Testimony of Stephen L. Ross Professor of Economics University of Connecticut

I am going to begin by discussing incentives. The current broker compensation system is a reason behind many abuses. Unlike other financial service providers, brokers are compensated like traditional automobile salesmen with compensation based on the price charged. Broker's compensation is driven by yield spread premia that are built into borrowers' interest rates. As with the car salesman, brokers focus on the monthly payment and intentionally push riskier products that offer lower monthly payments and allow greater compensation. This behavior increases defaults making loans less profitable, and yet lenders have done nothing to monitor or regulate this important segment of the market.

Meanwhile, lenders earnings are driven by the reselling of loans, as well as the servicing of loans including profitable delinquency and foreclosure services. Lenders profit from the loan volume created by abusive lending practices, but do not directly bear the costs. Further, the link between the investor and the lender is fairly weak. Mortgages pass through the investment banking system and are sold as securitized products. At every stage, key decisions are made by investment professionals whose own funds are not at stake and who likely focus on being a top performer (taking risks to win a tournament) rather than maximizing investors' risk adjusted expected return.

While I applaud the banking commissioner's proposals, those regulatory reforms will not address the fundamental incentives, and people always find a way around government regulations when faced with strong economic incentives. The S.B. 423, Connecticut Fair Housing Center's bill, has many important features. By imposing fiduciary duties on brokers and good faith requirements upon lenders, the bill forces brokers and lenders to consider borrowers' interests or face clear consequences, and may also help change the culture of the subprime industry. More importantly, the right of recission as a remedy, violations of fiduciary duty and good faith as a defense against foreclosure, and limited assignee liability will place serious pressure on the investment community to change their relationships with lenders and in turn force changes on mortgage brokers. We cannot know what form those changes will take, but we can be certain they will be substantially more effective than government regulation alone.

Finally, I want to address two myths. The first is that government regulation leads to a large reduction in subprime lending. Many studies have examined this question, and none have found large declines in lending, while studies that examine detailed loan features consistently find dramatic declines in the number of abusive loans. The second myth is that the industry will fix these problems in response to the current subprime crisis. However, the U.S. Congress had hearings on predatory lending in 1998 and little action was taken because "these problems would likely disappear as the subprime industry consolidated and matured." In fact, the Asian monetary crisis in the late 90's shut down the entire subprime market, but the market and the abuses rebounded with a vengeance a few years later. I remember a conversation in 2005 with a senior official at FreddieMac concerning abusive lending and his view was "there are probably still some problems, but it is certainly nothing like the wild west days between 1999 and 2002."

Obviously, now we know better, but the industry should have known better in 2000 or at least 2004. Without strong economic incentives for the industry to solve these problems, we are unlikely to see any substantive changes once the current crisis is over.