**HEARING BEFORE THE COMMITTEE ON BANKING,
CONNECTICUT GENERAL ASSEMBLY
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Thank you for the opportunity to testify today. My testimony today will focus on why Connecticut needs stronger home mortgage legislation to revive trust in the residential mortgage market and the broader economy.

Subprime mortgages are high-cost loans designed for borrowers with impaired credit. These loans pose a heightened risk of default. In the past ten years, press reports of abusive subprime loans have prompted regulators to institute repeated enforcement actions against subprime lenders and servicers for unfair practices and fraud.[1] Despite the seriousness of these

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1. For instance, in 2004, Citigroup Inc. and its subprime mortgage subsidiary, Citifinancial Credit Company, agreed to a cease-and-desist order in which the Board of Governors of the Federal Reserve System imposed a $70 million civil money penalty for alleged predatory lending practices. Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse*, N.Y. Times, May 28, 2004, at C1; Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 27, 2004), www.federalreserve.gov/boarddocs/ press/enforcement/2004/20040527/default.htm. The 2004 Citigroup order followed on the heels of an earlier $215 million settlement by Citigroup Inc. in 2002 to resolve FTC charges of predatory lending. Press Release, Federal Trade Comm'n, Citigroup Settles FTC Charges Against the Associates Record-Setting $215 Million for Subprime Lending Victims (Sept. 19, 2002), www.ftc.gov/opa/2002/09/associates.htm. Also in 2004, the Office of Thrift Supervision entered into a supervisory agreement with Ocwen Federal Bank to prohibit alleged predatory loan servicing practices. Supervisory Agreement, Ocwen Fed. Bank FSB and Office of Thrift Supervision, OTS Docket No. 04592 (Apr. 19, 2004), www.ots.treas.gov/docs/9/93606.pdf. The Federal Bureau of Investigation has pursued mortgage fraud aggressively. *See, e.g.*, Fed. Bureau of Investigation, *Statement of Chris Swecker Before the House Finan. Services Subcomm. On Housing and Community Opportunity* (Oct. 7, 2004), www.fbi.gov/congress/congress04/swecker100704.htm; Fed. Bureau of Investigation, Financial Crimes Report to the Public Fiscal Year 2006, www.fbi.gov/publications/financial/fcs_report2006/financial_crime_
2006.htm#Mortgage (reporting on investigations into equity skimming, property flipping and mortgage-related identity theft).

Between 1998 and 2008, the Federal Trade Commission prosecuted predatory lending cases against home mortgage lenders and brokers including Action Loan Co., Amor Mortgage, Abacus Mortgage, Associates First Capital Corp., Barry Cooper Properties, Capital City Mortgage Corp., Capitol Mortgage Corp., Chase Financial Funding, Inc., CLS Financial Services, Inc., Delta Funding Corp., Fairbanks Capital Corp., First Alliance Mortgage Company, First Plus Financial Group, Inc., Fleet Finance and Home Equity U.S.A., Granite Mortgage, LLC, Interstate Resource Corp., LAP Financial Services, Inc., Mark Diamond, Mercantile Mortgage Co., Mortgages Para Hispanos.Com Corp., Nationwide Mortgage Corp., NuWest, Inc., PWR Processing, Inc., R.A. Walker & Assocs., and Wasatch Credit Corp. *See* Prepared Statement of the Federal Trade Commission on Foreclosure Rescue Fraud before the Senate Special Committee on Aging, Feb. 13, 2008, www.ftc.gov/os/testimony/P064814foreclosure.pdf; Fed. Trade Comm'n, *Prepared Statement of the Federal Trade Commission on Efforts to Combat Unfair and Deceptive Subprime Lending Before the Senate Special Committee on Aging*, 3-8, Feb. 24, 2004, www.ftc.gov/os/2004/02/02242004subprimelendingtest.pdf; Letter from Donald S. Clark, Sec'y, Fed. Trade Comm'n, to Sandra F. Braunstein, Dir., Fed. Reserve Sys. Div. of Consumer and Cmty. Affairs (Feb. 23, 2005), www.ftc.gov/os/2005/03/050301enforcemntrpt.pdf; Press Release, Fed. Trade Comm'n, Capital City Mortgage Corp. Defendant Settles with FTC (May 14, 2004), www.ftc.gov/opa/2004/05/sanne.htm; Press Release, Fed. Trade Comm'n, Capital City Mortgage Settles FTC Charges (Feb. 24, 2005), www.ftc.gov/opa/2005/02/capitalcity.htm; Press Release, Fed. Trade Comm'n, FTC Challenges Bogus Mortgage Loan Brokers (June 1, 2004), www.ftc.gov/opa/2004/06/pwrprocessing.htm; Press Release, Fed. Trade Comm'n, FTC, DOJ and HUD Announce Action to Combat Abusive Lending Practices, (Mar. 30, 2000), www.ftc.gov/opa/2000/03/deltafunding.htm; Press Release, Fed. Trade Comm'n, FTC: Mortgage Broker's Deceptive Claims Tricked Consumers Looking for a Good charges, the harm from these problems originally appeared to be confined to a relatively obscure corner of the consumer finance market. Until mid-2007, there was little concern that defective subprime loans would spill over into the larger economy.

