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on behalf of

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before the

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Good morning Chairmen Bachus and Ney, and members of the Committee. My name is Teresa Bryce, and I am General Counsel of Nexstar Financial Corporation, in St. Louis, Missouri. Today, I appear before you as a representative of the Mortgage Bankers Association (MBA).[1]

First, on behalf of our entire industry, I wish to thank the chairmen for their unwavering leadership on the important consumer protection issues affecting mortgage lending. We are committed to supporting the Chairman in achieving dual goals of strengthening protections for the more vulnerable consumers while at the same time allowing for the expansion of mortgage credit access for all persons.

In order to achieve these "twin" goals, we believe it is crucially important to understand the structure and composition of today's vibrant mortgage market. This is especially important in the area of subprime lending, which has attracted much attention because of reports of "predatory" and "abusive lending," terms that are ill-defined and driven by anecdote, as opposed to solid, market-wide information.

I will, therefore, focus my testimony on providing an overview of the structure of our industry, stressing the importance of the subprime segment of the mortgage market, and describing our concerns regarding the passage of an increasing number of

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,700 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

disparate and overly restrictive state and local laws that intend to address predatory lending.

The major points that I will expand on my testimony are as follows:

- The U.S. mortgage market has enabled 68% of all Americans to own homes; a direct result of Congress establishing a national mortgage market to replace a local mortgage market.
- Subprime lending is a legitimate segment of the financial services industry that gives consumers who are unable to obtain traditional financing the opportunity to achieve the dream of homeownership. Without subprime financing many consumer would be unable to obtain mortgage credit.
- The continued availability and growth of the subprime market depends on lender and investor confidence, which is being eroded with a patchwork of confusing state and local laws.
- The proliferation of overly restrictive predatory lending laws passed by certain states and localities disrupts our national mortgage market, increases the cost of credit and injures the very consumers it is meant to help.
- As states lower thresholds for coverage of predatory lending laws and increase liability, fewer subprime loans will be originated because of lender and investor reluctance to deal in "high cost" loans.
- MBA calls for a national uniform standard that provides strong consumer protections while maintaining the free flow of mortgage credit nationwide.

Before I begin, I want to make clear that MBA stands in solid opposition to abusive practices in mortgage lending. We understand too well that there are unscrupulous individuals that abuse our most vulnerable populations. As we battle these unscrupulous actors and search for better protections for homeowners, we also have the duty and obligation of ensuring that we do not act in a way that constricts the flow of capital to credit-starved communities. These consumers have been the benefactors of

our industry's great success in expanding access to mortgage capital and we cannot afford to reverse on these hard-earned advances.

I. A National Mortgage Market

America's mortgage finance system is, without question, the envy of the world. Capital from all over the world flows to our mortgage markets and provides Americans with the lowest possible mortgage rates and the greatest diversity of products. As we attempt to improve the effectiveness of our existing consumer protection laws, we must do so in a manner that does not cripple the very efficiency that has created our superior mortgage market.

As a preliminary matter, our national mortgage market is made up of a "primary" market and a "secondary" market. The primary market is signified by lenders lending money to borrowers for home purchases. It is generally characterized by a lender's interaction with a borrower in the origination, counseling, and negotiation for residential real estate finance. After lenders and borrowers close on loans, the majority of those loans are sold to a secondary marketing entity, i.e. Fannie Mae, Freddie Mae, Ginnie Mae and private investors. By selling their loans to secondary marketing entities, lenders replenish their funds with the proceeds of the sale, thereby enabling them to originate additional loans. The secondary market provides two important elements: (1) it provides lenders with needed liquidity, and (2) it removes certain risks of the loan from the lender. After purchase, secondary market entities will either hold the loans or pool them into mortgage-backed securities, which are sold to a wide array of investors, including pension funds, insurance companies and foreign countries. [2]

It is noteworthy that Fannie Mae, Freddie Mac and Ginnie Mae are creatures of statute created by Congress. Congress appreciated the importance of making the opportunity

[2] Our estimates reveal that, in 2002, over 75% of all U.S. residential mortgage production was securitized and sold into the secondary market.

of homeownership available to as many American as possible. This government-created national structure makes homeownership affordable and therefore accessible.

