

# CURRENT TRENDS IN FORECLOSURES AND WHAT MORE CAN BE DONE TO PREVENT THEM

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## HEARING

BEFORE THE

## JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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JULY 28, 2009

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## **CURRENT TRENDS IN FORECLOSURES AND WHAT MORE CAN BE DONE TO PREVENT THEM**

**TUESDAY, JULY 28, 2009**

CONGRESS OF THE UNITED STATES,  
JOINT ECONOMIC COMMITTEE,  
*Washington, DC.*

The committee met, pursuant to call, at 10:00 a.m., in Room 210, Cannon House Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

**Representatives present:** Maloney, Hinchey, Cummings, Snyder, Brady, and Burgess.

**Senators present:** Brownback.

**Staff present:** Gail Cohen, Nan Gibson, Colleen Healy, Justin Ungson, Andrew Wilson, Jeff Schlagenhaut, Jeff Wrase, Chris Frenze, and Robert O'Quinn.

### **OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK**

**Chair Maloney.** The committee will come to order.

Good morning. I want to welcome our distinguished panel of witnesses, and thank you all for your hard work and your testimony today.

Today, the Government Accountability Office released a study which I requested that looks at the performance of nonprime loans in every congressional district in the United States. This is a valuable report because it captures the national trends and also gives us data so basic we can see the effects on our constituents.

The default and foreclosure rates for these mortgages in my New York district are relatively low compared to the rest of the country, but rising foreclosures continue to inflict pain in communities across the nation.

Borrowers, lenders, governments and neighbors all pay the price for vacant houses that attract vandalism and increase crime, that destroy communities and burden local governments.

The map behind me gives us a snapshot of the mortgage crisis inherited by the Obama administration. The map highlights an important point: the pain of foreclosures is not being felt evenly across the United States. What we see are pockets of pain, more heavily concentrated in certain areas of the country, and the red or the darker color highlights where the foreclosures are, and they are primarily in the States of California, Florida, Illinois, Massachusetts, Nevada, and New Jersey.

Congress and the administration have undertaken numerous efforts to stem the tide of foreclosures. Key measures include incentives to servicers to modify loans in the administration's Home Affordable Modification Program and an expansion of eligibility to receive a low-cost FHA loan in Hope for Homeowners.

Additionally, Congress has allocated money to counselors to help homeowners get the information they need to be able to modify their loans. Today, Treasury and HUD are meeting with mortgage servicers in an effort to speed the pace of modifications which are not happening quickly enough.

Servicers may be swamped, but families are literally drowning.

I look forward to our witnesses' insights into how the current policies are working and any proposed changes that will help us keep families in their homes. The pockets of pain may be due at least in part to differences in house price appreciation or the local economy, but the problems may also stem from different lending practices throughout the country.

Earlier this month, the Joint Economic Committee held a hearing on predatory lending and the targeting of minorities for high cost loans. In that hearing, we heard testimony that States have had difficulty enforcing anti-predatory lending laws because of Federal preemption of those laws for nationally chartered banks. Fortunately, some state attorneys general, including my home state of New York, took an active role in pursuing abuses at nationally chartered banks. While our immediate efforts are aimed at turning back the current tide of foreclosures, it is just as important for us to realize how we got into this predicament and how we can prevent it from happening in the future.

Last week, the Federal Reserve Board of Governors proposed significant changes to regulation Z of the Truth in Lending Act ratcheting up disclosure requirements and altering compensation to brokers, ending any incentive to direct borrowers into more expensive products. The improved amendments to disclosure information for consumers will help consumers gauge the true cost of mortgages and compare different products.

Additionally, the Fed recognized if brokers have a financial incentive to steer borrowers into more expensive products, that improved disclosure may be ineffective. I am hopeful that these proposed changes will change the flawed misalignment of incentives between borrowers and brokers.

We must do all we can to keep families in their homes. I look forward to the testimony today from our witnesses. Thank you for being here.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 32.]

[The Government Accountability study titled "Characteristics and Performance of Nonprime Mortgages" appears in the Submissions for the Record on page 33.]

[The chart titled "Estimated Percentage of Seriously Delinquent Nonprime Loans by Congressional District" appears in the Submissions for the Record on page 90.]

I now recognize Senator Brownback for up to 5 minutes.

**OPENING STATEMENT OF THE HONORABLE SAM BROWNBACK, RANKING MINORITY MEMBER, A U.S. SENATOR FROM KANSAS**

**Senator Brownback.** Thank you very much, Chairwoman. I appreciate the hearing, and I appreciate the panelists being here. I ask that my full statement be included in the record. I am just going to summarize briefly.

We have got a deep recession going on, no question about that. We are now seeing unemployment rates continue to inch up. We are seeing a lot of people not being able to service the mortgages that they got. It is a very difficult situation.

I think the key thing we need to focus on is getting unemployment rates down. That is the item that we need to do. I grow concerned that we may look at doing things that can be harmful in the longer term, such as modification in bankruptcy and cram down provisions and things like that that will actually end up driving interest rates up on individuals seeking to get a mortgage or to get a loan.

I am also concerned that some of these rewritings of mortgages, they are not moving very fast. We should note that, according to a June report of this year by the Congressional Budget Office, while \$50 billion of TARP funds have been committed to the Administration's foreclosure mitigation plan, the Treasury has not yet disbursed any of the funds allocated as of June 17, 2009, for foreclosure mitigation. None of them.

I think if we are going to have an impact here, these funds need to be used and put forward. I have noted that a number of mortgages that were modified in the first two quarters, close to 50 percent of the loans modified in the first two quarters of 2008 were in default again 9 months after the modification. Now, you can look at that and say 50 percent of them made it, and that is a good thing, at least through that 9 months. My guess is that the group that didn't make it, there was also something that happened in the employment market to one or another of the occupants, if it is a married spousal situation, that was there.

My point in saying these things is I think we need to keep our eye on the ball here. And the key piece of this being we have got a mortgage mitigation program that is out there. Let's get that going. Let's work aggressively on getting unemployment rates down by getting the economy going again.

I thought some of the provisions that were done that would stimulate the economy are ones that could help us get these unemployment rates down. What I am hearing from a number of my institutions back home, I met with some credit unions about 2 weeks ago, they were saying that people are turning their car keys over to them even while they are still paying for the car while they are current in their car payments because somebody in the family has lost their job. They are looking at the income stream, and they are saying I know I am current on this car payment, but I can see what is coming down the road and I want to give you the car back now. I know I am going to have to pay the difference, but maybe you can get it sold quicker, and my situation is deteriorating. I just think we have to keep a manic focus on these unemployment rates because that is the key in this whole picture here, particularly on

mortgages and mortgage foreclosures. Because if people don't have the income stream, they are not going to be able to afford what they have committed that income stream to. I hope we can focus on what we need to do to get that unemployment rate down.

Thank you for holding the hearing.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 91.]

**Chair Maloney.** Mr. Cummings.

**OPENING STATEMENT OF THE HONORABLE ELIJAH E.  
CUMMINGS, A U.S. REPRESENTATIVE FROM MARYLAND**

**Representative Cummings.** Thank you, Madam Chairman. I want to thank you for calling this hearing and thank our witnesses for being here.

As I listened to Senator Brownback, I could not help but think about an event that we held in my district about a month and a half ago where we had a thousand people show up, all of whom were losing their homes. We were able to help at least 4- or 500 of them, if not more, because we were able to put the borrower together with the lender and they were able to sit down and work out things.

The fact is that, you know, I too believe that we need to address this unemployment problem. But as I told my constituents, one out of every 10 who was losing their house, by the way, the question is what will happen. And I told them we will get through this downturn, but the question is who will be living in their house after it is over. Who will have their job. Will their company even exist.

I think that we have to get through this storm. So the fact is that we have got to, I think going back to what Senator Brownback said, one of the things that we have got to do is we have got to do what the President's people are doing today, and that is get to these lenders and say, number one, you have got to hire the personnel that you need because what we found, one of the biggest problems is that when people call, they can't get anybody on the phone. While we have been bailing out the banks big time, they ought to be able to find somebody to answer the phone.

Two, we have discovered that a lot of times when folks try to get these modifications, that they just could not—they were basically put on a stall plan. In other words, they were told you don't have to make any payments right now, we will try to work it out for you. While they are waiting to get it worked out, they are falling more and more in debt. And the next thing you know, by the time the lender comes back and says we are not going to modify, then they are really in bad trouble.

I think we have to have some practical solutions to this. The research has shown that borrowers can be separated into three categories, and this is according to *The Post* this morning. It says those delinquent borrowers who will self-cure or catch up on their loans, even without a modification, those borrowers, that despite a mortgage modification, will end up in foreclosure anyway, and those borrowers who cannot make their current payments but can keep up with a lower modified payment.



It seems as if the lenders, and understandably, according to *The Post* this morning, are more concerned, only concerned about those folks who with a modification can work it out. What I proposed in legislation is a bill which would give short-term loans to folks over an 18-month period. Hopefully, they will be able to find a job and do what Senator Brownback just talked about, that is, get this economy back going, but it seems to me if you have a bucket of people who are going into foreclosure every day, and you have got empty houses, you have got folks, vultures coming along and picking up those houses for cheap prices. In my neighborhood, there is one house that is going for one-sixth of what the other houses are valued at.

Everybody's property values are going down. It seems to me we need to do something to stop that hemorrhaging. It is one thing to do something for Wall Street, but it is another thing to do something for the very people who have supplied the very money that we have used to bail out Wall Street. My constituents are saying, "You are using my tax dollars to bail out Wall Street, what about me? What about me?"

And they are saying that if the TARP funds have been paid back and the banks claim to be well, and they have paid back some \$68 billion, why not help some folks who are under stress. I am interested to hear your solutions to this problem.