That changed last July, when subprime losses sank two Bear Stearns hedge funds and pushed a regional German bank named IKB Industriebank to the brink of failure. World markets trembled as stock markets plunged in the United States and Europe, subprime lenders failed in droves, sales of subprime bonds crashed, and the market for interbank credit seized up. As markets deteriorated, write-downs on U.S. subprime bonds triggered such a severe bank run at Northern Rock plc, a British bank, in September 2007 that the Bank of England felt compelled to issue a blanket guarantee for all deposits at British banks and ultimately had to nationalize Northern Rock. Nor were Northern Rock and IKB Industriebank alone. So many foreign investors bought toxic subprime bonds that even the small Arctic town of Narvik, Norway (pop. 18,000), went insolvent in December 2007 due to investments in bad subprime securities.

Back at home, skyrocketing subprime foreclosures pushed the United States to the edge of a recession. By February 2008, panic over credit quality had paralyzed the markets for term auction securities, leveraged financing, and asset-backed bonds securitizing commercial real estate loans, jumbo mortgages, and even student loans. Private-label mortgage-backed securitizations and subprime lending dwindled and no one knows what future form these markets will take. Financial services companies have taken approximately $150 billion in subprime write-downs to date since the beginning of 2007. In February 2008, the Group of Seven estimated that financial institutions worldwide face up to $400 billion in write-downs resulting from subprime losses.[2]

Market failures in the U.S. subprime mortgage industry lie at the root of these problems. My testimony begins by describing how the compensation systems for subprime mortgage professionals and investment banks created perverse incentives to artificially increase the risk of subprime loans. Next, the testimony chronicles how these incentives caused the subprime industry to spiral downward due to lax underwriting and outright loan fraud.[3] Finally, I discuss

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Rate (June 2, 2004), www.ftc.gov/opa/2004/06/ chasefinancial.htm; Press Release, Fed. Trade Comm'n, Home Equity Lenders Settle Charges that They Engaged in Abusive Lending Practices; Over Half Million Dollars To Be Returned to Consumers (July 29, 1999), www.ftc.gov/opa/1999/07/hoepa.htm; Press Release, Fed. Trade Comm'n, Home Mortgage Lender Settles "Predatory Lending" Charges (Mar. 21, 2002), www.ftc.gov/opa/2002/03/famco.htm; Press Release, Fed. Trade Comm'n, Midwest Mortgage Lender Agrees to Settle Illegal Lending Charges Brought by FTC, HUD, and State of Illinois, (July 18, 2002), www.ftc.gov/opa/2002/07/ mercantilediamond.htm; Fed. Trade Comm'n, FTC Subprime Lending Cases (since 1998), www.ftc.gov/opa/2002/07/subprimelendingcases.htm (last visited Feb. 28, 2007).

State attorneys general and state banking regulators have also instituted aggressive enforcement actions for subprime abuses. While the individual state proceedings are too numerous to all name, two nationwide settlements stand out. In 2006, forty-nine states and the District of Columbia reached a $325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. *See, e.g.*, Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay $325 Million and Reform its Lending Practices (Jan. 23, 2006). In 2002, state attorneys general from forty-four states and the District of Columbia secured a $484 million settlement from Household Finance Corporation to dismiss charges of deceptive subprime loans. *See* Press Release, Iowa Attorney General, States Settle With Household Finance: Up to $484 Million for Consumers (October 11, 2002).

[2] *G-7: $400 billion newest subprime tab*, INVESTMENT NEWS, Feb. 11, 2008, www.investmentnews.com/apps/pbcs.dll/article?AID=/20080211/REG/772519581.

[3] For a fuller treatment of the topics discussed in this testimony, see Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance Of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007); Kathleen C.

how the breakdown in credit markets results from a breakdown in trust by investors. I close by discussing why strong legislation is needed to restore that trust and bring the credit markets back to life. In particular, our new research findings indicate that lowering the annual percentage rate triggers in state home mortgage laws – and possibly adding assignee liability provisions – helps expand access to subprime credit.

