NEDAP

Neighborhood Economic Development Advocacy Project

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HEARING ON "EFFECTS OF THE SUBPRIME MORTGAGE CRISIS IN NEW YORK CITY AND EFFORTS TO HELP STRUGGLING HOMEOWNERS"

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

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Thank you Congresswoman Maloney and other members of the Subcommittee for holding today's hearing and for inviting me to testify. I am Co-Director of the Neighborhood Economic Development Advocacy Project, known as NEDAP. NEDAP is a non-profit resource and advocacy center that works with community groups in New York City and State to promote economic justice and to eliminate discriminatory economic practices that harm communities and perpetuate inequality and poverty.

NEDAP has been at the forefront of fighting abusive lending in New York City and State since the mid-1990s, using a variety of strategies, including policy advocacy, community education and outreach, coalition-building, and research and documentation. My experience with this issue began with my prior job, where I served for a decade as the Director of the Foreclosure Prevention Project at South Brooklyn Legal Services; we represented hundreds of lower income homeowners facing foreclosure as a result of abusive lending practices.

Unfortunately, abusive subprime lending is not a new phenomenon in New York City. Particularly since the mid-1990s, when the expanded securitization of subprime mortgages provided easy liquidity to the subprime market, subprime lenders targeted low and moderate income neighborhoods of color with an array of abusive mortgage products. A common characteristic of many of these high-cost loans has been their lack of affordability at inception. Loan flipping—or repeated refinancing of loans with little benefit to the borrower – has been rampant, as have hidden fees, prepayment penalties that lock borrowers into loans, and widespread misrepresentation by brokers and lenders about the true terms of a loan. Borrowers were routinely steered to higher cost subprime loan products – particularly on the basis of race-- when they otherwise should have qualified for a lower cost loan.

More recently, lenders have flooded the subprime market with non-traditional mortgage loans – such as 2/28 adjustable rate mortgages (ARMs), Payment Option ARMs, no-doc or low-doc mortgages, and piggyback mortgages – that are highly profitable for the industry, difficult for borrowers to understand, and based on dubious underwriting standards.

Unscrupulous speculators also have relied on lax underwriting standards in the industry to induce first-time, working poor homeowners into purchasing intentionally over-appraised properties in poor condition – a practice known as property flipping. Many of the first-time homebuyers targeted in these schemes ended up with unaffordable mortgages, and lost their only shot at homeownership.

I cannot emphasize enough how much abusive subprime lending is a civil rights issue in New York City and in urban areas throughout the country. The same New York City communities with the highest concentration of homes owned by people of color that mainstream lenders historically subjected to redlining – such as Bedford Stuyvesant, Flatbush, and East New York in Brooklyn, and Jamaica, St. Albans, and Springfield Gardens in Southeast Queens – have now been subject to "reverse redlining," where higher cost and abusive loans are heavily marketed. The result -- skyrocketing rates of foreclosure – has significantly destabilized these neighborhoods, .

Lenders have used these loans to strip hundreds of millions of dollars in equity from homeowners and communities of color. Many seniors and families who had owned their homes for generations lost all of their equity and were forced out of their communities. The unaffordable loans that have resulted from property flipping schemes have deprived huge numbers of young, working class families of color of any chance of viable homeownership. Lenders have widely steered people of color with decent credit histories into higher cost loans simply on the basis of race, propelling them into a cycle of debt and foreclosure. The attached map, produced by NEDAP, shows the extent to which lenders have concentrated high-cost subprime loans in communities of color, and the extent to which these loans have led to high numbers of foreclosures. This discriminatory targeting makes the massive abuses in the subprime market even more egregious.

The dramatic increase of non-traditional mortgages, such as 2/28 ARMs, has only exacerbated the situation. Although the initial rates on 2/28 ARMs are often referred to as "teaser" rates, in reality many of the ARMs were high-cost and unaffordable at their inception. The ARMs are underwritten at the initial rates, so that those borrowers who are able to make the initial payments can no longer afford their mortgages when the rates re-set and the payments significantly increase after two years.

In 2005, there were a high number of foreclosure filings in New York City, nearly 7,000. By 2007, that number had doubled, to nearly 14,000, an unprecedented number. I have attached a chart that breaks this number down by neighborhood, and further demonstrates the dramatically higher rates of foreclosure in neighborhoods of color. Although the subprime industry has touted itself as having provided expanded homeownership opportunities, it is abundantly clear that the explosion of irresponsible subprime lending has led to <u>diminished</u> homeownership opportunities. This is especially true since the bulk of unsustainable subprime loans have been in the refinance market, where already existing homeowners have been induced into loans that put their homes at risk.