Moreover, a vibrant secondary market diversifies geographic economic risk and loss severity and thus tends to stabilize interest rates across the country. Because today's mortgage market is a national one, an economic recession in one region will not mean the flight of credit from or an increase in rates for that region.

There is no doubt that mortgage lending is conducted on a truly national and international scope. These national sources for mortgage capital serve to achieve great cost savings for consumers through great efficiencies and considerable economies of scale. Through aggregation or pooling of like mortgages from across the country, our national mortgage market facilitates the flow of capital from money rich areas to money poor areas. Standardization of mortgage characteristics and risks creates a commodity that facilitates the inflow of capital because investors know with relative certainty what they are buying and what risks are inherent with a particular pool of loans.

This truly amazing mortgage structure, one that has provided Americans with the best, cheapest, and most efficient mortgage capital delivery system in the world, is however, greatly dependent on legal certainty and predictability. Secondary market investors must have the confidence of being able to purchase and trade mortgage-backed assets without undue complications and without the transfer of excessive or unquantifiable legal risk.

II. "Subprime" Lending

Capital flows from secondary market sources have been especially important with regard to the so-called "subprime" market sector—the topic of today's hearings. This sector of the market focuses on portions of the population composed of consumers that, for various reasons, have less than stellar credit records and other flaws and/or special characteristics. This subprime segment of the industry has become an increasingly

important, and very essential, piece of mortgage lending. As the U.S. Department of Treasury and the Department of Housing and Urban Development acknowledge in a recent report, "[b]y providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes."[3]

It is important to understand that, for various reasons, this segment of the market poses elevated operational costs. First, since lenders in this segment of the market specialize in serving credit-impaired consumers, it is generally true that the loans in this segment of the market have higher default risks. In addition, subprime lenders are likely to incur higher originating costs. For example, subprime transactions require higher salaried specialists that are trained in quantifying the unique credit risks posed by applicants with poorer credit quality, and the files and records of subprime borrowers might require a more comprehensive and thorough examination in order for lenders to understand the true nature of the borrower's credit risks. Moreover, denial rates in the subprime market run about twice those of the prime market, and can be even higher in certain specific markets. Loan officers thus have to take many more applications in order to generate the same number of loans. There are also considerable expenses associated with higher delinquency rates, which amount to costs that are twice as high for subprime than for prime loans. Nor can we ignore that subprime loans pose higher risks for reasons other than credit flaws. Non-prime borrowers may, for instance, qualify for subprime products because they carry significant outstanding debt, seek 100% financing, or have difficultly demonstrating their income due to self employment. In the end, the "per-loan" cost of subprime transactions is generally 2-to-3 times higher than that of prime loans.

It is also important to realize that until a few years ago, this segment of the population did not have the option of obtaining mortgage financing from traditional lending

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[3] United States Department of Treasury and Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000 ("HUD/Treasury Report").

institutions. In the not-so-distant past, lenders were simply not willing to risk their capital by lending large sums of money for extended terms to individuals with credit problems that statistically have a higher incidence of default. However, through innovations in the mortgage finance industry, and through various financing and risk enhancing tools created for the specific purpose of extending credit to our more needy communities, credit-impaired individuals now have ample opportunity to obtain loans through this "non-prime," or "subprime" market. Although riskier, subprime borrowers can now be considered very viable credit candidates through higher prices to cover the higher costs of the transaction, or with the assistance of financing options that serve to mitigate credit risks.

At present, subprime originations comprise approximately 9% of all mortgage originations. According to Federal Reserve Board estimates, subprime mortgage originations grew a stunning seven-fold over the 1994 - 2002 time period. This growth has disproportionately benefited low-income and minority borrowers, as these groups are much more likely to have credit blemishes and thus require access to subprime credit.

One clear and visible outcome of this expanded subprime lending activity has been an increase in homeownership rates for low-income and minority borrowers. According to Federal Reserve Governor Gramlich, "this represents a welcome extension of home mortgage and other credit to previously underserved groups—a true democratization of credit markets."[4] MBA agrees, and we fully appreciate the immense importance of subprime lending. Millions upon millions of low- and moderate-income families now own a home and have opportunities at building wealth and accessing credit through the availability and growth of the subprime credit market. There is no doubt that subprime credit must be protected—it is the only doorway to wealth and capital for countless consumers.