Perverse Incentives Toward Heightened Risk

In the past twenty years, the home mortgage industry underwent fundamental changes that increased its incentives to take reckless risks with subprime loans. Specifically, the mortgage lending industry evolved from one in which the lender retained the full risk that a loan would default to one in which lenders, mortgage brokers, and investment banks were paid upfront while passing off the risks onto borrowers and investors.

Securitization altered the structure of mortgage lending and the financial incentives of its players in ways that were underappreciated at the time. Before securitization, lenders usually did it all: they solicited loan applicants, underwrote the loans, funded those loans, serviced the loans, and held the loans in portfolio. Lenders earned profits on loans mostly in the form of interest payments, not upfront fees. If the loans went into default, the lenders bore the losses. Default was such a serious financial event that lenders took care when underwriting loans.

All that changed with securitization. Securitization allowed lenders to outsource parts of the lending process. This phenomenon, known as *unbundling,* reduced lenders' incentives to exercise care when making loans. With securitization, a lender could make a loan and sell it to investors, who would bear the financial brunt if the loan went belly-up. Unlike in the past, lenders mostly made their money on upfront fees collected from the borrowers and the cash proceeds from securitization offerings, not on the interest payments on loans. Lenders liked the security of being paid in advance, instead of having to wait for uncertain monthly payments over the life of the loan.

Lenders also knew that their risk from securitization was only a fraction of the risk they otherwise would assume from holding whole loans on their books. Besides, lenders rationalized, securitization sliced the risks that they passed on into finer and finer pieces that were diversified among investors. Because they knew they could pass the lion's share of subprime risks onto faceless investors, lenders had less reason to care about how well a loan performed. Some lenders even had two sets of underwriting standards: high underwriting standards for the loans they kept on their books and lax underwriting standards for the loans that they securitized. All the while, investors were clamoring for higher-yield bonds, which required backing those bonds with higher-risk home loans. Together, these dynamics encouraged lenders to make ever riskier loans and to pass off the worst loans onto investors.

Investors tried to protect themselves by requiring lenders to retain the riskiest parts of subprime securitizations. Lenders became able to dispose of that retained risk, however, by repackaging those interests and securitizing them all over again, this time as bonds known as collateralized debt obligations (CDOs).

Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002).

Most lenders used investment banks to underwrite their subprime securitizations. Of the major Wall Street firms, Lehman Brothers, Bear Stearns, Merrill Lynch, J.P. Morgan, Morgan Stanley, Citigroup, and Goldman Sachs underwrote most private-label subprime securitizations.[4] After IPO offerings dried up during the three-year bear market from 2000 through 2002, mortgage-backed securities deals and CDOs stepped into the breach and became one of the hottest profit centers for investment banks.[5] By 2006, Wall Street had cornered the subprime business, securitizing over two-thirds of subprime loans.[6]

Investment banks profited from subprime underwriting by collecting a percentage of the sales proceeds, either in the form of discounts, concessions, or commissions. Once an offering was fully distributed, the underwriter collected its fee in full. This compensation system for the underwriters of subprime securitizations caused Donna Tanoue, the former Chairman of the Federal Deposit Insurance Corporation, to warn: "[T]he underwriter's motivation appears to be to receive the highest price and best execution possible on behalf of the issuer - not to help curb predatory loans."[7]

Tanoue's warning proved prophetic. Earlier this month, Fitch Ratings projected that fully *forty-eight* percent of the subprime loans securitized by Wall Street in 2006 would go into default.[8] Despite that dismal performance, 2006 produced record net earnings for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.[9] That year, manager pay reflected the bottom-line importance that investment banks placed on private-label mortgage-backed securities, with managing directors in the mortgage divisions of investment banks earning more on average in 2006 than their counterparts in other divisions.[10]

As part of their duties, underwriters for subprime bond offerings drafted prospectuses and offering memoranda that were supposed to inform investors about the underwriting criteria and risks of the subprime loans in the loan pool. These documents usually stated that the lenders reserved the right to make exceptions to their underwriting standards in individual cases. But in 2006 and 2007, some offering documents failed to say that the exceptions – in other words, loans that flunked the lender's underwriting standards – far outweighed the number of loans that met those standards.[11] Ratings agencies have asserted that investment banks withheld due diligence reports from them that quantified the size of these exceptions. One due diligence firm has

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4 Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007; *Scorecard – Everyone Out of the Pool,* INSTITUTIONAL INVESTOR, Sept. 17, 2007.

5 Laura Mandaro, *Investment Banks Stay Busy,* INVESTOR'S BUSINESS DAILY, Feb. 21, 2006, at A14.

6 Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007.

