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SUBMITTED TO THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

HEARING ON: PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

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Standard & Poor's Ratings Services ("Standard & Poor's"), part of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), appreciates the opportunity to share its views on its approach to rating securities backed by loans governed by anti-predatory lending statutes. As an independent and objective commentator on credit risk, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative and regulatory actions would best accomplish that goal. Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Accordingly, Standard & Poor's is pleased to discuss the factors that it considers when evaluating the impact of anti-predatory lending laws on its rated transactions.

INTRODUCTION

Since beginning its credit rating activities in 1916, Standard & Poor's has rated hundreds of thousands of securities issues, corporate and governmental issuers and structured financings. Standard & Poor's began its ratings activities with the issuance of credit ratings on corporate and governmental debt issues. Responding to market developments and needs, Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds.

Today, Standard & Poor's has credit ratings outstanding on approximately 150,000 securities issues of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 20 countries around the world. With a U.S. staff of approximately 1,250 Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States.

Standard & Poor's believes that over the last century credit ratings have served the U.S. securities markets extremely well, providing an effective and objective tool in the market's evaluation and assessment of credit risk. Standard & Poor's recognizes the valuable role that credit rating agencies play in the U.S. securities markets and is committed to protecting and enhancing the reputation and future of its credit ratings business. In this regard, Standard & Poor's takes great care to assure that its credit ratings are viewed by the market as highly credible and relevant and will continue to review its practices, policies and procedures on an ongoing basis and modify or enhance them, as necessary, to ensure that integrity, independence, objectivity, transparency, credibility, and quality continue as fundamental premises of its operations.

When Standard & Poor's issues a rating, it is offering its opinion about a company's medium to long-term credit risk. Similarly, ratings on particular instruments, such as the securities related to structured finance transactions, reflect Standard & Poor's opinion about the likelihood of default on those securities. In determining all of its ratings, Standard & Poor's tries to take into account whatever relevant future events may be anticipated.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects Standard & Poor's opinion as of a specific date of the creditworthiness of a particular company or security based on Standard & Poor's objective and independent analysis.

EVALUATING PREDATORY LENDING LAWS

General

Increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

To protect borrowers from unfair, abusive, and deceptive lending practices, numerous state and local governmental bodies have enacted anti-predatory lending statutes. Typical statutes include provisions that:

- Limit the interest rates and fees that a lender may charge;
- Preclude lending to borrowers without regard to their ability to repay;
- Require refinance loans to provide a net tangible financial benefit to the borrower;
- Prohibit excessive prepayment penalties and balloon payments;
- Require disclosure to the borrower of various loan provisions; and
- Require counseling for borrowers who are planning to take out certain loans that are governed by these laws.

Anti-predatory lending statutes are designed to protect borrowers from such practices, and Standard & Poor's strongly supports efforts to combat predatory lending. For several reasons, however, these statutes may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given state to protect itself from being found in violation of the state's anti-predatory lending statute. Second, a lender might reduce its business because the cost of lending in accordance with a statute's provisions might be uneconomical. Third, a lender might reduce its activities within a given state if the market for the sale of loans originated in that state is effectively eliminated. This would occur, for example, if an anti-predatory lending statute imposes liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing to avoid liability under the statute.

Moreover, and most importantly from Standard & Poor's perspective, an anti-predatory lending statute's imposition of liability on purchasers or assignees of mortgage loans ("assignee liability") might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the statute. This would occur if the purchaser or assignee were found to hold a loan that violated the statute ("predatory loan"), even if the purchaser or assignee did not itself engage in predatory lending practices. Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's evaluates the impact an anti-predatory lending statute might have on the availability of funds to pay investors in the rated securities. To the extent that Standard & Poor’s determines that investors in securities backed by loans governed by an anti-predatory lending statute might be negatively impacted, Standard & Poor’s may require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in Standard & Poor’s rated transactions.

Evaluation of Statutes

In performing its evaluation of anti-predatory lending statutes, Standard & Poor's considers, among other factors, whether the statute provides for the following: (i) assignee liability; (ii) clearly delineated loan categories; (iii) penalties, including monetary damages, as well as restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue; and (iv) clarity of statutory violations and safe harbors.

1. *Assignee Liability*. As the first part of its analysis, Standard & Poor's will review an anti-predatory lending statute to see if it imposes assignee liability in connection with any

type of loan covered by the statute (a loan with associated assignee liability is referred to in this discussion as an "exposed loan"). Standard & Poor's defines assignee liability as liability that attaches to a purchaser or assignee of a loan (including a securitization trust) simply by virtue of holding a predatory loan. An anti-predatory lending statute may impose assignee liability in a direct action by the borrower or only defensively, i.e., in an action by the purchaser/assignee to enforce a loan. Typically, statutes that impose assignee liability permit a borrower to assert the same defenses against the purchaser or assignee as it could assert against the original lender.

If Standard & Poor's determines that no assignee liability is provided for under the statute, Standard & Poor's will, generally, permit loans covered by the statute to be included in Standard & Poor's rated transactions. If, on the other hand, Standard & Poor's determines that a given state's anti-predatory lending statute does permit assignee liability, Standard & Poor's will continue with the second part of its analysis.