The last thing I think we can do is turn our heads to our constituents, and the chairman pointed out this map because for every one of these people, they don't want to hear wait, wait, wait because they won't have a house. They won't have anywhere to live. It is not just about them, it is bigger than them. It is about their children and it is about transferring wealth and it is about generations yet unborn.

Thank you, Madam Chair. I yield back.

**Chair Maloney.** Thank you.

Mr. Brady.

#### OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

**Representative Brady.** Thank you, Madam Chairwoman. I am pleased to join you in welcoming the witnesses testifying today.

There have been a number of policy blunders during the last 20 years that have inflated an unsustainable housing bubble.

On a macro level, the Federal Reserve pursued an overly accommodative monetary policy for far too long after the 2001 recession. This policy, along with huge capital inflows rising from international imbalances, kept long-term U.S. interest rates far too low during much of this decade.

On a micro level, both the Clinton administration and Bush administration pursued a broadly supported national home ownership strategy, and increased the home ownership rates among historically disadvantaged groups.

After 1992, Federal officials pressed commercial banks, thrifts and mortgage banks to weakened loan underwriting standards, to reduce downpayments, develop exotic loan products such as interest only and negatively amortizing loans to help low income families qualify for mortgage loans to buy homes.

After 2000, Fannie Mae and Freddie Mac spurred the explosive growth in subprime mortgage lending by purchasing millions and millions of dollars of privately issued subprime mortgage backed securities. As in previous bubbles, unfortunately, swindlers took advantage of the unwary as the housing bubble neared its zenith. On the one hand, some home buyers misled lenders about their income and net worth to secure mortgage credit to speculate in housing.

On the other hand, some builders and lenders deceived home buyers about the obligations they were assuming. The housing bubble burst in July 2006. House prices have subsequently fallen by 32 percent, according to the S&P price index. Fallen housing prices create uncertainty about the value of mortgage backed securities that triggered a global financial crisis and the subsequent recession.

As history proves time and time again, good intentions do not necessarily produce good results. Today many Americans, especially historically disadvantaged families that Federal officials intended to help, are suffering. Interest resets on adjustable rate mortgage loans, falling housing prices that make refinancing difficult or impossible, and a rapidly escalating unemployment rate caused many families to fall behind on their mortgage payments, to default, and face a possibility of foreclosure.

Consequently, home mortgage loan delinquency and foreclosure rates are ballooning, a cascade of foreclosures may have serious negative externalities, dumping millions of foreclosed homes on the market may keep housing prices depressed for years, reducing household wealth, upending the budget of localities that depend on property taxes, and muting any economic recovery.

On February 18 of this year, President Obama announced the making home affordable initiative to refinance or modify existing mortgage loans to prevent unnecessary foreclosures. So far, neither this initiative nor earlier programs under President Bush have produced significant results. For example, the Hope for Homeownership Program enacted in 2008 helped only 25 homeowners through February of this year. About 4,000 loans were refinanced through the FHA secure program that expired late last year, and only 13,000 loans were modified under the FDIC's conservatorship of IndyMac.

Given the enormity of the home foreclosure problem, I look forward to hearing from our witnesses today about what can be done effectively to ameliorate it.

I yield back.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 92.]

**Chair Maloney.** Mr. Hinchey.

**Representative Hinchey.** Thank you, Madam Chair. I am very anxious to hear what our friends are going to say.

Mr. Cummings made the points I would make, and I very much appreciate him for doing it and the way he did it, so I am just going to pass on and hope we can get into the hearing.

**Chair Maloney.** Now I would like to introduce our panel of witnesses.

Dr. William Shear is director of financial markets and community investment Government Accountability Office. He has directed substantial bodies of work addressing the Small Business Administration, the Federal Housing Administration, regulation of the housing GSCs, the rural housing service and community and economic development programs. Dr. Shear received his PhD in economics from the University of Chicago.

Dr. Susan M. Wachter is the Richard B. Worley professor of financial management and professor of real estate and finance at the Wharton School at the University of Pennsylvania. Dr. Wachter served as assistant secretary for policy development and research at HUD under President Clinton. She served as president of the American Real Estate and Urban Economic Association, and was co-editor of Real Estate Economics. She is codirector of the Penn Institute for Urban Research and director of the Wharton Geospatial Initiative.

Dr. Keith Ernst is director of research at the Center For Responsible Lending. He has published research predicting the subprime foreclosure crisis in 2006, examining the relative cost of mortgage lending by delivery channel and on evaluating the effectiveness of State regulations in the subprime mortgage market. He holds both a law degree and a graduate degree in public policy studies from Duke University.

Dr. Joseph Mason is the Herman Moyse Jr. Louisiana Bankers Association endowed professor at the Louisiana State University and senior fellow at the Wharton School, and a financial industry and monetary policy consultant. He also formerly taught at Georgetown University and Drexel University, and before that was a financial economist at the Office of the Controller of the Currency in Washington, DC.

**Chair Maloney.** Welcome to all of our panelists. Would you begin Dr. Shear for 5 minutes.

**STATEMENT OF WILLIAM SHEAR, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE**

**Dr. Shear.** Chairman Maloney and members of the committee, it is a pleasure to be here today to discuss our work on the state of the nonprime mortgage market. My statement today is based on a report being released at this hearing. As we all know too well, non-prime loans accounted for an increasing share of the overall mortgage market from 2000 through 2006. Throughout this period, an increasing proportion of subprime and Alt-A mortgages had loan and borrower characteristics that have been associated with a higher likelihood of default and foreclosure.

After the surge in volume, in the summer of 2007, the subprime and Alt-A market segments contracted sharply, partly in response to a dramatic increase in default and foreclosure rates for these mortgages.

With respect to loan performance, serious delinquency rates were highest for subprime loans and certain adjustable rate mortgages. In addition, these rates varied by State as shown on the displayed map. Approximately 1.6 million of the 14.4 million nonprime loans

originated from 2000 through 2007 had completed the foreclosure process as of the end of this March.

Of the 5.2 million loans that were still active at the end of March, that is, that had not been prepaid or completed the foreclosure process, almost one quarter were seriously delinquent, meaning that they were either 90 or more days behind in payments or already in the foreclosure process.

Serious delinquency rates were especially high for certain adjustable rate mortgages. For example, in the subprime market, the serious delinquency rates for short term hybrid ARMs, which feature a fixed interest rate for two or three years and an adjustable rate thereafter, was 38 percent as of the end of March.

In the Alt-A market, the serious delinquency rate for payment option ARMs, which allow borrowers to make payments lower than needed to cover accrued interest, was approximately 30 percent. At the state level, California, Florida, Illinois, Massachusetts, Nevada, and New Jersey had the highest rates. Each state had serious delinquency rates above 25 percent, and Florida's rate of 38 percent was the highest in the country. In contrast, 12 States had serious delinquency rates of less than 15 percent, including Wyoming's rate of 9 percent, which was the lowest in the country.

We also looked at loans originated from 2004 through 2007, so a segment of this entire period we looked at. These loans from these more recent years—what we call cohort years—accounted for the majority of troubled loans. This trend is partly attributable to a stagnation or decline in home prices in much of the country beginning in 2005, and worsening in subsequent years. Of the active subprime loans originated from 2000 through 2007, 92 percent of those that were seriously delinquent as of the end of March were originated during this shorter period between 2004 and 2007.

Furthermore, these loans made up 71 percent of the subprime mortgages that have already completed the foreclosure process. Our full report provides additional information on the performance of nonprime loans. In two subsequent reports at the request of this committee, we will provide additional information on the condition of the nonprime mortgage market. These reports will include examinations of the extent of negative home equity among nonprime borrowers and the influence of different loan, borrower and economic variables on the likelihood of default.

It is a privilege to appear before this committee. I would be glad to answer any questions.

[The prepared statement of William Shear appears in the Submissions for the Record on page 93.]

**Chair Maloney.** Thank you very much.

Dr. Wachter.

**STATEMENT OF SUSAN WACHTER, PROFESSOR, FINANCE AND REAL ESTATE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA**

**Dr. Wachter.** Chairman Maloney and members of the committee, thank you for the invitation to testify at today's hearing.

Today, according to the MBA, the foreclosure rate is 4 percent, four times the historical average and the highest it has ever been since the Great Depression. It is fair to say, despite considerable

efforts to date, the Federal Government has failed to stem the foreclosure crisis. While much has been done and more can be done, there is a fundamental problem that is difficult to address with policy initiatives. The problem of foreclosed homes and mortgages in default started in a wave of foreclosures of subprime loans. In the coming years, there will be another wave of foreclosures, in part due to the recasting of payment option mortgages. These, and other complex, nontraditional mortgages, were a very small part of the market until they grew at an alarming rate starting in 2003. By 2006, they were almost half the total volume of mortgage originations.

As these untested, seemingly affordable but unsustainable mortgages were originated, they fueled an artificial house price boom which inevitably collapsed.

While the initial source of the problem was recklessly underwritten nontraditional mortgages, the asset bubble this created, the artificially and unsustainably inflated house prices, has been and is now a problem for many who borrowed for homes in the years 2004 and later. Homeowners who borrowed conservatively, putting 20 percent down and using tried and tested mortgages with steady mortgage payments, are in trouble. If they must sell due to job loss, for example, many of these owners who purchased at inflated prices will be forced into foreclosure.

Americans are now increasingly threatened with loss of their homes and their jobs, and the problem will get worse before it gets better.

The chart that is before you shows the growth in foreclosures and the decline in house prices, demonstrating the role of plummeting house prices in the worsening foreclosure problem. The current rate of 4 percent is expected to get worse, with an additional million homes in foreclosure by the end of year.

As average home prices fall for more and more households, and with the increase in the supply of foreclosed homes on the market, the amount for which they could sell their homes will increasingly be less than what they owe on their mortgages. A loss of a job, illness, or a sudden increase in required mortgage payments will force owners to sell and will force foreclosure.