7 Remarks by Donna Tanoue, Chairman, Federal Deposit Insurance Corporation, Before the Annual Conference, National Congress for Community Economic Development, New Orleans, LA, October 13, 2000, www.fdic.gov/news/news/speeches/archives/2000/sp13Oct00.html.

8 For loans in the 2007 subprime vintage, Fitch estimates that forty-three percent will go into default. *Fitch Places $139B U.S. Subprime RMBS On Watch Negative on Worsening Mortgage Performance,* REUTERS, Feb. 1, 2008, www.reuters.com/article/pressRelease/idUS203638+01-Feb-2008+BW20080201.

9 2006 Annual Reports for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.

10 Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt,* NEW YORK TIMES, Dec. 6, 2007.

11 Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans,* NEW YORK TIMES, Jan. 12, 2008.

further alleged that some investment banks ordered it to cut its random samples of subprime loan pools by half when checking for compliance with loan underwriting guidelines in order to permit those banks to turn a blind eye to the wide prevalence of exceptions.[12]

The major rating agencies also had financial incentives to understate the risks of subprime mortgage-backed securities and CDOs. The investment banks that underwrote subprime securitizations paid the rating agencies that provided them with investment-grade ratings. After an investment bank divided a subprime bond offering into different buckets (called tranches) according to default risk, the rating agencies rated each tranche. The rating agencies touted their top-rated subprime bonds – ranging from AAA down to A -- as hardly ever defaulting. These ratings lured droves of investors in the United States and abroad who were in search of higher yields to buy the top-rated subprime bonds and CDOs. The more good ratings that the agencies issued, the more deals that were sold, reaping profits for the rating agencies and the investment banks who hired them.

Securitization was not the only form of outsourcing in the subprime industry. Increasingly, subprime lenders, through their wholesale loan divisions, used independent mortgage brokers to solicit potential customers and process loan applications. Lenders even outsourced loan underwriting to contract underwriters for as little as $10 per loan application. Both sets of players had incentives to close loans at any cost and to deceive participants down the line about the risks of those loans.

Contract underwriters, for instance, were only paid a small flat fee per loan. Often that fee was too low to verify incomes and carefully evaluate credit risk. Contract underwriters, as a result, had economic incentives to dispense with verification and instead underwrite mortgages as stated-income or no-documentation loans.

The perverse incentives were even worse for brokers. Mortgage brokers only got paid if they closed a loan. Furthermore, subprime brokers were paid solely through upfront fees at closing, meaning that if a loan went bad, the losses would fall on the lender or investors, not the broker. In the most pernicious practice of all, lenders paid brokers thousands of dollars per loan in fees known as yield spread premiums (or YSPs) in exchange for loans saddling borrowers with steep prepayment penalties and higher interest rates than the borrowers deserved, based on their incomes and credit scores.

YSPs, by driving up interest rates, substantially increase the likelihood that subprime loans will default and go into foreclosure. Economists have estimated the size of this risk. For every one percent that the initial interest rate on a home mortgage goes up, the likelihood that a household will lose its home rises by sixteen percent a year. For adjustable-rate mortgages (ARMs), these statistics are even worse. When the interest rate on an ARM resets, every one percent increase in the reset rate makes it thirty percent more likely that a household will lose its home.[13] Many recent subprime hybrid ARMs have initial resets of three percentage points,[14] which drives home how much overpriced subprime loans put homeowners and investors at risk.

12 Jenny Anderson & Vikas Bajaj, *Loan Reviewer Aiding Inquiry Into Big Banks*, NEW YORK TIMES, Jan. 27, 2008.

13 Donald R. Haurin & Stuart S. Rosenthal, The Growth Earnings of Low Income Households and the Sensitivity of Their Homeownership Choices to Economic and Socio-Demographic Shocks (U.S. Department of

The compensation structure for mortgage brokers encouraged numerous subprime brokers to do whatever it took to close a loan. Sometimes this involved padding a borrower's income or assets. Sometimes this was with the borrower's involvement, but more often it was not. Sometimes doing whatever it took meant commissioning an inflated appraisal; other times it meant duping borrowers with overpriced loans. Many of these borrowers had credit scores that were high enough to qualify them for cheaper prime loans.[15] Moreover, if a broker put a borrower into a loan that the homeowner could not afford, the broker could always offer to refinance that loan and pocket another round of fees. In all of these ways, brokers had financial incentives to boost the risk of subprime loans and to foist that risk onto borrowers, lenders, and investors. In theory, these injured parties could sue careless or fraudulent brokers, but in reality, most of those brokers had meager capital, leaving them judgment-proof.

