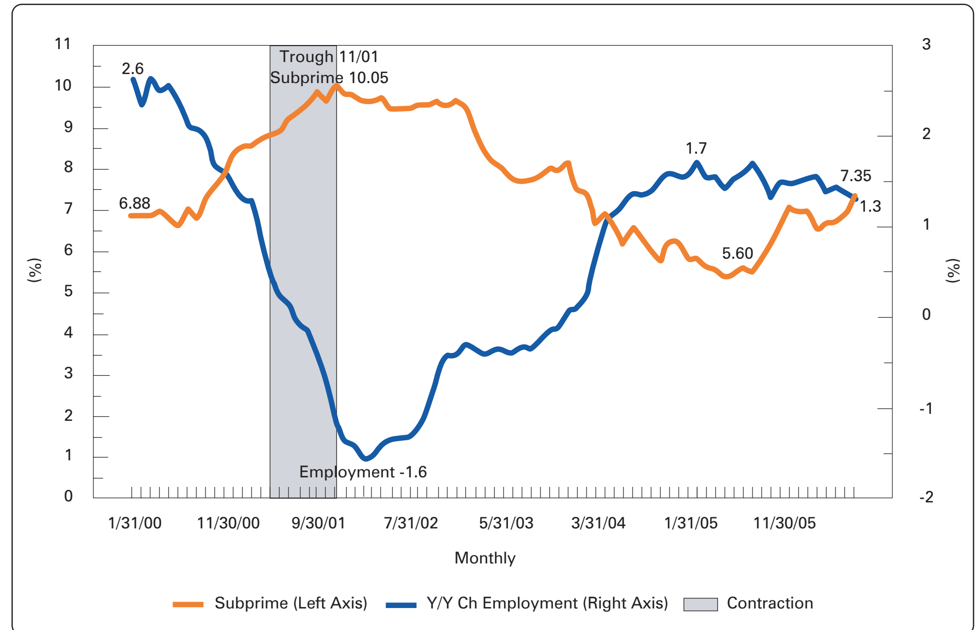
term interest rates – and the related payment shock of the borrowers – cannot explain the relatively higher default rates of adjustable-rate subprime loans originated in 2005.

Nor can we explain the relatively higher default rates of adjustable-rate subprime loans originated in 2005 by reference to the erosion of underwriting criteria. In several reports, we found no quantitative evidence of any significant erosion of underwriting criteria in 2005. The salient characteristics of subprime loans – combined loan-to-value ratio, debt-to-income ratio, and credit score – did not diverge in 2005 from long-run averages. We also found that the layering of credit risk occurs among a small proportion – 2.0% - of all subprime loans. (Layering is the combination of two or more characteristics that may increase the risk of default on a mortgage loan.)

However, we can explain the relatively higher default rates by reference to the increase in the default rates of all subprime loans in the past year. The default rate of adjustable-rate subprime loans originated in 2005 rose in concert with the default rate of subprime loans generally. The weighted-average default rates of subprime loans in the 361 MSAs increased by 61% from 5.38% in July 2005 to 7.35% in July 2006.

Figure 4. Default Rates of Securitized Subprime Loans in 361 MSAs and Year-Over-Year Change in Payroll Employment: January 2000 – July 2006 (% Unpaid Principal Balance)



Sources: LoanPerformance and FBR ABS Research calculations

Outsized Default Rates in 94 MSAs

Why then did default rates increase in 2005 and not in 2003 and 2004? We attribute the increase to weak economic conditions in 95 of the 361 MSAs (Figure 5):

- **Weak labor market conditions in 76 MSAs.** At least 48 of the 76 MSAs experiencing persistently high default rates of subprime loans depend on employment by automobile manufacturers and related companies. Such employment represents more than 5% of payroll employment in eight of the 48 MSAs: Ann Arbor, Michigan; Detroit, Michigan; Elmira, New York; Flint, Michigan; Kokomo, Indiana; Mansfield, Ohio; Saginaw, Michigan; and Wichita Falls, Texas. In these 48 MSAs, payroll employment and household unemployment rose by 1.12% and by 3.70%, respectively, year over year in July 2006. In contrast, payroll employment expanded nationally by 1.66% and household unemployment contracted by 3.20% over the same interval. Accordingly, the default rate of subprime loans jumped to 12.93% from 10.20%.
- **Weak labor market conditions in 6 MSAs in New England.** We first observed weak labor market conditions in the Massachusetts MSAs in August 2005. Subsequently, labor markets have also weakened in adjacent Providence, Rhode Island. In these 6 MSAs, payroll employment expanded modestly by 0.08%, while household unemployment rose by 0.82% year over year in July. The weakness is widespread, affecting 12 of the 19 supersectors of employment defined by the Bureau of Labor Statistics: goods producing; private services; manufacturing; natural resources; durable goods manufacturing; non-durable goods manufacturing; wholesale trade; retail trade; transportation; information; leisure and hospitality; and government. These supersectors represent approximately 73% of payroll employment in the 361 MSAs. We cannot identify any specific event that has precipitated such widespread weakness, but we observe that one speaker at the conference on the subject sponsored by the Federal Reserve Bank of Boston on May 22, 2006 concluded that "price increases associated with restricted