Wall Street investment banks shoulder a huge responsibility for the subprime fiasco. Without the easy liquidity provided by the securitization process, mortgage lenders could not have continued to originate such a high volume of unaffordable and unsustainable loans. The securitization of subprime loans became so highly profitable, that investment banks aggressively marketed exotic and non-traditional products to the mortgage lenders, urging them to make a higher dollar volume of loans regardless of sustainability.

There was no incentive at any level of the process to make responsible and sustainable loans to borrowers—mortgage brokers got their fee up front regardless of affordability, lenders were guaranteed a secondary market for unaffordable loans, and the Wall Street underwriters of the securitization trusts made a killing bundling the loans and selling various creative slices of the trusts to investors. The ready accessibility of bond insurance, and the consequent AAA rating from the ratings agencies, ensured that everyone profited, except the working poor and working class homeowners themselves, who were left holding the bag. There was certainly never any consideration in this process for the plight of borrowers – the mortgages which put so many families at risk were commodified in such a way that they were seen as little more than pork bellies to be traded and profited from.

Despite the long-standing damage that abusive subprime lending has caused, this situation was not seen as a "crisis" until subprime mortgage-backed securities began to take a dive and investors suffered. Advocates throughout the country had complained for years to Wall Street and to Federal regulators that many of the subprime loans backing the securities were unaffordable and abusive, and that the securitization trusts were therefore a veritable house of cards. The investment banks that underwrote the trusts ignored ample evidence that the securities that they were heavily marketing to investors were built on shaky ground.

Federal regulators, in particular the Federal Reserve under Alan Greenspan, also had ample notice about the myriad problems in the subprime market, but failed to take needed action out of blind faith in the markets as a corrective. As a result of industry irresponsibility and federal inaction, millions of Americans have lost their homes, and millions more are at risk of foreclosure.

Congress must therefore act now to protect borrowers facing foreclosure, and to enact strong preventative legislation that will both prohibit abusive loans, and ensure that the secondary market is held accountable for the purchase of such loans.

Servicers cannot be relied upon to voluntarily offer comprehensive and sustainable loan modifications

Despite the industry's insistence, it has become evident that servicers are not modifying loans in any kind of scale needed to legitimately address the current foreclosure crisis. For example, numbers released by the Mortgage Bankers Association for the third quarter of 2007 show that subprime foreclosures outnumbered loan modifications by a 7 to 1 ratio. For subprime ARMs, this ratio was 13 to 1. Furthermore, many of the servicers encourage forbearance, or repayment, plans instead of affordable loan modifications. These forbearance plans, in which borrowers waive their legal defenses to foreclosure, fail to assist borrowers whose loans were unaffordable in the first place.

The Bush-Paulson plan, which relies on servicers to voluntarily freeze the interest rate on ARMs that are facing re-set, falls woefully short of the response needed. The eligibility is so narrow, that the Center for Responsible Lending estimates that only 3% of homeowners with subprime ARMs are likely to get assistance under the plan.

Generally, the securitization structure has given servicers a disincentive to work with borrowers and seek sustainable loan modifications. It costs servicers money to complete a loan modification (as cited in *Inside B & C Lending)*, while servicers receive fees for foreclosures. Servicers therefore resist modifications and push foreclosures, even though in most instances modification would be in the best interests of investors. While voluntary actions by servicers will not solve the crisis, Congress should use all of its powers to push the industry much further to offer streamlined and sustainable modifications that are in the best interests of homeowners and investors.

<u>Bankruptcy changes permitting court-ordered modifications are desperately needed, and HR 3609 represents a sound compromise framework that could save many homes</u>

One clear way to slow the foreclosure crisis and assist distressed homeowners is to allow bankruptcy judges to modify existing loans by court order. Under current bankruptcy law, judicial modification of loans under a Chapter 13 payment plan is prohibited—in fact, despite the central importance of housing to the health of families and communities, mortgage debt is the only debt that judges are not allowed to modify.

HR 3609 would allow bankruptcy judges to modify certain distressed subprime mortgages, and in doing so would help more than 600,000 families facing foreclosure to keep their homes (*Center for Responsible Lending*), without any cost to the U.S. Treasury.

I have heard complaints from the industry that allowing subprime loans to be modified in bankruptcy would dry up the secondary market for such loans, but the compromises made in HR 3609 should alleviate any industry concerns. Relief would be available only when a family lacks sufficient income to pay their mortgage and is facing foreclosure, and the proposed bill limits the discretion of judges to ensure that the rates and terms of the modified loan stay within commercially reasonable rates. The bill will sunset after 7 years. Finally, under the compromise, relief is available for existing loans only, rendering moot any industry concerns about the future availability of subprime credit.

While permanent changes in the bankruptcy code are needed to better assist distressed homeowners, HR 3609 is a critical and straightforward emergency fix that would help stem the bleeding from the foreclosure crisis. I would like to strongly encourage any members of the Subcommittee who have not already done so to co-sponsor this bill.

