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Before the
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit

Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit
November 5, 2003

I would like to thank Chairman Ney and Chairman Bachus for the opportunity to testify today at this important hearing on predatory lending. I am Micah S. Green, president of The Bond Market Association, which represents approximately 200 securities firms and banks that underwrite, trade, and sell fixed-income securities both domestically and internationally.

The secondary market for mortgage debt—the segment of the financial industry that purchase and repackage loans as mortgage-backed securities or MBS—witnessed tremendous growth over the past decade. At present, there are about $5 trillion in mortgage-related bonds outstanding, or nearly a quarter of all fixed income securities. Such significant participation by the capital markets in the mortgage lending business benefits consumers in the form of lower interest rates and more widely available credit. No doubt there are thousands, if not millions, of families who were able to find mortgage financing and purchase a home because of the secondary market.

This success has come with some setbacks, however, as the volume of subprime loans extended to consumers has ballooned and incidents of predatory lending appear to have increased. There can be no question that such abusive lending practices are bad and should be stopped. In response to this trend, state and local governments have pursued many different anti-predatory lending initiatives. Some of these efforts would place new responsibilities on participants in the secondary market. Some initiatives adopt an approach that could make loan purchasers the subject of lawsuits by borrowers who believe the lender committed lending abuses.

The Bond Market Association opposes the concept of extending liability to the purchaser or assignee of a loan for violations of which they had no knowledge. The Association supports the right of borrowers to defend themselves in the event an assignee seeks to foreclose on their property. But the concept of "assignee liability" embodied in recent anti-predatory lending measures goes a step further. It would grant borrowers the ability to seek redress from the loan purchaser for virtually any alleged violation during the origination process. This is bad public policy that will ultimately shrink the supply of credit available to subprime borrowers. It is important that well-intentioned proposals to combat predatory lending—such as the statutes discussed below—not seek to use the secondary market as an enforcement tool. Moreover, subprime borrowers would benefit from a single national standard as opposed to the present variety of state and local predatory lending laws. Disparate and conflicting rules in multiple jurisdictions will raise the cost of credit as secondary market participants pass on compliance costs or withdraw funding which limits competition among lenders.

Georgia and New York: Examples of the Wrong Approach

With the expansion of the subprime market has come increased scrutiny from regulators and consumer groups concerned with alleged abusive tactics used by some lenders. The practice has no clear-cut definition, but is commonly called predatory lending. Generally, a predatory lender is one who violates consumer lending laws to take financial advantage of a borrower in the course of originating a loan or else uses legal loan features or lending tactics in an abusive way. Examples include loading up loans with points and fees that are disproportionate to the amount an individual is borrowing, as well as outright fraud and misrepresentation. Loans extended without regard to a borrower's ability to repay or with features such as balloon payments that are unfavorable to borrowers can also be considered predatory. Predatory lending is sometimes also associated with home improvement contractors who offer to arrange financing for cash-poor homeowners.

As predatory lending captured headlines in the late 1990s, regulators at the state and local level began to address the issue. One of the first to act was the state of North Carolina with a 1999 statute that defines a high-cost loan more narrowly than the federal HOEPA (Homeowner Equity Protection Act) standard in addition to prohibiting certain practices. Several other states and some cities have passed similar anti-predatory lending laws with varying effects on the secondary market.

Generally, state and local initiatives sought to tighten the definition of a high-cost loan under HOEPA. In Georgia, lawmakers approved the Georgia Fair Lending Act (GFLA) which included an assignee liability provision that would hold secondary market participants responsible for the actions of lenders should they purchase predatory loans. The Georgia law proved so disruptive to the mortgage market—mortgage rates reportedly jumped a quarter of a percentage point as market participants withdrew—the legislature was forced to repeal the assignee liability provisions.

Like other anti-predatory lending legislation, GFLA expanded the definition of covered loan established under HOEPA using sometimes vague criteria. More importantly from the Association's perspective, anyone who purchased a covered loan, or is assigned the loan, would have become liable for the actions of the originator and face unlimited potentially unlimited damages.

Under GFLA, assignees—including loan purchasers and securitization trusts—are subject to claims that borrowers might raise against lenders whether or not the assignees knew of the circumstances giving rise to the alleged violation. The secondary market signaled early on that the Georgia law would disrupt that state's mortgage market when Freddie Mac announced it would no longer purchase loans covered by the law. Several other financial institutions followed suit and at least 40 lenders[1] left the Georgia market because of the law. The legislature has since repealed parts of GFLA and many lenders have returned.

While several lenders and secondary market participants lobbied against GFLA and announced intentions to leave the market early on, the critical blow to the new statute came when the three major credit rating agencies said they would not rate pools of mortgages that included Georgia loans. Without credit ratings, the MBS backed by pools including at least one Georgia loan would be shunned by many traditional investors such as pension funds or endowments that are only permitted to invest in "rated" securities. The secondary market, then, would likely stop purchasing these loans. The rating agencies called for revisions to clarify the circumstances under which assignees could be held liable and a reasonable limit on the damages borrowers could seek. The legislature recognized losing the secondary market as a funding source for the Georgia mortgage market would ultimately hurt Georgia borrowers by raising mortgage rates.