Lenders looked the other way because they profited from higher loan volumes and planned to securitize the loans anyway and shift the risk to investors. To maximize their loan volume from brokers, many lenders relaxed their quality controls on brokered loans. In fact, one subprime lender, Novastar Financial, made no bones about that fact when it reportedly sent a brochure to its brokers trumpeting, "Did You Know NovaStar Offers to Completely Ignore Consumer Credit!"[16]

At the end of the day, securitization and its sister forms of outsourcing gave financial incentives to actors in the mortgage industry to originate unduly risky subprime loans. Mortgage brokers originated faulty loans because they knew they could shift the credit risk onto lenders while collecting their pay at closing. Lenders agreed to make defective loans because they got paid upfront while dumping those loans onto investors. Investment banks and rating agencies glossed over the risks of subprime loans because they knew they would get paid from the securitization proceeds. Investors took the ratings on blind faith because they were greedy for high returns and did not insist on closer scrutiny of loan pools. To the contrary, relentless demand by investors at home and abroad for high-yield subprime bonds required shunting a continuous stream of borrowers into subprime loans.

The Subprime Surge and Bust

From 1994 to 2005, subprime loans rocketed in growth at twenty-six percent a year. In order to maintain this meteoric rate of growth, the subprime sector needed to deliver a steady stream of customers for high-cost loans. To ensure that stream of customers, the subprime industry came to rely on – and fueled – looser and looser underwriting standards.

In the early years, it was easy for the subprime market to grow fast because it started out so small. Back in 1994, subprime mortgages accounted for less than five percent of home loans.

Housing and Urban Development April 2005): vii, 18, www.huduser.org/Publications/pdf/EarningsOfLow-IncomeHouseholds.pdf

14 Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

15 Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL STREET JOURNAL, Dec. 3, 2007.

16 Gretchen Morgenson, *Creative Loans, Creative Compensation*, NEW YORK TIMES, Nov. 18, 2007.

Even by 2001, subprime mortgages only made up nine percent of total home loans. During those early years, from the viewpoint of macroeconomists, subprime mortgages were just a drop in the bucket compared to home mortgages overall in most parts of the country.

But with the traumatic events of 2001, everything changed. The previous year, the dot-com bubble had burst, plunging the U.S. economy into recession. By August 2001, the S&P 500 Index was off twenty-six percent from its previous high. Then tragedy struck. On September 11, al-Qaeda attacked the World Trade Towers and the Pentagon, striking at the very heart of Wall Street. As the country grieved, the faltering economy attempted to revive, only to sustain another blow in December 2001, when Enron filed for bankruptcy. As one corporate scandal after another came to light, public confidence in the stock markets crumbled. The S&P 500 slid another fifteen percent and did not begin to bounce back until the fall of 2002, after Congress passed the Sarbanes-Oxley Act.

Throughout it all, the housing market was the one bright spot in the economy. In mid-2000, with the dot.com bubble about to burst, the Federal Reserve Board exercised its "Greenspan put" and slashed interest rates, causing housing prices to grow at a steady clip of ten percent a year nationally. After the 9/11 attacks, with the recession in full swing, the Federal Reserve Board ordered further rate cuts in order to jump-start the economy.

Between August 2001 and January 2003, the Fed lowered the discount rate from 3 to 0.75 percent. Mortgage rates followed suit and sank to new lows. By May 2003, rates on thirty-year fixed mortgages had fallen to their lowest point in decades. Mortgage lenders did land office business and were flooded by consumers who wanted loans to buy or refinance homes. On the sidelines, Fed Chairman Alan Greenspan heaped praise on consumers for fueling consumer spending by taking out adjustable-rate loans in order to extract equity from their homes.

The mortgage boom was good for prime loans, but it was even better for subprime loans. Between 2001 and 2005, subprime lending's market share doubled in size, to twenty percent of consumer originations, and it stayed at twenty percent through 2006. Nationally, home prices grew at double-digit rates in 2004 and 2005. As housing prices rose, consumer confidence soared and lenders plied homeowners with offers of easy credit.[17]

Rising home prices created problems of their own. On the coasts, spiraling home prices outpaced family incomes, threatening to put home-buying out of reach for many aspiring homeowners. Meanwhile, interest rates began to go up. Between July 2004 and July 2006, the Federal Reserve Board raised the federal funds target rate by four percent and did not start lowering it until July 2007, which made mortgages more expensive and pushed up the index rates on adjustable-rate mortgages. Lenders found it harder and harder to qualify borrowers using standard underwriting criteria for safe fixed-rate mortgages.