S. 2452, the "Home Ownership Preservation and Protection Act", would prevent widespread lending abuses in the future and create a fair mortgage marketplace

The Federal Reserve's amendments to Regulation Z, while a step in the right direction, do not go nearly far enough in providing key protections to homeowners in the future. Strong federal legislation is urgently needed.

S. 2452 provides critical safeguards, and would help stabilize the market by making Wall Street investment banks accountable for the loans that they purchase. Introduced by Senator Dodd, S. 2452 requires that loans are underwritten for affordability for the full term of the loan, rather than at the initial rate, and prohibits subprime abuses such as loan flipping, yield spread premiums, and prepayment penalties.

Most important, S. 2452 provides for limited assignee liability— which gives distressed borrowers recourse against the current holder of their loan so that they can effectively fight foreclosure. The securitization process has effectively "laundered" predatory mortgages, by helping to strip borrowers of their ability to raise defenses in foreclosure. When borrowers assert defenses in foreclosure, the trusts inevitably assert the "holder in due course" doctrine, claiming that they purchased the loan with no knowledge of the abuses. Borrowers are left defenseless -- their only legal recourse is against the originators who no longer hold the loan and have no ability to stop the foreclosure. Many of these originators have gone bankrupt. Depriving borrowers of the right to defend against foreclosure is wrong as a matter of fairness and public policy.

The lack of assignee liability has created a total lack of accountability in the secondary market, and has enabled Wall Street investment banks to purchase unsustainable and irresponsible loans without any concern for the viability or legality of the loans. This lack of accountability has created huge profits for Wall Street at the expense of millions of American homeowners, and ultimately at the expense of investors. This failure in the marketplace must be addressed by holding the secondary market accountable for the loans that they purchase. The Dodd bill, by providing for limited assignee liability, would help to disincentivize the securitization of predatory loans, and would give borrowers targeted by abusive loans a means to fight for their home.

The House equivalent of the Dodd bill, HR 3915, contains certain strong protections, but does not contain provisions for assignee liability. This would leave many borrowers in foreclosure defenseless, even if the loan violated the law. For this reason, I strongly urge the members of the Subcommittee to work to adopt a preventative bill modeled after S.2452.

There is a desperate need for large-scale federal remediation efforts, and for further flexibility in the underwriting of loans guaranteed by the Federal Housing Administration

While bankruptcy relief is critical to saving the homes of hundred of thousands of Americans, further large-scale and emergency remediation efforts are desperately needed to slow the wave of foreclosures. There are few refinancing options for homeowners who are stuck in unaffordable loans, but who could afford a loan if it were priced fairly.

Representative Vaca of California has proposed legislation (HR 4135) that would create a Family Foreclosure Rescue Corporation, modeled after the Depression-Era Home Owners' Loan Corporation, to purchase distressed loans from securitization trusts at a discount. The borrowers would then be able to refinance into more affordable, fixed-rate loans. Senator Dodd is introducing similar legislation in the Senate, which would capitalize a Federal Homeownership Preservation Corporation at $10-20 billion, paying for the distressed mortgages with long-term government bonds. Both initiatives are promising and deserve strong support.

One hurdle that the initiatives may face in their ability to assist a large volume of homeowners is a lack of flexibility to make loans to borrowers who are more than 60 days delinquent, but who have the ability to make payments on a fairly-priced loan. This lack of flexibility results from an inability to sell such loans to the Government-Sponsored Enterprises (GSEs), or to any other secondary market entity. States like New York and Massachusetts have set up loan programs to assist distressed subprime borrowers, but these programs are limited to borrowers who are less than 60 days delinquent.

Advocates across the country know that most borrowers do not seek assistance when they are already more than 60 days past due on their mortgage. This is a primary reason why the programs in New York and Massachusetts have been able to refinance only a very small handful of borrowers. For any large-scale refinance program to function effectively, there has to be a secondary market that has the flexibility to purchase sustainable loans made to borrowers who are more than 60 days delinquent, or who have lower credit scores due to abusive lending.

If Congress were to empower the Federal Housing Administration (FHA) to guarantee loans refinanced through special programs to borrowers who have the ability to pay but were more than 60 days delinquent on their prior loan, it would help make the federal and state loan fund initiatives far more effective. If these special refinance loans were guaranteed by FHA, they would be easy to sell into the secondary market, and would enable tens of thousands of distressed borrowers to refinance into affordable loans.

Conclusion

Thank you for holding this hearing on such a critical topic. If Congress acts quickly and decisively, it can take a leadership role in saving the homes and communities of millions of Americans, and in restoring stability and integrity to the mortgage markets.