Today, the threat of a job loss is worsening and there may well be an increase in mortgage payments due for option ARMs in the coming years.

Are there additional steps we can take to mitigate the crisis? The crisis will abate when home prices stop falling. But, in fact, home prices are still falling although the rate of decline is decelerating. They will continue to fall until fundamentals turn around. The key fundamental factor is unemployment, thus the importance of fiscal stimulus. It is also critical that mortgage rates remain affordable, thus the importance of continuing Federal support for the FHA and the GSEs, and the maintaining of historically low mortgage rates.

In addition, it is important to stem excess foreclosures which are adding to the forces driving home prices down in an adverse feedback loop.

Losses upon foreclosures are extreme. However, if mortgage amounts due exceed home values, loan modifications based on low-

ering or postponing interest rate payments alone may not be able to stem the growing foreclosure problem.

The administration's HAMP plan is attempting to address the lack of incentives and capacity of mortgage servicers to respond to the foreclosure problem. A recently issued GAO report has suggestions. And, in fact, the administration is convening a meeting today to encourage further efforts.

In addition, it would be useful to implement, as suggested in the University of Pennsylvania IUR Task Force Retooling HUD report, and for which I believe there is legislation, monitoring of the progress of the HAMP program, especially spatially since there is, as the map GAO put in front on you, an important spatial component to the problem.

Further loan modifications through principal write downs may be necessary. This involves marking mortgages, especially second mortgages, to market.

The financial system that triggered the crisis encouraged the production and securitization of uneconomic loans which eventually brought the system down. As I have written elsewhere, private label securitization failed, as did the markets, basically because securitization was not subject to market discipline.

Is a less pro-cyclical financial system an achievable goal? I have written with co-authors and wish to enter in the record an article which addresses the underlying failure of the regulatory market structure. There we address the incentives to dismantle lending standards and the artificial housing boom which made it seem that loans being made were safe when they were lethal.

Going forward, regulatory supervision needs to be put into place to prevent this.

Thank you.

[The prepared statement of Susan Wachter appears in the Submissions for the Record on page 103.]

[The article titled "Systemic Risk and Market Institutions" appears in the Submissions for the Record on page 105.]

**Chair Maloney.** Thank you very much.

Mr. Ernst.

#### **STATEMENT OF KEITH ERNST, DIRECTOR OF RESEARCH, CENTER FOR RESPONSIBLE LENDING**

**Mr. Ernst.** Good morning, Chairwoman Maloney and Ranking Members Brownback and Brady and members of the committee.

Thank you for your continued efforts to address the foreclosure crisis, and for the invitation to participate today.

I serve as director of research for the Center For Responsible Lending, a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit, community development financial institution that has provided over \$5.6 billion of financing to 62,000 low wealth families, small businesses, and nonprofit organizations in North Carolina and across America.

Before summarizing our research, it is worth a moment to reflect on the devastating consequences of the foreclosure crisis. An estimated 13 million mortgages will have been foreclosed by 2014. One

out of ten mortgagors is currently delinquent. Tens of millions of homes near foreclosed properties have suffered a decrease in value resulting in hundreds of billions of dollars of lost wealth.

Although many factors are important in today's crisis, risky subprime loans have been a central concern. Empirical research shows that these loans carried an inherent and excessive risk. This risk was driven both by the terms of the loans and by the conditions under which they were made. In other words, substantial risk was part and parcel of the subprime market irrespective of borrower qualifications. In 2006, the Center published a projection that one in five weakened subprime loans would end in foreclosure, a projection that was derided at the time as pessimistic but actually has turned out to be an underestimate.

A complementary 2008 study that we undertook with researchers from the University of North Carolina also found that subprime loans were risky products. This report showed that subprime loans were three times more likely to fail than lower cost, primarily fixed rate mortgages made to comparable borrowers. The study also found that subprime loans with adjustable interest rates, prepayment penalties, and those made through a broker were riskier. In fact, when these factors were layered into the same loan, the risk of default was four to five times higher on subprime mortgages.

Finally, CLR published research demonstrating that lower credit score borrowers who obtained their loan through a mortgage broker paid significantly more than their counterparts who dealt correctly with lenders. In a related development last week, we were pleased to see the Federal Reserve announce a proposal to eliminate the yield spread premiums that we believe were at the heart of these disparities. Notwithstanding this development, and in light of our research, Congress should take additional steps to prevent reckless lending that could once again fundamentally disrupt our economy.

Most importantly, we urge you to support the consumer financial protection agency embodied in H.R. 3126. The measure would consolidate the consumer protection that is already currently scattered across different agencies and create a single agency with the sole mission of protecting families and, by extension, our economy. The agencies currently charged with this mission were warned early and repeatedly about the dangers of subprime mortgages, yet, not only did they fail to act to protect consumers, but in many instances they frustrated State consumer protection efforts as well.

It is also imperative to pass legislation that would require sensible and sound underwriting and prevent abusive loan practices that contributed to reckless and unaffordable home mortgages. H.R. 1728 represents a good start to this end.

Finally, we urge Members to take further action to help save the homes of the millions of families facing impending foreclosure. As part of this effort, we must closely monitor and evaluate opportunities to improve the Administration's home affordable program. At the same time, we strongly believe that no voluntary program will be effective until there is a backstop available to homeowners. For that reason, we are pleased to see that Congress is beginning to revisit the need to permit judges to modify mortgages in bankruptcy court as a last resort.

Thank you again for your invitation to appear today. I look forward to your questions.

[The prepared statement of Keith Ernst appears in the Submissions for the Record on page 120.]

**Chair Maloney.** Thank you.

Dr. Mason.

**STATEMENT OF JOSEPH MASON, PROFESSOR OF FINANCE,  
LOUISIANA STATE UNIVERSITY**

**Dr. Mason.** Thank you, Madam Chair and committee members, for inviting me to testify today. I have submitted a more detailed paper I would like to ask to be included as part of the record. What follows is a summary of that work.

Recent history of servicing is rife with examples of subprime servicer problems and failures resplendent with detail on best and worst practices. The industry has been through profitable highs and predatory lows, over time reacting to increased competition with greater efficiency.

But intensively customer service-based enterprises, such as servicing, are hard to evaluate quantitatively so that proving a servicer's value is difficult even in the best business environment. Unfortunately, today's is not the best business environment. So proving servicer value has now become crucial to not only servicers' survival, but the survival of the market as a whole.

There are seven key reasons why servicers are facing difficulty with today's borrowers. First, modification is expensive.

Second, the arrearages that servicers have to pay to investors are a drag on profits.

Third, modifications and defaults mean that mortgage servicing rights values decline for servicers.

Fourth, increased fees are only a partial fix.

I wrote about these in the fall of 2007. Many have been addressed in recent administration proposals. But, as congressman Cummings mentioned, when servicers have their business threatened, employees and the expertise they bring flee. Reduced servicing staff, particularly with respect to the most talented employees that have other options, will have a demonstrably adverse effect on servicing quality. And, indeed, has had that effect.

So most importantly, what we need to pay attention to now is that servicer bankruptcy creates very perverse dynamics. While most securitization documents stipulate a transfer of servicing if the pool performance has deteriorated, or if the servicer has violated certain covenants which are expected to generally precede bankruptcy, the paucity of performance data makes it difficult for the trustee or the investors to detect servicer difficulty prior to bankruptcy, to make the change, and get servicing to someone who can carry it out effectively and efficiently, and modify loans effectively and efficiently.

Default management is much more art than science. While modifications can be a useful loss mitigation technique when appropriate policies and procedures are in place, servicers that are unwilling or unable to report the volume, type and terms of modifications—and there have been many—to securitized investors or regulators may be poorly placed to offer meaningful modifications.



The main drawback, therefore, with current policy is the industry can use modification to game the system and investors are wary of that. Some servicers are taking advantage of both borrowers and securitized investors, and I think it makes sense to incentivize the securitized investors to help promote more modifications where economically meaningful.

There are four major reasons for investor concern. First of all, and this has been well known since the late 1990s, aggressive re-aging makes delinquencies look better than they really are. Re-aging is the process by which you declare a loan to be current once again after it has been in default. Investors know that redefault rates on modified loans are high, approaching 80 percent, so calling the modified loan current again immediately is disingenuous at best.

Second, aggressive representations and warranties also skew reported performance. At their best, representations and warranties help stabilize pool performance. At their worst, representations and warranties inappropriately subsidize the securitization. In practice, it is difficult to decompose the difference between stabilization and subsidization, and we need to pay attention to that.

Third, re-aging and representations and warranties are used to keep deals off their trigger points that would lock servicers out of the value of the subordinate pieces of the securitization they hold. Residual holders, nee servicers, continue to push for lowering delinquency levels no matter how artificially in order to maintain positive residual and interest only strip valuations that keep the servicer out of insolvency. Triple A class investors are, therefore, at the mercy of servicers who are withholding information on fundamental credit performance through modification.

Fourth, current private sector industry reporting doesn't capture even these most basic manipulations. Servicers that utilize unlimited modifications or modifications without appropriate controls can end up necessitating greater credit enhancements in securitizations to maintain credit ratings, whether because of servicer capabilities or the possibility for maintaining this residual value by delaying step down in the securitization by skewing delinquencies.

These problems are all well known. The State foreclosure prevention working group's first report in February 2008 acknowledged that senior bond holders fear that some servicers, primarily those affiliated with the seller, may have incentives to implement unsustainable repayment plans to depress or defer recognition of losses in the loan pool in order to allow the release of over-collateralization and, therefore, value to the servicer themselves. This is a clear conflict of interest that I think can be rectified in the next iteration of policy-making in this regard.