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[17] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html; Federal Reserve System, Truth in Lending, 73 Fed. Reg. 1672, preamble (Jan. 9, 2008).

As consumers became financially stretched, housing starts started to decline.[18] In the industrial Midwest, plant closings and job losses pushed many middle-income homeowners into default. Lenders and brokers, seeing the handwriting on the wall, changed their mix of loan products to keep loan originations – and their fee income – from falling off the cliff. To keep initial monthly payments within affordable reach, lenders began making more adjustable-rate mortgages (ARMs) and qualifying the borrowers only at the lower introductory rates. These subprime ARMs were not your parents' ARMs of yore, with low reset rates and manageable lifetime caps. Instead, the introductory rates on these subprime adjustable-rate loans started at seven to nine percent. Indeed, for mortgages originated in 2006, the average starting rate for subprime adjustable-rate mortgages – 8.29% -- was *higher* than the average 8.06% rate on subprime fixed-rate loans.[19] After the introductory period – normally, two or three years – when rate reset, high margins on these loans caused borrowers' monthly payments to go up overnight by fifty to one hundred percent or more. Far from the exception, these subprime "hybrid" ARMs accounted for three-fourths of subprime loans securitized in 2004 through 2006.[20]

Other ARMs had even more exotic features. Interest-only ARMs allowed borrowers to pay only interest, not principal, for an initial period. Even worse were option payment ARMs with negative amortization, which were peddled to prime borrowers and designed to make the borrowers' principal *grow* over time. Over three-fourths of borrowers with option payment ARMs only made the minimum payments, which increased the principal they owed on their loans.[21]

Lenders also dealt with rising home price appreciation by approving loans without verifying the borrowers' incomes or assets. If the borrower's income was too low to qualify, no problem. The lender could simply reach into its bag of tricks and pull out a stated-income loan, a NINA loan – no income, no assets – or even a NINJA loan – no income, no job, no assets -- based on the house value alone. Lenders even made these loans when borrowers gave them full documentation of their assets and income because lenders earned higher interest rates on low- and no-documentation loans. By 2006, more than forty percent of subprime loans and eighty percent of "Alt-A" loans that were securitized consisted of these sorts of "liar loans."[22]

As competition intensified, lenders and brokers scrambled for loan customers by reaching down the credit scale while loosening their underwriting standards. For borrowers with no down

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18 Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

19 Remarks by FDIC Chairman Sheila Bair, University of Connecticut School of Law, Hartford, Conn., Feb. 14, 2008.

20 Federal Reserve System, Truth in Lending, 73 Fed. Reg. 1672, preamble (Jan. 9, 2008).

21 Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

22 Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html; Gretchen Morgenson, *Crisis Looms in Market for Mortgages*, NEW YORK TIMES, March 11, 2007.

payment, 100 percent financing was easily had, generally by using piggyback second mortgages. Loans for the full property value or more went to people with tight incomes and spotty payment records. Loan terms were stretched out to forty or even fifty years. Desperate to keep origination volumes up, lenders layered risk upon risk, making no-documentation ARMs with high payment shock and no down payments to cash-strapped borrowers with low credit scores. The low initial payments on these loans lured numerous unsuspecting borrowers into larger loans than they could afford.[23]

There were warning signs in late 2006 that the subprime market was on the verge of collapse. Delinquencies were rising and so were foreclosures. That fall, Goldman Sachs and Balestra Capital placed lucrative bets that subprime investment vehicles would fall in value.[24] Investors began to insist that lenders buy back failed subprime loans. Funding sources began to dry up and in December 2006, Ownit Mortgage Solutions and Sebring Capital Partners became the first in a long line of subprime lenders to fail.[25]

In 2007, the house of cards came tumbling down. For the first time since the Great Depression, housing prices declined nationwide, sharply in some markets, and distressed borrowers found that they had limited options.[26] Rising interest rates, stricter underwriting, falling home prices, and harsh prepayment penalties made it difficult for borrowers to refinance. Falling real estate values prevented delinquent borrowers from paying off their loans in full by selling their homes.

Defaults soared and so did foreclosures. By November 30, 2007, one-fifth of subprime ARMs nationwide were ninety days or more delinquent or in foreclosure, many due to early payment defaults. Foreclosures are expected to rise as more loans come due to reset.[27]

Breakdown in Investor Trust

Even in isolation, the current rash of foreclosures would provide ample reason for concern. The repercussions from the subprime crisis, however, have been much more severe. To the disbelief of many observers, subprime loans that proved defective – due to lax underwriting or, worse yet, fraud -- have triggered a domino effect, causing multiple credit markets to become paralyzed worldwide. These credit markets broke down because investors lost confidence in the performance of subprime loans and any credit market and institution possibly tainted by them.

