Testimony of

National Association of Consumer Advocates

by

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Mr. Chairman, Ranking Member DeMint, and members of the Subcommittee, thank you for inviting me to testify before you today about the breakdown of the American home mortgage market and its impact on our nation's homeowners and communities.

My name is Ira Rheingold, and I have been a public interest attorney for my entire adult career. I have worked in some of our nation's poorest urban and rural communities and I've witnessed the incredible resilience and optimism that mark the great strength of our nation's people. I have also seen the incredible fear and despair of Americans faced with the loss of their long-term home and its devastating impact on their families and on their communities.

In the mid – 1990's through 2001, I lived and worked in Chicago, where I ran the Legal Assistance Foundation's Homeownership Preservation Project. During those years, I watched (and worked against) the unfair and deceptive practices of all the actors in the mortgage industry, that slowly, but inexorably stripped away the wealth of that city's low and moderate income minority communities. Today, I am the Executive Director of the National Association of Consumer Advocates (NACA), an organization of attorneys and other advocates who represent those very same consumers and communities all across this country. At NACA, I also manage the Institute for Foreclosure Legal Assistance, a project that provides funding and training to non-profit legal organizations that help homeowners negotiate alternatives to foreclosure. In my current roles, I speak to and assist our nation's consumer advocates who, on a daily basis, meet with and represent the consumers victimized by bad lending practices and see the very real-life consequences of an out of control mortgage lending marketplace. What I see from them are the same unfair and deceptive practices that I personally witnessed in Chicago, except now, those behaviors have moved across all of our nation's communities. What I hear from their clients is the same fear and despair that I heard all too often on the streets of Chicago. At today's hearing, I hope that you will hear their voices through me, and that you will begin to see what we all need to do to build a rational, robust and well-regulated mortgage market that actually serves the needs and demands of consumers and communities across our nation.

Introduction

To understand what it has been like to be a consumer attempting to buy their first home, a homeowner attempting to refinance their home for necessary home repairs or to help pay for their children's education or to lower their payment so they could remain in their life-long home on a fixed income, we must first understand how the mortgage market has been working. The mortgage market of the late 1990s and early 21st century, in no way resembled what most of us thought we understood about buying a home or getting a loan. I have talked to literally thousands of consumers, who, until recently, believed (or were led to believe) that the mortgage entity that originated their loan, would

only profit when they timely made their monthly mortgage payment. While this may have been the case when our parents or even our grandparents bought their homes, this has not remotely been the truth for more than the past dozen years. Instead, because of the growth of securitization as the tool to fund both prime and subprime mortgages, with all its confusing layers, multiple actors and often perverse incentives, the nature of the consumer- mortgage originator relationship (unbeknownst to the consumer) had fundamentally changed. These changed relationships and backwards incentives have led us to the precipice that we stand at today.

Securitization and the Consumer

For my purpose today, I'm going to keep this very simple.[1] At its most basic level, securitization is a process, which involves the pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors. As securitization grew to be the dominant way that mortgage loans were funded, the role and purpose of mortgage originators (and all the other actors in the mortgage market) fundamentally changed. No longer were mortgage originators, "lenders" who expected (or really cared) about mortgage repayments. Instead, these originators became manufacturers of a commodity, the American mortgage borrower (unfortunately, most homeowners did not and don't understand their role in this transaction). This commodity was then sold to the capital markets, which in turn, chopped, spindled and mutated this new commodity into something that could be purchased by investors from around the world.

While advocates of securitization have argued that the process produced additional capital and greater access to homeownership for some consumers, they fail to recognize the fundamental shift and potential dangers it created in the consumer marketplace. No longer was the borrower's best interest (or even their ability to repay the loan) part of the mortgage transaction calculation. Instead, the real transaction was between the mortgage originator and the investment bank, which not only set the standards for the borrower/product they wanted to buy (and then turn around and sell), but also provided the money for the originators' loans.

Under these set of circumstances, what American consumers needed was the vigorous enforcement of existing consumer protections as well a new set of consumer protections to correspond with the very different mortgage world that had now been created. Unfortunately, what the federal government gave us was the exact opposite, not only diminishing its regulation and enforcement of this market, but providing interference

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[1] For a much greater detailed discussion, please see Peterson, Christopher Lewis, "Predatory Structured Finance" . Cardozo Law Review, Vol. 28, No. 5, 2007

and protection (under the guise of preemption) for mortgage market players when states, recognizing the fundamental flaws in the system, attempted to protect their own citizens.

The mortgage market, unfairness, deception and the consumer

Understanding what mortgage originators (and all of the actors in the process) were attempting to do, i.e. create commodities to sell, when they made a loan to consumer helps us understand all the unfair and deceptive practices that have flourished in the mortgage marketplace over the last decade. I'd like to talk about some of those practices now, and explain why they were not caused by a few rogue actors, but were instead a product of the fundamentally flawed marketplace that securitization created and the federal government passively permitted to flourish.

A. The Predatory Pitch

As the demand for product to sell to Wall Street investment banks grew (ultimately exponentially), the pitch to vulnerable homeowners (and prospective homeowners) became more targeted and more personal. Armed with financial and personal data and carefully conducted research, mortgage brokers and lenders (and their "bird dogs") used TV and radio advertising, mailings, telephone calls, and even home visits to reel in consumers who otherwise had no real reason to get a new home mortgage. With promises too good to be true ("refinance your home, fix your roof and lower your monthly payment") consumers were later bait and switched to loans far more expensive than they thought they were promised. Because the mortgage "originators" received their full compensation when they manufactured the "product/borrower" to sell onward and upward, there was little concern whether the loan was sustainable. As many of us knew, and most of us have now learned, many of those loans were completely unsustainable.