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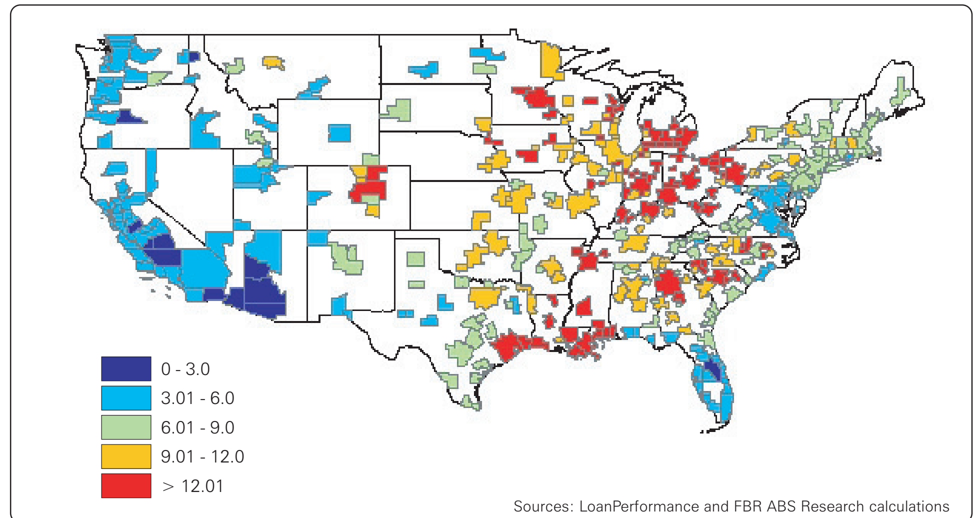
supplies of housing subsequently appear to lead to declines in employment and income." Accordingly, the default rate of subprime loans jumped to 8.68% from 4.64%.

- **The impact of Hurricanes Katrina and Rita on Louisiana and Mississippi.** In the 13 MSAs struck hardest by the two hurricanes (eight in Louisiana, four in Mississippi, and Beaumont, Texas), payroll employment fell by 4.2% and household unemployment rose by 23.8% year over year in July. Accordingly, default rates of subprime loans in these MSAs soared to 19.11% from 9.45%.

If we remove these 95 MSAs from the aggregate of all subprime loans, default rates would have increased by 40.4% from 4.16% in July 2005 to 5.84% in July 2006. Therefore, we may attribute the sharp increase year over year in the default rates of subprime loans generally to the outsized increases in the default rates of loans in a minority of MSAs, which are experiencing weak local economic conditions. The default rates of adjustable-rate subprime loans originated in 2005 inevitably reflect these conditions.

Figure 5. Default Rates of Securitized Subprime Loans in July 2006 (% Unpaid Principal Balance)



Footnotes

1. See Jody Shenn, "'05 Home Loan Delinquency Rise a Riddle," *American Banker* (May 23, 2006), pp. 1 and 6.

2. We define the default rate as the unpaid principal balance of loans that are 90-days delinquent, in foreclosure, or real estate owned, divided by the unpaid principal balance of all loans in any month.

3. *Layering of Credit Risk in Subprime Mortgage Loans*, ABS Research, Friedman, Billings, Ramsey & Co. Inc. (May 11, 2006), pp. 1-12, *Reconsidering Alternative Documentation Mortgage Loans: The Subprime Case*, ABS Research, Friedman, Billings, Ramsey & Co., Inc. (September 30, 2005), pp. 1-18, and *Recent Trends in Underwriting Single-Family Mortgage Loans,* ABS Research, Friedman, Billings, Ramsey & Co., Inc. (June 17, 2005), pp. 1-12.

4. The Bureau of Labor Statistics (BLS) estimates payroll employment each month in *Transportation Equipment Manufacturing* as a subset of *Durable Goods Manufacturing* (supersector 31). BLS classifies jobs into 23 supersectors under the North American Industry Classification System (NAICS).

5. Edward L. Glaeser*, The Economic Impact of Restricting Housing Supply*, Rappaport Institute for Greater Boston, Policy Brief PB-2006-3 (May 2006), p. 1.

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