There are three major reasons why delinquent subprime loans mushroomed into contagion. The first is *leverage*, which refers to the fact that bad subprime loans often served as

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23 Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007.

24 Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt,* NEW YORK TIMES, Dec. 6, 2007; Nelson D. Schwartz & Vikas Bajaj, *How Missed Signs Contributed to a Mortgage Meltdown,* NEW YORK TIMES, Aug. 19, 2007.

25 Vika Bajaj & Christine Haughney, *Tremors at the Door,* NEW YORK TIMES, Jan. 26, 2007; see also The Mortgage Lender Implode-O-Meter, http://ml-implode.com/.

26 Anna Bernasek, *When Does a Housing Slump Become a Bust?,* NEW YORK TIMES, June 17, 2007; David Leonhardt & Vikas Bajaj, *Drop Foreseen in Median Price of U.S. Homes,* NEW YORK TIMES, Aug. 26, 2007.

27 Speech by Federal Reserve Board Randall S. Kroszner at the American Securitization Forum 2008 Conference, Las Vegas, Nevada, Feb. 4, 2008, www.federalreserve.gov/newsevents/speech/kroszner20080204a.htm.

collateral for several subprime bonds. Assume, for example, that Lender X makes a subprime residential mortgage to the Harris family and then securitizes that loan. The Harris family home will serve as collateral for the original mortgage-backed securities. In addition, Lender X may separately securitize any prepayment penalty on the Harris loan as a net interest margin security (a NIMS) for which the Harris home also serves as collateral. Sometime later, the issuer may take some of the original subprime mortgage-backed securities backed by the Harris family home, bundle them together with other subprime mortgage-backed securities, and resecuritize the bundle as a collateralized debt obligation (CDO). The Harris family home will serve as collateral for the CDO too. Finally, the investment bank that underwrote the CDO may resecuritize the CDO into a CDO of CDOs, with the Harris loan again serving as part of collateral. In this way, Lender X and investment banks *leverage* the Harris loan to serve collateral for multiple bonds.

If the Harris loan is defective and the family is forced into default, it will jeopardize repayment not just for one bond issue, but for several. The default of the Harris loan will boost the credit risk on four bond issues: (1) the original mortgage-backed securities; (2) the NIMS; (3) the CDO; and (4) the CDO of CDOs. Of course, these instruments are backed by hundreds or thousands of other subprime loans as well. If a large percentage of those subprime loans go into default – which is happening as we speak – then these bond issues faced deep losses and rating agency downgrades. Anyone who made the wrong derivative bets on the direction of these subprime mortgage-backed securities also sustained losses. As these dynamics came to fruition, the subprime mortgage-backed securities market dried up and so did subprime loans. The drought of mortgage credit became so severe that any mortgage not insured by Fannie Mae, Freddie Mac, or the federal government became highly costly or just plain unavailable. The most important example, of course, is jumbo home loans. In the process, banks once more must hold their non-conforming loans in portfolio, which puts their safety and soundness at risk.

Collateral is the second reason why subprime loans infected other markets. Many investors who bought subprime bonds later pledged those bonds as security for other types of credit. These investors included large institutional investors, both here and abroad, such as banks, hedge funds, state and local governments, insurance companies, and other large corporations. Some of these investors used their subprime securities as collateral for loans. Banks, for instance, pledged their subprime bonds as security for short-term loans from other banks on the market for interbank credit. Major corporations borrowed money from other corporations on the short-term commercial paper market by issuing paper backed by subprime bonds. Some money market funds purchased subprime-backed commercial paper as well. In recent months, concern about the underlying collateral caused the interbank credit market and the asset-backed commercial paper market to seize up. Some money markets that invested in commercial paper backed by subprime bonds have had to struggle to avoid "breaking the buck."

General investor panic is the third reason for contagion. Even in transactions involving no subprime collateral, concerns about the subprime crisis have had a ripple effect, making it difficult for companies and cities across-the-board to secure financing. Banks do not want to lend to other banks out of fear that undisclosed subprime losses may be lurking on their books. Investors do not want to buy other types of securitized bonds, such as bonds backed by student loans or car loans, because they have lost faith in the ratings issued by the rating agencies. Stocks in commercial banks, insurance companies, and Wall Street investment firms have taken a beating because investors fear that these companies have more subprime-related write-downs in their future. Cities are having trouble floating municipal bond offerings because the AAA ratings of municipal bond insurers are in jeopardy due to mounting subprime liabilities at those insurers. In recent weeks, investor panic has crippled the leveraged financing market and the market for auction-rate securities. Initial public offerings have become a rarity. In a flight to safety, investors have flocked to U.S. Treasury bonds and gold. Increasingly, markets that have no subprime involvement are faltering due to generalized investor mistrust and flight. Because they do not know exactly who is tainted by subprime, investors have stopped trusting almost everyone.