2. *Statutory Loan Categories*. As the second part of its analysis, Standard & Poor's examines the categories of loans that are identified in the statute. Standard & Poor's considers whether the language of the statute clearly distinguishes between those loans that are covered by the statute and those that are not, as well as among the various loan categories (for example, covered, high cost) covered by the statute. Standard & Poor's looks to see if a loan originator, a seller of loans into a securitization transaction, or a purchaser or assignee of loans would be able to determine what category of loan (according to the statute) the entity is originating, selling, or purchasing.

If Standard & Poor's concludes that the distinctions discussed above are not clearly set forth in the statute, then Standard & Poor's may not be able to rate transactions that include any loans originated in the relevant jurisdiction.

If, however, Standard & Poor's determines that the distinctions discussed above are clearly set forth in the statute, Standard & Poor's will determine for which loan categories the statute provides assignee liability. In general, and consistent with its approach discussed above in section 1, Standard & Poor's will permit loans with no associated assignee liability to be included in its rated transactions. In connection with exposed loans, Standard & Poor's will continue with the third part of its analysis.

3. *Penalties*. For exposed loans, Standard & Poor's will consider whether the statute exposes the assignee or purchaser to monetary damages and, if so, whether such monetary damages are limited to a determinable dollar amount (i.e., the damages are capped). Standard & Poor's will perform this analysis for all types of monetary damages that may be assessed under the statute, including statutory, actual, and punitive damages, as well as any other type of monetary damages provided for in the statute.

If the damages for violation of a statute in connection with a given loan category are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis and thus will not, as a general matter, permit these loans to be included in Standard & Poor's rated transactions.

If, on the other hand, Standard & Poor's determines that, for any given loan category, the monetary damages are capped, as a general matter, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute and will continue with the fourth part of its analysis. In this regard, it should be noted that the ability of Standard & Poor's to size capped damages in its credit analysis is distinct from the question as to whether it would make economic sense to securitize loans, especially if the credit enhancement required equals or exceeds the monetary value of the loan. For example, some statutes provide for rescission or voidance of a predatory loan and require that all amounts paid, including principal and interest, be returned to the borrower. Other statutes permit a borrower to continue to hold a predatory loan, but forgive all interest that otherwise would be due. In addition, if a statute provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value. In some of these instances, securitization of these loans may prove to be too costly.

If an anti-predatory lending statute imposes nonmonetary penalties on purchasers or assignees, e.g., restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue, Standard & Poor's will review these penalties to determine the effect, if any, that these penalties will have on securitization transactions.

4. *Clarity of Statutory Violations; Safe Harbors*. As the fourth part of its analysis, Standard & Poor's will look to see how clearly an anti-predatory lending statute sets forth what constitutes prohibited actions and/or omissions for each exposed loan category. Standard & Poor's looks for clear language that would enable an originator, seller, or assignee of an exposed loan to comply with the statute. In addition, Standard & Poor's will look to see if the statute sets forth certain methods (for example, due diligence procedures and policies against the purchase of certain loans covered by the statute) that a purchaser or assignee can implement to avoid liability ("safe harbors").

Evaluation of Seller's Compliance Procedures and Creditworthiness

In addition to reviewing an anti-predatory lending statute for the factors discussed above, Standard & Poor's will also review the compliance procedures and creditworthiness of any entity that proposes to sell mortgage loans into a securitization ("seller"). In this regard, Standard & Poor's will review a seller's (i) compliance procedures, to determine if they are effective to identify (a) exposed loans, i.e., those subject to assignee liability, and (b) predatory loans, i.e., those that are in violation of the statute; and (ii) creditworthiness, to determine if the seller is willing and financially able to repurchase any predatory loan for a purchase price that would make a securitization trust whole for any costs incurred in connection with the predatory loan. These factors assume increased significance in transactions where the seller proposes to include exposed loans. Generally, Standard & Poor's requirements will be considerably more stringent for those transactions that pose an increased risk of inclusion of exposed loans that are predatory. Standard & Poor's requires that a securitization trust be kept whole to guard against any reduction of funds to pay investors in its rated securities.

Based upon its evaluation of all of the factors discussed above, as well as any other factors Standard & Poor's deems pertinent, Standard & Poor's will determine if any of the loans covered by an anti-predatory lending statute may be included in its rated transactions, and what, if any, additional credit enhancement may be required.

CONCLUSION

In summary, in its evaluation of the credit risk to investors of rated securities backed by mortgage loans governed by anti-predatory lending statutes, Standard & Poor’s looks for statutory language that clearly sets forth what constitutes a violation under such a statute, which parties may be liable under the statute, the extent of such liability (monetary and otherwise), and whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor’s adopts a conservative interpretation of an anti-predatory lending statute, and may, in instances in which liability is unlimited, exclude mortgage loans governed by a given anti-predatory lending statute from transactions that it rates.

In offering these written comments, Standard & Poor’s reiterates to the Honorable Members of the Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit that, as a public policy matter, it is in favor of legislation that attempts to curb predatory and abusive lending practices. Standard & Poor’s also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy, the making of which is the responsibility of elected officials.