B. The Over-Inflated Appraisal

In a rational world, a consumer would not want to pay (or borrow) more for a home than what it was worth. In the securitization created "bizarro" mortgage world, an over-inflated house made perfect sense to the parties involved in the transaction (except for the unsuspecting consumer, of-course, and maybe the ultimate investors left holding the bag). Let's look at the parties to the transaction. We have the mortgage originator (the broker or the lender or sometimes both) whose incentive is quite obvious. Simply put, the greater the house price, the larger the loan, the greater the fee they will receive from the transaction. (The same can be said for the investment bank). Sometimes the incentives are a little more complicated. Take for instance a homeowner whose existing mortgage is already 100% of the actual value of the home. If the real house value was used, no loan could be made, no product could be created. So the house value is increased to meet the loan purchasing parameters (the underwriting guidelines) set by the investment bank and

the loan gets made and everyone is happy (including the "unknowing" investment bank who has another product to slice and dice and sell to someone else).

As for the appraiser who creates the fraudulent value for the home, we've seen time and again why they go along with this fraud. Simply, if they actually want to stay in business and continuing doing appraisals, they'll create the value the mortgage originator wants.

What we have left, is a consumer who has a mortgage that is too often worth more than the real value of their home.

C. Yield Spread Premiums and Prepayment Penalties

Unfortunately (for me), I have been around long enough to hear multiple and ever-shifting explanations as to why yield-spread premiums (ysps) are an acceptable practice and why they can work for consumers. I can safely state, that none of those arguments are true in the mortgage marketplace that actually exists in our country. I do however, fully understand why they work for every mortgage market actor except, again – of course - for the consumer.

Let's see. Mortgage brokers get paid more if they produce mortgages with an interest rate higher than what a borrower qualifies for (that, in short is a "ysp"). Unless a mortgage broker actual lives up too their off-stated (but never written) commitment to serve in the best interest of their consumer client, their incentive – a bigger paycheck - to produce a loan with a ysp is clear. Same with the mortgage lender and investment bank, who now have a loan with a bigger interest rate to sell.

To make matters worse, almost any loan with a ysp is sure to have a prepayment penalty. In English, a prepayment penalty is a charge to a consumer who repays their loan "too soon," typically during the first few years of the loan's existence. What makes this product so cynical, and so closely intertwined with a ysp, is that the very existence of the ysp means that the consumer has an interest rate that is higher than they actually qualify for. Therefore, if the consumer acts rationally and shops for a lower interest and enters into a new mortgage, they will be punished with a steep prepayment penalty.

In all my years talking, interviewing, and representing consumers, I have yet to meet that one consumer who actually understood that they were charged a ysp or that the ysp led to a higher interest rate than they were otherwise qualified for. I simply can't imagine how this practice is not deceptive or just plain unfair. Yet none of our nation's federal regulators have ever really done anything about it (except to find ways to allow its widespread use).

D. The Disappearance of Escrow Accounts

Because the borrower has become the product to be created and sold, mortgage originators have become experts at getting borrowers to take out loans that make little or no economic sense. A classic and pervasive practice in the mortgage market is the "promise" that a new loan will allow the borrower to pay a lower monthly mortgage payment. What the borrower is not told is that their new payment does not include their taxes and insurance (for escrow), so that their lower payment really is just a mathematical fiction (otherwise known as a lie). While the Federal Reserve now finally appears ready to take some action on this practice, it is ridiculous that this blatantly unfair and deceptive practice (which had been standard operating practice in the mortgage marketplace for over a decade), had never been outlawed or prosecuted by our federal regulators.

E. Reckless Underwriting and the Rise of Community Endangering Loan Products

In place of an efficient market that provides real consumer choice and rewards consumers for smart credit decisions and rational aspirations, we have seen, in the past few years, a mortgage market that has recklessly created and sold ridiculously risky mortgage products that have excessively benefited all of the market players at the expense of the American consumer and our nation's communities. In a rational marketplace these loans make no sense. Looking at them however through the lens of our fundamentally flawed and unregulated mortgage marketplace, they unfortunately made perfect sense (at least at the time they were made).

Simply put, in order to meet the product demand of voracious Wall Street investors, originators ignored basic, common-sense underwriting principles in order to boost their loan volume. No-doc or "stated-income" loans were great because loan originators made more money (it was less work and they could charge borrowers a higher interest rate) and they fed the beast that wanted high-risk products that would produce a higher return for investors. Underwriting adjustable rate mortgages only at the initial interest rate, without considering how homeowners would be able to pay their loans once the payment adjusted upward, was also quite profitable for mortgage originators and the investment banks that were fed by them. These fundamentally unsustainable loan products, in all their derivations (including 2-28s and option ARMs) were destined for failure and failed they have and we're all now living with the consequences.

But it didn't have to be this way. Many of us saw the current disaster coming, but our voices were ignored. This administration, its federal regulators and this Congress could have chosen to protect consumers, but instead it sat on the sidelines as our mortgage market came to a predictable crash. My only hope is that we have all learned the right lessons from this current and ongoing crisis, and we move together to build a well-regulated mortgage market that meets the needs of all our nation's homeowners.