Restoring Investor and Borrower Confidence

Going forward, what is necessary to restore public trust? While a number of measures are needed, one thing is for certain: people need assurance that in the future, home mortgages will be properly underwritten and free from fraud. The Connecticut General Assembly cannot turn around the economy by shaping national monetary policy. However, it *can* assure that home mortgages made in Connecticut are sensibly underwritten and not conducive to fraud.

Some might argue that the mortgage market has recently corrected the problem. If anything, the pendulum has swung too far the other way. According to press reports, it is now hard to get a residential mortgage unless you have a credit score of 700 or higher and at least six months' savings in the bank. These standards are so demanding that half of American households or more would flunk them on the spot.

In the meantime, history tells us that two things are certain. First, the subprime market will spring back in some form. Subprime loans disappeared for awhile in 1998 due to bankruptcies of subprime lenders, but eventually those loans came back. Subprime securitizations experienced a dent around 2001 to 2002, but later roared back to life. It may take awhile, but some way, in some form, the subprime market will return.

Second, history also proves that the subprime industry lacks sufficient incentives to guard against lax underwriting and fraud. It is too late to go back to the days when the lender marketed customers, underwrote loans, serviced those loans, and held them solely in portfolio. The unbundling of the mortgage market is a fact of life. Unbundling and the compensation structures that come with it create irresistible incentives for reckless lending and fraud. Even at this late date, moreover, the mortgage broker industry and the mortgage lending industry continue to resist effective self-regulation in the form of strong rules with binding effect and outside examinations for compliance.

Thus, if anyone is to restore confidence and trust to the home mortgage market, it will have to be the government. All three mortgage lending bills pending before the Committee – RHB 5577, SB 21, and SB 423 – would go a long way toward helping restore the faith of investors and borrowers in the Connecticut home mortgage market.

A new study that I coauthored with Kathleen Engel and economists at The Wharton School, the University of Southern California, and Marquette University sheds light on the effect that state anti-predatory lending laws have on the flow of subprime credit.[28] In our study, we compared the effect of anti-predatory lending laws in different states on the likelihood that a subprime loan would be originated in 2004 and 2005. Surprisingly, we found that lowering the annual percentage rate (APR) triggers in state laws to regulate more loans *increased* the likelihood that a lender would originate a subprime loan.[29] Moreover, lowering those triggers helped offset any negative effect on access to credit that might flow from restrictions on loan practices such as prepayment penalties and balloon clauses in those laws.

In a follow-up study, my coauthors and I specifically examined the effect of assignee liability provisions in the state laws on access to credit.[30] We found no definitive evidence that assignee liability laws, even the strongest ones, restricted access to subprime loans. In six of the states with assignee liability laws, subprime origination probabilities went up consistently, while in the other three states, those probabilities went up using one definition of "subprime" and went down using a second definition of "subprime."

Our results help provide confidence that expanding regulation of home mortgages will increase access to credit, not restrict it. Lower triggers and assignee liability provisions in state anti-predatory lending laws may increase access to credit by providing lenders legal certainty and protecting them from competitive pressures to relax underwriting standards. Lower triggers and assignee liability provisions may also give consumers who previously had stayed on the sidelines the confidence to apply for home mortgages.

All three bills before the Committee would lower the triggers for coverage, while two of those bills would provide assignee liability to injured borrowers. Our research suggests that these provisions – particularly lowering the triggers – would help expand access to credit for borrowers who have the ability to pay for home mortgages.

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28 Raphael W. Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan M. Wachter, *State and local anti-predatory lending laws: The effect of legal enforcement mechanisms*, 60 JOURNAL OF ECONOMICS & BUSINESS 47-66 (2008), http://www.sciencedirect.com/science?_ob=PublicationURL&_cdi=5851&_pubType=J&_auth=y&_acct=C000050221&_version=1&_urlVersion=0&_userid=10&md5=99e5dcd694a5f8f00fb8c8283f73e621&jchunk=60#60.

29 In our study, we held the definition of a subprime loan constant, regardless where the APR triggers were set.

30 Raphael W. Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan M. Wachter, *The Impact of State Anti-Predatory Lending Laws: Policy Implications and Insights* (working paper Jan. 25, 2008).