[4] Remarks by Governor Edward M. Gramlich at the Texas Association of Bank Counsel, 27th Annual Convention, South Padre Island, Texas (October 9, 2003).

III. Market Participants

I note, however, that despite the impressive growth of subprime lending, the subprime market is still in its infancy. Any significant disruption in the flow of capital could severely and permanently impair the sustainability of this market. Not all mortgage lenders are able to participate in this market. Indeed, only a small percentage of mortgage lending institutions offer loans to subprime customers. Our market analysis estimates that the 9% of loans in the United States that fall in the subprime category is served by about 150 lending institutions.

There are numerous reasons why this segment of the industry is served by only a few specialized institutions, and why it is therefore important to ensure they remain active in this market. We suggest a few below--

Risk of loss: First, as described above, there is the all-important "risk" factor in the sense that lenders are reluctant to lend in markets where lending history and underwriting experience demonstrate greater probability of default.

Barriers to Obtaining Secondary Market Capital: Subprime loans are not eligible for Fannie Mae, Freddie Mac or Ginnie Mae purchase or securitization. As a result, this product has historically lacked the ability to attract the same level of capital from private investors. Securitization of subprime loans is significantly smaller for a number of reasons, including the expense and complexity of issuing private label securities (i.e., a security issued by the lender). Only large companies with significant net worth have the capability of issuing their own pools.   Pooling requirements, net worth requirements, registration requirements and expenses, rating agency standards, and collateral structure all create barriers to small originators issuing their own securities and attracting capital. Moreover, since subprime borrowers are by definition riskier, investors review the loans with greater due diligence and place significant obligations on originators and servicers of this product.

Legal Risk and Complex Regulation: Financial exposure is not, however, the only source of risk for lenders and investors. An equally significant source of risk is derived from the colossal legal uncertainties that now surround subprime mortgage transactions.

It is important to understand that the mortgage lending industry is one of the most heavily regulated industries today. Mortgage lending is subject to pervasive regulation and must comply with a wide array of federal consumer protection laws including the Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Housing Act, Fair Credit Reporting Act, Equal Credit Opportunity Act, Fair Credit Billing Act, Home Mortgage Disclosure Act, Federal Trade Commission Act, and Fair Debt Collection Practices Act.

Of particular relevance to today's hearings are the additional laws that apply to so-called "high cost loans." Pursuant to the Home Ownership and Equity Protection Act (HOEPA), mortgage loans that exceed specific cost thresholds must abide by more stringent rules that require additional disclosures, set additional protective provisions and strict prohibitions on certain financing tools, and impose additional penalties and liabilities for lenders and investors that participate in the origination of these loans.

The HOEPA law has a very fundamental impact on subprime lending—the harsh reality today is that practically very few institutions will make a loan that is covered by the HOEPA thresholds. The central point that policymakers must understand is that HOEPA's triggers serve as an absolute "ceiling" to mortgage lenders and secondary market participants. In effect, this law is a deterrent for every lender that must charge additional fees or higher prices in order to cover the higher costs of subprime loans. The reasons for the HOEPA "stigma" are multiple. First, there are real and very significant cost burdens associated with the making of HOEPA-covered loans. The stringent rules and requirements inherent in "covered" loans create complications in compliance that require specific management and due diligence attention. These include, for example, complex trigger calculations, additional disclosures, and

uncertainties created by the extended right of rescission. In light of HOEPA's significant penalty provisions, these added difficulties require significant time and resource allocations by lending institutions that engage in such loans.

In addition, today's reality is such that the mere origination of HOEPA-covered loans negatively affects a lender's reputation. The mere label of "HOEPA" infuses a pejorative connotation that associates covered loans with mortgage abuse. This stigma is extremely important for the lending industry since a lender's ability to attract and retain customers is directly linked to the trust and good reputation they develop in the communities they serve. Plain and simple, the label of "HOEPA" is used as a proxy for "predatory loan." Federal and state examiners, as well as public perception at large, equate HOEPA-covered loans with "predatory" transactions.