Aside from Georgia, rating agencies have also assessed the effect a law enacted in New York State would have on investors in pools that contained loans covered by the statute. The agencies concluded they would decide whether to rate such pools on a case-by-case basis so long as they only included a minimal amount of "high-cost" loans as defined by a law that became effective April 1, 2003. Even this relatively limited uncertainty will increase the cost of securitizing New York State loans, which in turn will put upward pressure on mortgage rates in that state. Ultimately, disrupting the secondary market for subprime loans will always hurt the subprime borrower in the form of higher interest costs and fewer borrowing opportunities.

If investors cannot be certain of the risk associated with investing in MBS because of the jurisdiction in which one of the loans backing the security was originated, they will demand a higher return. Under such a scenario, MBS will become less attractive as a

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[1] See *Georgia Rattles US Home Equity Market: State legislation to Protect Sub-Prime Borrowers is Threatening a Sector Worth $132 billion last Year*, by Jenny Wiggins, Financial Times, Feb. 13, 2003, p. 21.

source of mortgage loan funding. Subprime borrowers will face higher interest rates and less available credit.

Clarifying Assignee Liability

Under current law, civil actions brought against lenders for infractions of HOEPA may also be brought against an assignee of the lender if the violation is “apparent on the face of the loan document.”[2] An assignee or the purchaser of a mortgage will not be subject to the claims and defenses of the borrower if a “reasonable person exercising ordinary due diligence, could not determine” the mortgage was a high-cost loan under HOEPA .[3] Unfortunately, neither this standard nor subsequent court decisions have effectively settled the question of what “apparent on the face” means in practice. The recent Georgia and New York State laws compound this problem by creating still more standards for assignee liability.

The presence of loans originated using predatory practices in the pools of loans backing mortgage securities is not in anyone's best interest. Not only do predatory lenders target individuals with risky credit profiles, but the terms of predatory loans often promote default. The more defaults a MBS pool experiences, the less attractive the security becomes to investors. Securitizers of mortgages, then, have a clear incentive to eliminate from pools any loans they can identify that violate applicable predatory lending laws.

Though presently facing a court challenge, a recent New York City law seeks to employ the secondary market as *de facto* policeman by requiring an arbitrary level of due diligence on loan pools in order to escape liability for subprime lending violations. Complying with the due-diligence level set by this statute could significantly raise the cost of purchasing covered mortgages, which would increase borrower costs.

In many cases, such screening would simply be impossible. The bill requires assignees to determine whether subjective loan origination standards were met, such as whether the terms of a loan were misrepresented or whether the loan provides a “net tangible benefit” to the borrower. The purchaser of a loan cannot know what a lender told a borrower. Nor does the purchaser have unique insight into what type of loan or specific loan features are suitable for that borrower. Blanket assignee liability under these circumstances is unreasonable. Assignees have neither the opportunity to identify violations in advance of purchasing the loans, nor the ability to mitigate legal exposure once they do identify violations.

[2] 15 U.S.C. 1641(a)
[3] 15 U.S.C. 1641(d) 1

Nonetheless, this approach effectively holds assignees responsible for the conduct of lenders by threatening to void the assignee's interest in the loans they have purchased unless the arbitrary due-diligence level is met.

Preemption: The Need for a National Standard

Several other states and localities are pursuing—or have enacted—legislation similar to the new Georgia and New York laws. Not only are these initiatives unduly restrictive, but their substantive provisions are frequently inconsistent from one jurisdiction to another. This fragmented approach to legislating the parameters of "acceptable" and "unacceptable" subprime lending threatens to balkanize the subprime credit industry in the United States. The outcome might well be a return to the days of severely limited credit opportunity and significant regional and local disparities in credit availability for those who need credit most.

The development also presents a new compliance burden for lenders and secondary market participants. Multi-state lenders must constantly adjust lending practices and underwriting standards as new statutes with varying definitions of predatory lending emerge in different states. In some instances—Georgia, for example—lenders will choose to withdraw completely from the market for certain loans. In other cases, lenders may choose to adjust underwriting guidelines to minimize the chance of violating new standards. In doing so, subprime lenders run the risk of violating the federal Fair Lending Act, which prohibits the denial of credit under certain circumstances. This type of regulatory confusion only creates a disincentive for lenders to participate in the subprime market at all. The preservation of credit for borrowers in all markets is one of the strongest arguments available in favor of federal preemption of state and local predatory lending laws.

The Need for a National Standard for Assignee Liability

The Association believes clarifying the potential liability to which a secondary market participant can be exposed and making that standard applicable nationally, is the best way to stop predatory lending without disrupting the secondary market for subprime loans. Such an approach would strike a better balance between consumer protection and market forces than any state or local initiative enacted or introduced to date. We urge these committees to consider the need for preemptive legislation in order to ensure subprime borrowers enjoy continued access to credit that is reasonably priced and widely available.

Broad assignee liability provisions are not necessary to ensure that borrowers have remedies available to them in the event of a foreclosure on their home. Regardless of whether the original lender or an assignee holds a loan, if the loan was made on predatory terms, borrowers should have the right to make such a claim.

There can be no doubt predatory lending is a harmful practice with which no reputable part of the American financial industry wants to be associated. Threatening secondary market participants with assignee liability to enlist them as enforcers of acceptable lending practices, however, makes their participation in the market for subprime residential mortgage market largely untenable from an economic perspective. Withdrawing the liquidity provided by the secondary market will deny credit to thousands of subprime borrowers. The access tens of thousands of deserving borrowers once had to mortgage credit would be lost.

Placing the burden of enforcement of anti-predatory lending rules on the secondary market is bad public policy with consequences that are both undesirable and unnecessary.

Thank you again for the opportunity to testify on this important issue today.