Regulators can, therefore, do a great service to both industry and borrowers in today's financial climate by insisting that servicers report adequate information to access not only the success of major modification initiatives, but also performance overall. The increased investor dependence on third-party servicing that has accompanied securitization necessitates substantial improvements to investor reporting in order to support appropriate administration and, where helpful, modification of consumer loans in both the private and the public interest. Without information, though, even the

most highly subsidized modification policies are bound to fail. Thank you.

[The prepared statement of Joseph Mason appears in the Submissions for the Record on page 126.]

**Chair Maloney.** Thank you very much for your testimony.

**Chair Maloney.** First, I would like to ask all of the panelists to respond to the article that was on the front page of The Washington Post today on foreclosures saying they are often in the lenders best interests. It says in many cases, there is a financial incentive to let borrowers lose their homes rather than work out a settlement that some economists are putting forward.

Dr. Shear, would you like to respond? And Dr. Wachter, you referenced it in your statement earlier. Dr. Mason, how it impacts securitization, your point of changing the law is a relevant one.

Dr. Shear.

**Dr. Shear.** I would like to comment on it, not directly, but I want to make reference to, as many of you know, we issue reports on the TARP program every 2 months. The last one was issued last week.

When I read this article, I see it through the lens of our last TARP report which dealt with the HAMP program.

We realize the enormity, as Treasury does, and the challenges of running this program, and we have made a number of recommendations. The HAMP program has a lot of incentive payments to try to get servicers, borrowers, and investors to come together to resolve, to modify certain mortgages. And so I see it through our lens as an audit agency that we think that Treasury really has to develop a strong system of internal controls to ensure that the different parties are taking the actions that the incentives are supposed to provide to them.

**Chair Maloney.** Thank you.

Dr. Wachter.

**Dr. Wachter.** I haven't read the article, but I have heard it references a Boston study. All economics studies rely on assumptions, as this one does, so they must be tested for the validity of their conclusions.

Nonetheless, it is absolutely true that lenders individually often do have the incentive to foreclose. It is often the economic solution for lenders individually, when it is not for lenders in the aggregate. If lenders foreclose, adding foreclosure supply, this further drives down prices, leading to further foreclosures. This is why it is a collective problem and why we need to address it from a policy perspective.

I agree with the comments of my colleagues on the panel regarding the need for reporting and monitoring.

**Chair Maloney.** Mr. Ernst.

**Mr. Ernst.** Building off that answer, it is true that foreclosure starts continue to outpace modifications. In a sense we are falling behind with each passing month. The modifications that have been done in the recent past have not always been as helpful as they could have been. I think some of the data that went into that article reflected modifications before the Administration's program went into effect, for example, and there are reasons to believe there are more opportunities than that article suggests.

To the extent that article is raising the concern that not every borrower can be helped, certainly that will be true. But I think what that article also stands for is that much more can be done to help borrowers avert needless foreclosure, to relieve the pressure on declining housing prices and to help turn communities around that currently are being devastated by the foreclosure process.

**Dr. Mason.** Thank you for the question. It is an important one. It is an issue that I originally brought up in my October 2007 paper that not everyone is suited for a modification. A borrower has to want a modification and be able to afford a modification. I was led to this conclusion by working with members of NACA in Boston who had a very successful community-based modification effort.

I think that the figures that you are seeing in that article are suggesting that, because of the substantial number of redefaults, you can most likely expect to go through the foreclosure process anyway. So now you add to the cost of the modification to the cost of the foreclosure that you do anyway; and of course, the total cost of the two becomes greater than the cost of just foreclosing in the first place.

So I think we are overextending modification perhaps, expecting too much out of modification programs.

Can it help? Certainly.

Is it the entire solution? No.

As Dr. Wachter mentioned, we do have a collective problem that comes down to the inventory of real estate on the market right now that is suppressing home prices. When we have builders publicly announcing that they are going to continue to build now new smaller homes that compete directly with the price of foreclosed homes on the market, we have an even worse inventory problem and can expect more down the road.

This introduces what some other members have talked about today, an interplay between employment and housing. If you are looking to keep up construction to maintain employment—by building more houses, that adds to the inventory that suppresses housing values. I think you are going in a circle and you need to stop that exercise at some point.

**Chair Maloney.** Thank you.

Senator Brownback.

**Senator Brownback.** Thank you.

Dr. Wachter, you were noting in here we have four times the historical average of foreclosures taking place, which is a horrific level, and I think everybody is pointing out the problems that led to it. I really do believe from this point on forward we need to make sure money is available to buy houses, maybe we incentivize the repurchasing of houses would be a good thing as well because you try to get people into the marketplace to get some of the depressed housing prices off, but that unemployment is going to be the key figure for us to be watching from this point on forward. I may be off on that, but I would like to know if you, or maybe Dr. Shear knows this, is there a correlation that we have seen historically between unemployment rates over a period of time and foreclosure rates, that we could have some predictability or thought as

to where these foreclosure rates go if we get to a 10 percent unemployment rate into next year, as some are predicting?

**Dr. Wachter.** Yes, Senator, there is literature that links unemployment to foreclosure. Indeed, it suggests as unemployment worsens, foreclosures will increase. I would be pleased to provide some of the formulas that specifically link unemployment and foreclosures.

**Senator Brownback.** Is there a rule of thumb? Do we have any sort of rule of thumb on unemployment rates over time and foreclosure?

**Dr. Wachter.** The reason there is not a rule of thumb is because there is an interactive variable which is home price declines. It is the combination of home price declines and unemployment, so it is not simply linearly related to unemployment.

**Senator Brownback.** So as your price declines continue, and unemployment rates go up, the number of foreclosures go up by some factor?

**Dr. Wachter.** That is correct.

**Senator Brownback.** So we could expect this four times historical average to go up as unemployment goes up, but as the housing market flattens, you were noting that the housing market flattens.

**Dr. Wachter.** Before the flattening, we still have home prices declining. We do expect that 4 percent rate to increase.

**Senator Brownback.** To what?

**Dr. Wachter.** This is unknowable, since we don't know how much prices will fall and we don't know how much unemployment will increase. But nonetheless, estimates out there are that the foreclosure rate could go as high as 5 or 6 percent. Others on this panel probably have other estimates.

**Senator Brownback.** Let me continue that line of questioning. We are going into next year with a higher unemployment rate next year as unemployment trails economic recovery. So does that rate continue to go up through next year?

**Dr. Wachter.** Yes, I believe so.

**Senator Brownback.** Have you seen any estimates on that?

**Dr. Wachter.** Again, the estimates vary. The consensus estimate is north of 5 percent.

**Senator Brownback.** Dr. Shear, do you have a comment or thought on this?

**Dr. Shear.** For the most part, I will defer to Dr. Wachter and the other panelists. I will just point out in the report that we issued last week, there were some statistics provided on changes in unemployment rates in different States in the country and impacts on housing. So there are some simple statistics in that report that might be useful.

**Senator Brownback.** So those are higher in the States where you have high unemployment rates, and higher or more of a decline in housing prices, correct?

**Dr. Shear.** Yes. There is a higher level of serious delinquencies and foreclosures in States with declining home prices and with—we did it based on increases in unemployment rates in those States. So we have some statistics that provide a map with that kind of information.

**Senator Brownback.** So what are we looking at the highest foreclosure rates projections into next year in the worse situations in the country?

**Dr. Shear.** We haven't projected, so I can't really address that.

**Mr. Ernst.** If I might, unemployment is certainly a critical element of this foreclosure crisis that we are in. But I think we shouldn't lose sight of what makes this foreclosure different. In the boom years of subprime lending in 2005 and 2006, subprime loans accounted for one in every five mortgages being originated. In many, many instances these mortgages were made without due regard of the ability of the borrowers to repay. So this crisis, unlike the crises that have developed some of these formulas that help us understand the important relationship between unemployment and housing prices, has this added layer of inherent risk in the outstanding loan pool. I think that is an important additional dimension.

That is why it is critical that modification efforts be pursued to their ultimate because these borrowers are not governed just by the natural laws or the economic laws that have been driving research to date, but have this added layer of risk that they are challenged by.

**Senator Brownback.** It seems like that was the dynamite cap, a big one, and it has exploded the rest of it.

I would appreciate, Dr. Wachter, the formula, if you could, if you can get that in to us. Thank you.

**Chair Maloney.** Thank you.

Mr. Cummings.

**Representative Cummings.** Following up what you just said, we are finding now that a lot of prime, and I think you may have said it, prime borrowers are being foreclosed upon?

**Mr. Ernst.** Certainly foreclosure and delinquency rates are up across the board. I think it is a little difficult in some of the prime data to tease out which are the contributions from prime mortgages and which are the contributions from Alt-A mortgages, a segment that is also detailed in the GAO report that we are getting to see today. But certainly it is true, it is undeniable that rates are up in every mortgage segment. That is true.

**Representative Cummings.** When we look at this map, Dr. Wachter, it is interesting when you look at this map, when you look at the middle of the country, they have the lowest foreclosure rates, and then you look at these other States, Florida and California and so on with the highest, so is it safe to say, and I remember many months ago now when Bernanke came before us, this committee, and they talked about, we were talking about this whole idea of foreclosure and he and others kept saying, Well, it is spotty. You have some foreclosures in some States but you don't have them in others and it is going to work out, basically. This was awhile back now.

I am wondering, does this mean likely in these States, following up on what Senator Brownback was talking about, does this mean that these are likely high unemployment States and rapid decline in value of property States? Do you follow me?

**Dr. Wachter.** Yes, that is exactly right. They are both.

**Representative Cummings.** So how do we get here though? That's what I am trying to figure out. This is a lot of yellow, yellow being the least, the States that are better off. And so they were doing something different.