In light of all these difficulties, there are considerable burdens associated with HOEPA that come in the form of special assurances and limits imposed by the secondary market. Secondary market purchasers, including Fannie Mae and Freddie Mac, simply refuse to purchase HOEPA-covered loans, regardless of whether they are otherwise fully compliant with all relevant laws and regulations.

Proliferation of State and Local Predatory Lending Laws: As has been widely reported, there is currently an unprecedented level of legislative activity aimed at passing so-called "anti-predatory" measures at state and local levels. Although well-intentioned, these state and local laws are imposing very onerous restrictions that obstruct lending operations in the subprime market. More importantly, these state and local laws are confusing and difficult to decipher, and impose a veritable patchwork or rules and regulations that are impossible to implement in a way that ensures compliance with the differing standards. I'll be clear— all the problems I described above in relation to legal and regulatory risks under HOEPA are today being multiplied and replicated, in different permutations, on a state-by-state and municipality-by-municipality basis.

This “balkanization” of the legal system is an extremely serious threat. As noted above, secondary market investors provide the necessary capital to fund the vast majority of our industry’s operations. As purchasers of mortgage assets and asset-backed securities, secondary market investors must have absolute certainty that the underlying mortgage assets are sound and compliant with all applicable laws and regulations. Legally defective assets can leave investors exposed to very large financial loss and, perhaps more importantly, to vast legal and administrative liabilities, including securities violations. In today’s environment, where nearly 30 states have enacted unique and different sets of laws and regulations covering subprime lending, it has become utterly impossible to achieve the necessary assurances of absolute legal certainty.

To illustrate the concern, I note that secondary market transactions rely on sales and purchases of entire “pools” of mortgage loans. A typical “pool” of loans sold in the secondary market can contain 300 or more loans. Such pools typically contain loans of similar characteristics from several different states. Since these transactions are, in effect, negotiated in bulk, purchasers of such pools assume legal and financial risks associated with the entire bulk of loans purchased. Minor legal mistakes can be extremely costly. If the lender or originator of one of the loans included in the pool fails to make one material disclosure, or if there is an oversight that leads to a numerical miscalculation, the mistake can result in a legal defect that could potentially unravel the entire pooled transaction. This could be disastrous in terms of financial loss and liability. Although the purchasing investors have no role whatsoever in the miscalculation or the interface with the consumer, they could be saddled with all the losses and all the liabilities.

Diminution of Credit: In the end, MBA warns that subprime lenders are facing a muddled and very risky legal and regulatory environment that discourages operations and competition in this market segment. In their zeal to protect vulnerable consumers, state legislators and consumer groups are creating a very hostile legal regime that is causing lender flight and diminishing capital access for the most needy segments of our communities.

The proliferation of these laws creates massively complex compliance labyrinths that are entirely unwieldy. Multi-state lenders today find it extremely difficult, if not impossible, to formulate models for compliance in any one geographic location without the high probability of falling out of compliance in a different locality. In fact, the unending passage of these "predatory lending" laws at state and local levels is creating a situation where multi-state lenders are finding it almost impossible to comply, or even keep up with the full barrage of local rules and regulations that are continually enacted.

The fragmentation of legal requirements caused by differing state legislation imposes crippling confusion for purposes of purchasing and enforcing mortgage loans since every individual portfolio in a given pool of loans could carry differing legal requirements based on the particular state and/or locality where the loan was originated. In such an environment, secondary market operations are in disarray, as complex questions of compliance and enforceability stifle efficient flows of mortgage capital. In the current "balkanized" environment, secondary market players are now required to undertake extensive and costly due diligence analyses, and implement costly operating systems to comply with varying and ever-changing laws.

If that were not enough, these difficulties are now being exacerbated by recent enactments of state legislation that impose unlimited purchaser or assignee liability for the practices of an originator, broker, or even servicer. This trend has begun to draw a strong negative reaction by segments of the secondary market community. In the past several months, rating agencies such as *Fitch* and *Standard & Poor's* have refused to rate assets that contain loans originated in jurisdictions that impose liability on assignees. This trend is dangerous, as the agencies' refusal to rate assets is extremely alarming to investors, and will invariably dry up secondary market investment in the subprime market. It is likely that the agencies' refusal to rate covered assets will severely restrict funding for all loans covered by these laws.