**Dr. Wachter.** Yes, that is correct.

**Representative Cummings.** What were they doing?

**Dr. Wachter.** This is a continuation of Mr. Ernst's point. The mortgages that were originated in states shown in the deeper colors like red were these nontraditional mortgages. So they had a larger share of the market, therefore causing artificially high housing prices at which homeowners today can no longer sell. That problem is pervasive in these States with high foreclosure problems. These are where the nontraditional mortgages were disproportionately originated. By the way, unemployment rates are also higher in these areas, in part because of the extremity of the housing crisis.

**Representative Cummings.** So the Obama administration has put out I will call it a tool kit to try to deal with foreclosure. As I said a little earlier, in my district when we were able to put the borrower together with the person, with the lender, we were able to get some results. The question becomes is there something, other tools that need to be in this kit? And what would they be because right now people are drowning in foreclosure. Listening to the statistics you all just announced, it looks like we are heading toward a worsening condition come next year, if not before. So what are the tools that you would put in that tool kit, if any? Dr. Wachter, and then I will get to you, Dr. Mason, if I have time.

**Dr. Wachter.** Counseling is critical. The GAO report suggests that HUD should monitor that the counseling is occurring.

Secondly, it is extremely important to monitor the progress and to look servicer-by-servicer at that progress.

Third, we must look at second liens. Second liens are indeed a problem, and having the cooperation of the owners of the second mortgages is key to finding a solution to this problem.

**Representative Cummings.** Dr. Mason.

**Dr. Mason.** You have to keep in mind in some of those regions that you have a heavy reliance on pay option arm loans with unnaturally low payments. Those loans help payment affordability, not price affordability.

In those regions as well, you have a lot of investor properties. In reviewing the operations of several large mortgage origination firms, myself and other experts have established that the labels "prime" and "Alt-A" assigned by the originator, mean nothing. The originator has a separate internally classified area that is called "stealth prime" or "shadow prime" or "stealth Alt-A" which really weren't Alt-A or prime, but could look like Alt-A or prime loans from the outside if the lower monthly payments offset the borrowers' lies about their income.

Part of the reason originators did that was because the borrower would have four, five, six, I have seen 25 investor properties. Such an owner has no interest in residing in the house. They were hoping to ride the bubble; 24 of those homes are going to be into foreclosure, there is nothing you can do about that.

But in these regions in particular in red, what you saw was aggressive expansion to the frontier of the urban area. In many of these places you have developments literally in the middle of nowhere, 2½ hours outside the city center with no easy access to roads or transport to integrate them in the rest of the urban area. The idea was to build on spec. Build it and they will come. There is nothing there now. There is farmland around it, and no reason to be there. Other spec building was done in the inner city converting neighborhoods that were formerly disadvantaged into viable housing. So the same effect is happening. Again, there is no desire to live there once the house goes into foreclosure.

I think part of the way out here is the fundamental aspects of the Community Reinvestment Act that we talked about years ago of rebuilding communities, not just focusing on the individual home, but giving a person a reason to live there, in fact giving a group of people a reason to live there, which builds community and builds value to the home.

**Representative Cummings.** Thank you very much.

**Chair Maloney.** Mr. Brady.

**Representative Brady.** Thank you, Madam Chairwoman. When you look at this map, clearly there are areas in the Northeast and others that are economically distressed. But you also see, especially California, Florida and Nevada, the result of speculation. I have an acquaintance who, sadly, told me he has got a retired mom in Nevada who took out—invested in three homes, took out zero down payment loans, hoping to make money for retirement.

We are probably not going to be able to help people like that. I think it is sort of naive to say that every borrower can be helped. I want to focus on those who took out loans in good faith, had a job, have run into a tough situation, need help; if we can sort of provide that cushion in time, then be able to work out that distress. We have got a home that has got a higher value, the family stays in. That ought to be our focus.

I sometimes wonder if lenders have the specific knowledge that would allow them to identify those borrowers and really focus on them.

A couple of points I wanted to follow up on. I have a frustration that the same bank regulators who provide the guidance to effectively lower standards and create exotic loans to help people get in the homes, without recognizing their inability to repay—and then we are blissfully ignorant of the impact of all that across our economy—are today in the same banks, with the same regulators who have declared every commercial loan to be a problem loan, and blissfully ignorant of what impact it will have on a spiral down on the commercial foreclosures that the Chairwoman held a hearing on most recently.

My point there is, regulators don't always get it right. In fact, they can exacerbate a problem going both directions. And it has been hard for Congress to really get a handle on that.

I want to follow up on what Dr. Wachter said earlier. My question is sort of basic. How long can we expect foreclosures to rise? When do you think they will level off and hopefully, at some point, decline? Knowing there are a lot of factors, Dr. Wachter basically

said through the end of 2010 we expect foreclosures to rise. Is that your general sense? Is that the general sense of the panel as well?

Yes, Dr. Mason. Mr. Ernst.

**Mr. Ernst.** Yes, I would agree with that.

**Representative Brady.** Given a lot of circumstances, do you expect them to level off in 2011 and start to decline, or are we waiting to see at that point how the economy does and other factors?

**Dr. Shear.** I will start with a partial answer, because we haven't tried to forecast what will happen to foreclosures going forward. But what I will say based on what we have done, there are certainly hundreds of thousands of people who are in danger of losing their homes with the serious default rates we see in many parts of the country.

In particular, what I would point to is that now, with the payment option ARMs, many of them were originated in the years 2004, 2005, 2006, and those are mortgages that had what we call negative amortization, but after 5 years they get recast. So many of them are being recast now. You already see a serious delinquency rate of about 30 percent on those mortgages. And that is a place where we expect it to get worse.

**Representative Brady.** Do you expect the foreclosures, as they rise in 2010, will they level off at a high rate in 2011?

**Dr. Shear.** We are not forecasting, but I am just pointing out that there are a number of people that are in trouble. We don't know—we haven't forecast house prices, but we are particularly concerned about payment option ARMs because so many of them are going to be recasting now and will become less affordable to those homeowners.

**Representative Brady.** Yes. Other panelists.

**Mr. Ernst.** Just to come back around to my initial answer. To put some numbers to it, we have almost 6 million mortgages in this country right now that are delinquent or in some stage of the foreclosure crisis. Last quarter, 700,000 homes entered foreclosure for the first time.

So why are these numbers continually building and going in the direction they are? One answer is, every effort at modifying mortgages to date has been predicated on the voluntary participation of servicers and their willingness and ability to build up the capacity and the wherewithal to be able to execute those modification plans.

So I think one of the things that Congress is starting to revisit is the question of whether there needs to be a fallback position to help borrowers when the systems designed to encourage voluntary modification fall short.

Dr. Wachter suggested the principal modifications may be something that need to be investigated and encouraged. And one way to think about doing that is through permitting bankruptcy judges, as a last resort, to play a role.

**Representative Brady.** I was wondering, trying to get a handle of the problem going forward, Dr. Wachter, Dr. Mason, do you want to talk about what 2011 would hold for us? A leveling off of the high rate of foreclosure, or do we start to see a decline?

**Dr. Mason.** A leveling off in 2011. There is some uncertainty how far you are going into 2011 because of the pay option ARM problem. The original resets that were in the contract would have



been 2010, 2011, but those resets are also tied to when the homeowner maxes out the loan-to-value ratio based upon negative amortization and reassessment at either 115 or up to 125 LTV. So that is bringing those reset dates even closer in.

All that negative amortization and reassessment does is increase the peak that we hit in 2010 versus a shallower reduction into 2011. We are not sure which is going to occur there. We are sure that the effects are going to easily drag into 2011, 2012, and beyond. And that is why I am particularly maddened by this continued building on adding inventory to homes.

**Chair Maloney.** Thank you very much.

Mr. Hinchey.

**Representative Hinchey.** Thank you, Madam Chairman. This is a very interesting hearing. I thank you for everything you have said and the responses to the questions.

We are dealing with one of the most difficult set of circumstances economically that this country has ever faced. The worst since the 1930s. We are doing some things about it, but we are not doing nearly enough.

This subprime mortgage crisis is a major part of it, which has not been addressed adequately. It is a problem that, as we have discussed here, has been going on for now more than 5 years, maybe as much as 6 years. In the initial years, it was completely ignored and intentionally ignored by the regulators who were supposed to deal with this. And the situation came about as a result of not just some accident, but some manipulation of the oversight and regulatory operations that are necessary to prevent these kinds of things from happening.

We saw what happened back in the 1930s. Situations like this were addressed. They were addressed adequately. And they stopped. They stopped not just then, but for 50 years. Now we are dealing with a situation that has not been addressed adequately.

The last Secretary of the Treasury, Secretary Paulson, even though he wanted to ignore the economic problems for a long time, he focused our attention on the banks. Seven hundred billion dollars. A lot of us voted against that because we knew that that wasn't dealing with all of the aspects of this problem in a very constructive way.

So the subprime mortgage crisis is a major part of the issue that we are dealing with. And it is going to continue to be part of the problem. It may have peaked but, nevertheless, it is going to continue for some time to be a major part of the problem.

So I wonder if you could tell us what, in your opinion, are the major regulatory manipulations and shortcomings that led to this problem that we are facing and what we should be doing—what this Congress and what this administration should be doing to stop it and to deal with it more effectively.

**Dr. Shear.** Okay if I start?

**Representative Hinchey.** Please, Mr. Shear.

**Dr. Shear.** You raise a very important question, because sometimes memories are short and people say, "Well, once we get out of this crisis, it won't happen again." And there has been attention placed on how to try to ensure that things like this don't happen again.

Chairman Maloney referred to changes in regs Z in the Truth in Lending Act. I will mention that there has been legislation that has been introduced in both the 110th and the 111th Congress in House Financial Services that proposed statutory expansions in the Truth in Lending laws. And I will mention that we have a report we are issuing Friday, done for that committee, that looks at the potential impacts of certain provisions that could protect borrowers.

We have also done work on the regulatory structure involving the financial services industry. We have a regulatory structure that doesn't meet the needs of our modern financial markets; namely, you had a lot of subprime lenders and Alt-A lenders that are either independent or nonbank subsidiaries that haven't been subject to sufficient oversight. And we have addressed those issues.

So I think it is very important to keep our eye on what changes should occur in the regulatory structure, what changes should be made to make sure that mortgage lenders that are outside of banks, how they are regulated, and how Truth in Lending provisions can protect consumers.

**Representative Hinchey.** Dr. Wachter, you said specifically that there was a failure of regulatory market structures. Maybe you could amplify that.

**Dr. Wachter.** Yes, there was. In work with colleagues Patricia McCoy and Andrey Pavlov in an article written in the Connecticut Law Review, we talk about regulatory arbitrage and the race to the bottom. In other work with Anthony Pennington-Cross, we talk about State regulation and preemption, the move, again, to the regulator with least regulation.

At the same time, there was an expansion of private label securitization, which in fact incentivized the provision of mortgages that did not reflect the risk.

Again, in work with colleagues, we showed that, amazingly, the price of this risk, the cost of this risk to borrowers, was decreasing over time as securitizers attempted to place more of these mortgages in the market.

Now the critical piece there is that these securitizations were not, in fact, marked to market. There was not only regulatory failure; there was also market failure. These securities did not face the discipline of the market. They were heterogeneous and were therefore impossible to trade.

As a finance professor, I believe that markets do indeed move towards equilibrium, but only if markets are allowed to be in play. In this case, these securities did not trade. They were marked to model. Those models were, in part, put together by the rating agencies, which also failed.

**Representative Hinchey.** Mr. Ernst.

**Mr. Ernst.** I agree with that. Certainly, we have issued a report detailing the failures of specific regulatory agencies, but I think it is also important to see that there was a systemic built-in defect in the regulatory system.

We had multiple agencies in charge of consumer protection and, as a result, we largely had no agency accountable for consumer protection.

We had interagency guidance, for example, in subprime lending. But, it came too late and was too weak to prevent the crisis from

unfolding. I think that is why, going forward, we favor consolidating consumer protection in one agency that can move forward with that mission and produce timely regulations that will help prevent the next crisis from happening. There are specific agencies and these specific problems, but there is also a systemic dimension to this crisis as well.

**Dr. Mason.** If I could, I would also like to agree that the dispersion of responsibility for consumer protection regulation is a problem. And that can be solved fairly easily. But the way I look at this, this is a classic—what we call asymmetric information—crisis. There is risk in the system. There always is. People took risks, but we get a shock to asset values. Investors don't know who is exposed to the shock, so they pull back from the system as a whole until they can get better information.

But this information shortcoming is not an efficient markets problem. All the information is used. The problem is there is not enough information.

Now, anytime you have financial innovation, there is always a point at which you don't have information. That is part of financial innovation. That is not a problem unless you get too much reliance upon the new innovative products. That is what we had here.

Bank regulators allowed huge reliance upon securitization and illiquid markets for funding what we typically take to be the foundation of our financial system, that is, commercial banks where depositors keep their money. These are institutions that we have typically kept very conservative and prohibited from getting too risky. Instead, banks were allowed to go funding themselves with the newest most innovative financial instruments in untested markets.

So information is crucial, but information is costly so you never have enough information. Hence, the trick to allowing innovation to proceed is balancing the amount of information that is not out there with other existing risk exposures. This is a crucial point because the question then comes down to: If you had a systemic risk regulator, who would listen to it? Because the systemic risk regulator would not get information from anywhere to back their argument that a substantial risk exists because the information doesn't exist.

So part of the job of managing risk and information is to look for the dog that didn't bark. There wasn't data on these markets. We didn't know where real estate values were going. We didn't know what asset-backed securities were worth.

In fact, one key element that triggered the crisis was the development of what we now know as the ABX that is publicized by the Markit group which told us an index of the prices on major residential mortgage-backed securities. In fact, when investors saw that home values were falling, they started shorting the market rationally because the information told them where the market was going. And that is what caused the crisis.

So we had too much product sold on the basis of this noninformation and we experienced a shock when information entered the market.

**Dr. Wachter.** If I may add to that, the ABX indicator did not cause the market to fall. In fact, it was a lagging indicator. I am

not as pessimistic as Dr. Mason. I do believe the information is, and was, out there. I believe it can be monitored and should be monitored.

**Chair Maloney.** Thank you very much. That was very informative.

Congressman Burgess.

**Representative Burgess.** Thank you. This is indeed a fascinating discussion this morning.

Dr. Mason, let me just ask you one quick question on follow-up to something you said. If I understood you correctly, you said that there is a problem now that builders are continuing to build, although they are building a different product, but that different product is now competing with the existing housing stock which has yet to be absorbed from the foreclosure bubble; is that correct?

**Dr. Mason.** That is correct. I look at it as an inventory problem. If we add to the inventory, we have more of an inventory problem.

**Representative Burgess.** Well, are the builders who are building these new products able to get the interim financing to build these new products?

**Dr. Mason.** You've got me on that one. I would like to know that myself.

**Representative Burgess.** Well, Madam Chairwoman, perhaps we could explore that further, because that would seem to be a fundamental issue that needs to be addressed.

I want to just talk a little bit about this chart. It is the first time I have seen it. It is a fascinating chart—and not because Texas looks so good, but it does. And I will tell you the reason it does is because we went through a frightening real estate contraction in the late 1980s with the implosion of the savings and loans.

I don't think the enthusiasm for pricing real estate really caught on in Texas because of having so recently been burned in that last real estate bubble in the 1980s. I can't claim that it was necessarily Kevin's and my leadership that made Texas a safe place to be, but we are all grateful that Texas looks as good as it does.

But it does bring up the point that there are many congressional districts where things look rather startling. And it does seem to be something that does follow congressional district lines.

I am struck by the fact that Michigan, which has been in crisis for some time as far as its employment figures, actually doesn't look too bad on the foreclosure side. Perhaps because all of those foreclosures happened much earlier in this sequence, and we are just looking now at the aftermath of what has been a tough and lingering recession in that area.

And, Dr. Shear, I would like for you to comment on this, since you are the representative from the Government Accountability Office. In January of this year, the *Wall Street Journal* published an article on January 5 dealing with some of the problems that were brought to the subprime loan industry by Members of Congress who were encouraging the letting of these subprime, no-document, ninja loans to people in their congressional districts to bolster homeownership, to improve the economy. I don't know why, but this was a rather intense article. It was a long article.

Dr. Shear, the point that was made over and over again, that it was also tied to political contributions as well. This homeowners' group, HOGAR, that was set up to foster home ownership, if there were contributions through this agency, people could place fellows that were actually lobbyists within the organization or they get favorable press releases from a real estate organization.

Did you encounter any of this in the course of your investigation? Did you look into this at all?

**Dr. Shear.** That is something that we haven't looked into.

With respect to your observation about Michigan, let me make one comment. One of the things that we tend to observe when we look where this problem is the most pronounced is in places where you had housing price bubbles that were occurring. Housing prices were high to begin with, and they were rising. You had certain bubbles going on and you had kind of intense marketing of certain products.

Now the bubble has broken in those places. Michigan never was one that was having the uptick in prices, such as in California and in some parts in the Northeast.

**Representative Burgess.** But, again, coming back to the article last January, the reason that those markets in southern California and Florida were perhaps having some of the problems was that it was being generated by, actually, Members of Congress.

We are talking about new regulations and the Congress is going to be the one to stop reckless behavior, but it looks like Congress might have been one of the proximate causes in driving the reckless behavior.

**Dr. Shear.** I really don't have any basis to really react to that.

**Representative Burgess.** I am going to try to help you get some basis. Let me put these thoughts down on paper and, Madam Chairman, I am going to make a request to the Government Accountability Office that they look into this, because we have a crisis right now in confidence. No one believes Congress. Our approval ratings are abysmally low, and no one believes we can fix the things that we keep telling the American people we are going to fix. And if we never come back and address the fact that we may have been a part of the cause of this—we may not have caused all of it, but we certainly may have lit the fuse that caused the implosion of the bubble.

I think it is incumbent upon us to deal with that before we go forward with an entirely new regulatory scheme that—who is going to believe we can set one up when we couldn't even police ourselves in 2004 and 2005?

**Dr. Shear.** And what I say, and it is really a general statement for the committee and both sides of the aisle, is that we are always happy to meet with your staffs and to discuss what issues you think we should be looking at, just as we have for the committee in looking at this crisis.

**Representative Burgess.** Well, Madam Chairman, I will make a copy of the *Wall Street Journal* from January 5 and I would like to enter a copy of this into our record today.

[The prepared statement of Representative Burgess appears in the Submissions for the Record on page 127.]

[The article titled “Housing Push for Hispanics Spawns Wave of Foreclosures” appears in the Submissions for the Record on page 128.]

**Chair Maloney.** Thank you very much. I would like to go back to the loan modification programs by Treasury that everyone is mentioning. I would like a clarification, Dr. Shear. The loan modification programs by Treasury are limited to owner-occupied housing; isn’t that correct?

**Dr. Shear.** Yes, that is my understanding.

**Chair Maloney.** So, in other words, we are not trying to bail out speculators, similar to what some of my colleagues have been talking about, but only those owner-occupied housing?

**Dr. Shear.** Yes. I think it is focused especially on those that have high debt-to-income ratios and that are in danger of losing their homes.

**Chair Maloney.** We have also heard about high re-default rates for modified loans. But the FHFA’s report shows that loan modifications in 2008 tended to increase, not decrease payments. Only recently have modifications led to lower payments. Do you think this may be part of the problem?