In the end, we note that the clear impact of this burdensome, confused, and fragmented regulatory framework at the state and local level is lender and investor flight from the states and municipalities covered by these laws.

IV. Other Observations

This current legislative trend at the state and local levels, though well-intentioned, is costing the industry millions of dollars in compliance and legal fees, which in turn, leads to direct and dramatic effects on the price that borrowers pay for credit and the lenders' willingness to do business in particular markets.[5] There are however, other important effects that are seldom discussed.

First, it should be noted that lender and investor flight will not only decrease capital availability in affected markets, but will, with all certainty, raise the costs of the remaining sources of mortgage capital. If legitimate institutional players leave this market segment, the price of capital in those markets will skyrocket as supply is diminished relative to demand. If history is a lesson, supplies of capital could decrease to the point of pushing cash-strapped consumers to non-traditional, and indeed very costly, money sources.

Second, as set forth above, the liabilities and penalties that can result from non-compliance are so severe that simple mistakes can cost lenders thousands of dollars per consumer. These draconian penalties, in themselves, raise the costs of credit as they increase legal risks for even unintentional mistakes on the part of lenders. Equally important, they have the unintended effect of allowing only large financial institutions to operate in this market. It is clear that the massive uncertainties coupled with extremely high penalties and liabilities create a solid barrier for small entities since even unintentional mistakes can decimate small business operations. Only large entities possess the volume and reserves to be able to absorb the gigantic legal costs

[5] For an excellent description of the unintended harms of the GFLA, see "*Georgia Fair Lending Act: Unintended Consequences*," Georgia Credit Union Affiliates, Community Bankers Association of Georgia, Georgia Bankers Association (January2003).

associated with operating in this market. This is evident from the current scenario where small lenders are almost non-existent in this market segment—for small businesses, the legal risks are simply too great.

V. Uniform Standard

In light of all the challenges we describe above, MBA again reiterates the most important point—that the only way to ensure the proper and efficient delivery of subprime mortgage capital to our neediest populations is to develop a national solution to "predatory" lending. We are urging your committees to support us in the push for an efficient marketplace through the establishment of a uniform national standard to combat abusive lending practices.

MBA believes that a single standard through strengthened federal laws will encourage competition and will ensure that the entire mortgage lending industry complies with one set of rules while allowing consumers to have a greater grasp of the lending process to keep them from falling prey to unscrupulous practices. We believe that we can, and must, craft strong safeguards that afford effective levels of protection for all of our citizens and that preserve the efficiencies of a unified legal structure.

We ask this committee to listen to the urgent and combined calls for the development of national uniform standards to fight against "predatory lending." Our most credit-starved communities will be the principal losers if you fail to act.

VI. Consumer Education

As a final point, we cannot ignore the role of consumer education as an imperative element in the struggle to deter predatory lending abuse. An educated consumer in a competitive market place is the best solution to predatory lending. MBA contributes to this consumer education effort through our development and distribution of a 'Stop Mortgage Fraud' pamphlet and maintenance of the 'Predatory Lending Resource

Center' on our website. In addition, MBA is in the process of creating a website to walk consumers through the mortgage purchase process. We urge that your committees consider additional steps and additional funding to assist in the expansion of consumer education nationwide.

VII. Conclusion

In summary, we believe that subprime lending has served as a source of loans for a portion of the market that is very much in need of credit options. In crafting solutions for the problem of abusive lending, regulators must advance thoughtfully and carefully to assure that additional rules promote, rather than restrict, credit extension.

We thank you for devoting attention to the structure of this industry's operations, an industry that has achieved the most impressive and efficient mortgage market in the world. We urge that you recognize the serious perils being posed by the increasing balkanization arising from state and local legislative activity. MBA believes that we must focus on the development of a uniform national standard to effectively and efficiently combat abusive lending practices.

MBA appreciates the opportunity to appear before these subcommittees. I look forward to answering all your questions.