**Dr. Shear.** We are certainly aware of certain studies done—what FHFA has observed, what the Office of the Comptroller of the Currency and others have looked at—that if you are going to have a chance for modifications to lead to a better outcome, that you are going to have to reduce the monthly payments that the borrowers are making.

**Chair Maloney.** When we talk about the servicers, the same parties who originated these bad loans are now in the business of modifying them. Why do you think they will do a better job this time?

Anyone?

They created these bad loans. Now they are modifying them. Why are they going to do a better job?

**Dr. Mason.** That is the point of what I wrote. I see no reason to keep doing the same thing and expect a different outcome.

**Chair Maloney.** There seems to be a problem with understaffing—which some of you talked about—with the servicers, which is contributing to the delays. But also it has been reported that servicers do not have the right incentives to modify these loans.

That was part of your testimony, Dr. Mason. Your paper on the disparities in servicer quality seemed to indicate that mortgage backed securities and collateralized debt that vary by servicer make it even more difficult for investors to judge the value of the asset—and, back to one of your points, that not really knowing the extent of the problem and the value in the problem.

Why do you think that we have not been using up the \$50 billion in TARP funds? Could you share your thoughts, Dr. Shear, of the efforts of Treasury and loan modification? I believe you testified that they have not even started to use this \$50 billion.

**Dr. Shear.** Well, in our report, what we point out is that there was a certain period of time where there were—I think they call them trial periods. I think it was actually this week, which was the first week that those would come. So there are some numbers in-

cluded on the highlights page of our report that reports how many letters went out, how many applications came in, how many are involved in this trial period. So it is a matter that I think it is the way the HAMP program was set up and now we will start to see—

**Chair Maloney.** So it hasn't really been in the process of kicking in until now.

**Dr. Shear** [continuing]. It hasn't kicked in. That is a very good way of putting it.

**Chair Maloney.** I have no further questions.

Mr. Burgess, do you have further questions?

**Representative Burgess.** Yes. Thank you, Madam Chairwoman.

First off, on just the foreclosure rate—and several of you gave your opinions as far as projections—are we likely to see a secondary reduction or a secondary increase in foreclosures because of the joblessness that is now accompanying the lengthening recession? The initial wave of foreclosures was a lending practice problem. Some of that is still going on.

I think *Newsweek* said today the recession was over. But are we going to see another dip in foreclosures or another increase in foreclosures because of the job situation? I will take anyone's answer on that.

I will ask Dr. Mason to comment.

**Dr. Mason.** We are expecting a feedback loop through to extend the crisis. I have done some work to parameterize that feedback loop. It is very rough work but, in general, yes, we expect the unemployment situation to continue the foreclosure crisis.

**Representative Burgess.** I don't have a dollar figure—that is what I was just looking for—to see if I could tell you how many billions of dollars Congress has committed to helping people with the foreclosure crisis. It is a lot. We did something with Fannie and Freddie last July, we did some more in September, we did TARP in September and October. We did a stimulus package and we have done HOPE for Homeowners. How big a help have those programs been?

**Dr. Mason.** I want to make the point that there is a disconnect between the unemployment and the foreclosure problem. Most people who will be hit by job losses, by and large, aren't in homes that they are trying to buy. They are renters. And so that is why the correlation in the foreclosure effect is less than one, and it is significantly less than one.

So I think if you are thinking about fiscal policy alternatives, it may make sense to expand unemployment benefits. That would, of course, help someone in their home continue to afford the home, perhaps on a modified loan basis, but also would more broadly help those who haven't had a chance to enter home ownership and, of course, maybe give them a chance to do so later on.

**Dr. Wachter.** I would say that the Federal efforts to date have been critical in bringing us back from the precipice. We were at a precipice. We were facing the collapse of the financial system and the global economy. And we are no longer at that precipice. This is due to the Federal intervention.

**Representative Burgess.** Which Federal intervention?

**Dr. Wachter.** It was actually a series of interventions and the combination of these interventions that brought us back from the precipice. But the stimulus was critically important.

**Representative Burgess.** We haven't spent the stimulus yet. We are going to spend it right before Election Day, I think.

**Dr. Wachter.** My understanding is some of it has been spent. But even the expectation that it will be spent matters. Secondly, and very importantly, the Fannie and Freddie support, which kept mortgages at historically low rates of 5 percent, has been absolutely critical to containing the crisis.

**Representative Burgess.** Dr. Wachter, in your statement, when you were talking about marking mortgages to market, you have this sentence—and I don't want to take it out of context. It says: There's an uncomfortably high probability that the Obama modifications will not succeed in quelling the foreclosure crisis due to the impact of so many underwater homeowners being so deeply under water.

Could you expound on that statement?

**Dr. Wachter.** It is absolutely the case. We are seeing an increase in foreclosures. And it is a concern. We have been through a great recession and we were facing the potential collapse of the economy. So we have had significant positive impacts of a series of programs.

That is not to say that the foreclosure problem has been completely stemmed. This is an ongoing problem. It continues to pull down the economy and it needs to be further addressed.

**Representative Burgess.** Well, I think Chairwoman Maloney referenced the fact that \$50 billion that was available under TARP has yet to be dispersed for Help for Homeowners. Did I understand that exchange correctly? Dr. Shear.

**Dr. Shear.** The Hope for Homeowners program—again, we looked at HAMP. It still hasn't played out yet—because of when the program basically started—in terms of those who completed the trial period and are really heading into loan modifications. I think this is the first week. With the meetings going on and outlined—

**Representative Burgess.** Did you say this is the first week?

**Dr. Shear** [continuing]. It is the first week where modifications would occur. There was a certain 3-month period that was worked into it. Again, I could pull out some information and provide it to the committee from our report as far as the timelines involved in the program.

**Representative Burgess.** The timeline would be extremely helpful because people are going to say you passed TARP in September, October; now we are seeing help this week on the homeowner front. That is a significant lag between action and reaction.

**Dr. Shear.** And we can certainly make that material—it is in our report from last week—but if the committee wants it, we could put it into the record for this hearing.

[The report entitled, "Troubled Asset Relief Program: Treasury Actions Needed to Make the Home Affordable Modification Program More Transparent and Accountable," was released by the Government Accountability Office on July 23, 2009, and can be found on the GAO website at <http://www.gao.gov>.]

**Representative Burgess.** Dr. Wachter, so I understood.



Your comments from earlier, the bailout bill—we weren't supposed to call it that—the financial rescue package that was enacted by Congress in October you feel was one of the things that was important in preventing the crisis, the foreclosure crisis from being worse?

**Dr. Wachter.** I do think we would have had significantly more job losses without the stimulus.

**Representative Burgess.** I was referring to the financial rescue package that most of us call the bailout, for convenience, that passed the 1st of last October.

**Dr. Wachter.** Yes, absolutely. I do think the bank rescue has been very significant in bringing civility back to markets.

**Representative Burgess.** So this has been a bipartisan rescue of both the Bush and Obama administrations that prevented the abyss from being deeper?

**Dr. Wachter.** I do believe some efforts that were begun even prior to Obama's Presidency contributed to the move back from the precipice.

**Representative Burgess.** Thank you, Madam Chairwoman. I will yield back the balance of my time.

**Chair Maloney.** Thank you very much.

I would like to thank all of our witnesses for being here today to talk about the trend in nonprime foreclosures and what can be done to prevent it in the future. We must do everything we possibly can to keep American families in their homes, to stabilize our housing prices, stabilize our economy.

I thank all of you for your research, your time here today, and your commitment to helping our country solve these really critical challenges.

Thank you very much for being here. I appreciate it. Meeting adjourned.

[Whereupon, at 11:36 a.m., the committee was adjourned.]



## **SUBMISSIONS FOR THE RECORD**

PREPARED STATEMENT OF CAROLYN B. MALONEY, CHAIR, JOINT ECONOMIC  
COMMITTEE

Good morning. I want to welcome our distinguished panel of witnesses and thank you all for your testimony today.

Today, the Government Accountability Office released a study which I requested that looks at the performance of non-prime loans in every Congressional district in the United States. This is a valuable report, because it captures the national trends and also gives us data so granular that we can see the effects on our constituents.

The default and foreclosure rates for these mortgages in my New York district are relatively low compared to the rest of the country, but rising foreclosures continue to inflict pain in communities throughout the nation.

Borrowers, lenders, governments, and neighbors all pay the price for vacant houses that attract vandalism and increase crime, which destroy communities and burden local governments.

The map behind me is a snapshot of the mortgage crisis inherited by the Obama Administration.

The map highlights an important point—the pain of foreclosure is not being felt evenly across the United States. What we see are pockets of pain more heavily concentrated in certain areas of the country—most notably California, Florida, Illinois, Massachusetts, Nevada, and New Jersey.

Congress and the administration have undertaken numerous efforts to stem the tide of foreclosures.

Key measures include incentives to servicers to modify loans in the Administration's Home Affordable Modification Program and an expansion of eligibility to receive a low cost FHA loan in Hope for Homeowners.

Additionally, Congress has allocated money to counselors to help homeowners get the information they need to be able to modify their loans.

Today, Treasury and HUD officials are meeting with mortgage servicers in an effort to speed the pace of modifications, which are not happening quickly enough.

Servicers may be swamped, but families are drowning.

I look forward to our witnesses' insights into how the current policies are working and any proposed changes that will help us keep families in their homes.

The pockets of pain may be due at least in part to differences in house price appreciation or the local economy. But the problems may also stem from different lending practices throughout the country.

Earlier this month, the Joint Economic Committee held a hearing on predatory lending and the targeting of minorities for higher cost loans. In that hearing, we heard testimony that states have had difficulty enforcing anti-predatory lending laws because of federal pre-emption of those laws for nationally chartered banks.

Fortunately, some state attorneys general, including in my home state of New York, took an active role in pursuing abuses at nationally chartered banks.

While our immediate efforts are aimed at turning back the current tide of foreclosures, it is just as important for us to realize how we got in this predicament and prevent it from happening again.

Last week, the Federal Reserve Board of Governors proposed significant changes to Regulation Z of the Truth in Lending Act ratcheting up disclosure requirements and altering compensation to brokers. The improved amendments to disclosure information for consumers will help consumers gauge the true cost of mortgages and compare different products.

Additionally, the Fed recognized that, if brokers have a financial incentive to steer borrowers into more expensive products, then improved disclosure may be ineffective. I am hopeful that these proposed changes will change the flawed misalignment of incentives between borrowers and brokers.

We must do all we can to keep families in their homes. I look forward to the testimony of our witnesses to help us do just that.



United States Government Accountability Office  
Washington, DC 20548

July 28, 2009

The Honorable Carolyn B. Maloney  
Chair  
Joint Economic Committee  
House of Representatives

The Honorable Charles E. Schumer  
Vice Chairman  
Joint Economic Committee  
United States Senate

*Subject: Characteristics and Performance of Nonprime Mortgages*

During the first part of this decade, the number of mortgage originations grew rapidly, particularly in the nonprime segment of the mortgage market, which includes subprime and Alt-A loans.<sup>1</sup> In dollar terms, nonprime loans accounted for an increasing share of the overall mortgage market, rising from 12 percent in 2000 to 34 percent in 2006. Over this period, the dollar volume of nonprime mortgages originated annually climbed from \$100 billion to \$600 billion in the subprime market and from \$25 billion to \$400 billion in the Alt-A market.<sup>2</sup> However, these market segments contracted sharply in the summer of 2007, partly in response to a dramatic increase in default and foreclosure rates for these mortgages. As we reported in 2007, a loosening of underwriting standards for subprime and Alt-A loans contributed to this increase.<sup>3</sup> As of the first quarter of 2009, approximately 1 in 8 nonprime mortgages were in the foreclosure process. The negative repercussions from nonprime lending practices has prompted greater scrutiny of this market segment, a number of government efforts to modify troubled loans, and proposals to strengthen federal regulation of the mortgage industry.

To inform congressional oversight and decision making about efforts to address current problems in the mortgage market, you requested that we examine the evolution and condition of the nonprime market segment. Accordingly, this report

<sup>1</sup>Although the categories are not rigidly defined, subprime loans feature higher interest rates and fees and are generally made to borrowers who have tarnished credit histories. Alt-A loans are generally for borrowers whose credit histories are close to prime, but the loans have one or more high-risk features such as limited documentation of income or assets.

<sup>2</sup>See Inside Mortgage Finance, *The 2009 Mortgage Market Statistical Annual* (Bethesda, Md., 2009), 4.

<sup>3</sup>See GAO, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, GAO-08-78R (Washington, D.C.: Oct. 16, 2007).

discusses (1) trends in the loan and borrower characteristics of nonprime mortgages originated from 2000 through 2007 and (2) the performance of these mortgages as of March 31, 2009. Additionally, this report provides supplemental information, including detailed statistics by annual loan cohort, state, and congressional district. We provide this additional information in enclosures I through VI.

As agreed with your offices, in two subsequent reports we will provide information on the extent of negative home equity in metropolitan areas, the influence of nonprime loan and borrower characteristics and economic conditions on the likelihood of default, and sources of data on nonprime loans. Also, the information provided in this report will be updated in these subsequent reports to reflect the most recent available data and additional analyses.

To conduct our work, we analyzed data from LoanPerformance's (LP) Asset-backed Securities database for nonprime loans originated from 2000 through 2007.<sup>4</sup> The database contains loan-level data on nonagency securitized mortgages in subprime and Alt-A pools.<sup>5</sup> About three-quarters of nonprime mortgages have been securitized in recent years, and the LP database covers the vast majority of them. For example, for the period 2001 through July 2007 the LP database contains information covering (in dollar terms) an estimated 87 percent of securitized subprime loans and 98 percent of securitized Alt-A loans. Research has found that nonprime mortgages that were not securitized (i.e., mortgages that lenders held in their portfolios) may have different characteristics and performance histories than those that were securitized. For purposes of our analysis, we defined a subprime loan as a loan in a subprime pool and an Alt-A loan as a loan in an Alt-A pool.<sup>6</sup> We focused our analysis on first-lien purchase and refinance mortgages for 1-4 family residential units.

To determine trends in nonprime loan and borrower characteristics, we calculated the numbers and percentages of subprime and Alt-A mortgage originations. We then disaggregated them by loan purpose (e.g., purchase, refinance), loan type (e.g., adjustable-rate mortgages [ARM], fixed-rate mortgages), and other characteristics, including interest rates at origination, borrowers' credit scores, and loan features such as low or no documentation of borrower income or assets and prepayment penalties. To determine the performance of nonprime mortgages, we calculated the number and percentage of mortgages that were in different performance categories—for example, current (up to date on payments), delinquent (30-89 days behind), in default (90 or more days behind), in the foreclosure process, or had

<sup>4</sup>LP is a unit of First American CoreLogic, Incorporated.

<sup>5</sup>Nonagency mortgage-backed securities (MBS), also known as private-label MBS, are backed by nonconforming conventional mortgages securitized primarily by investment banks. Nonconforming mortgages are those that do not meet the purchase requirements of Fannie Mae or Freddie Mac because they are too large or do not meet their underwriting criteria.

<sup>6</sup>The LP database has a loan-level indicator for loan class (i.e., subprime or Alt-A), but it is not well populated. We therefore used the pool-level classification. According to mortgage researchers, some of the loans in subprime pools may not be subprime loans, and some of the loans in Alt-A pools may not be Alt-A loans.

completed the foreclosure process as of March 31, 2009.<sup>7</sup> We also examined the performance of specific loan cohorts and loans for homes in different geographic areas, including Census divisions, states, and congressional districts.<sup>8</sup> To estimate loan performance by congressional district, we linked ZIP code-level information in the LP database to congressional districts.<sup>9</sup> Specifically, we (1) calculated for each ZIP code area the total number of loans and the number of loans either in default or in the foreclosure process (seriously delinquent), (2) used mapping software to determine the proportion of each ZIP code area that fell within a given congressional district, and (3) used information from the first two steps to estimate for each congressional district the total number of loans and the number and percentage of loans that were seriously delinquent. Our analysis assumed that the loans in each ZIP code area were evenly distributed across the area. For example, if 80 percent of a ZIP code area fell within a given congressional district, we assumed that 80 percent of the loans in that ZIP code area were in the congressional district.

We reviewed documentation on the process LP uses to collect and ensure the reliability and integrity of its data. We discussed this process and the interpretation of different data fields with LP representatives. In addition, we conducted reasonableness checks on data elements to identify any missing, erroneous, or outlying data. We concluded that the data we used were sufficiently reliable for our purposes. We conducted our work in Washington, D.C., from September 2008 through June 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the evidence obtained provides a reasonable basis for our findings based on our audit objectives.

### Results in Brief

Nonprime mortgage originations grew rapidly from 2000 through 2005 before sharply contracting in mid-2007. Subprime mortgages accounted for approximately two-thirds of the increase in nonprime originations over that period—rising from 457,000 in 2000 to 2.3 million in 2005—before declining somewhat in 2006. Alt-A originations, although a smaller share of the nonprime market, increased at an even faster rate than subprime originations, increasing 18-fold from 2000 through 2005. From 2000 through 2007, an increasing proportion of subprime and Alt-A mortgages had loan and borrower characteristics that have been associated with a higher likelihood of default and foreclosure. These characteristics include adjustable

<sup>7</sup>Unless noted otherwise, we treat delinquent loans, loans in default, and loans in the foreclosure process as mutually exclusive categories. We considered a loan to have completed the foreclosure process if it was in real estate-owned status as of March 31, 2009, or was paid off after being 90 or more days delinquent, in the foreclosure process, or in real estate-owned status.

<sup>8</sup>A loan cohort is a group of loans originated in the same year.

<sup>9</sup>The LP data provide the state and ZIP code of the property associated with each loan.

interest rates, less than full documentation of borrower income and assets, and higher debt service-to-income (DTI) ratios.<sup>10</sup>

Approximately 1.6 million of the 14.4 million nonprime loans originated from 2000 through 2007 had completed the foreclosure process as of March 31, 2009. Of the 5.2 million loans that were still active (i.e., not foreclosed or prepaid), almost one-quarter were either in default or in the foreclosure process (seriously delinquent), indicating that hundreds of thousands of additional nonprime borrowers are at risk of losing their homes in the near future.<sup>11</sup> Within the subprime market segment, about 28 percent of active loans were seriously delinquent, and within the active Alt-A segment, the serious delinquency rate was about 17 percent. Within both segments, serious delinquency rates were even higher for certain loan products with adjustable interest rates. Most of the serious delinquencies involved mortgages originated from 2004 through 2007. The rates varied widely across states and Census divisions, with the highest rate occurring in Florida (38 percent) and the lowest rate occurring in Wyoming (9 percent).

### Background

The mortgage market has four major segments that are defined, in part, by the credit quality of the borrowers and the types of mortgage institutions that serve them.

- *Prime*—Serves borrowers with strong credit histories and provides the most attractive interest rates and mortgage terms.
- *Nonprime*—Encompasses two categories of loans:
  - *Alt-A*—Generally serves borrowers whose credit histories are close to prime, but loans have one or more high-risk features such as limited documentation of income or assets or the option of making monthly payments that are lower than required for a fully amortizing loan.
  - *Subprime*—Generally serves borrowers with blemished credit and features higher interest rates and fees than the prime market.
- *Government-insured or government-guaranteed*—Primarily serves borrowers who may have difficulty qualifying for prime mortgages but features interest rates competitive with prime loans in return for payment of insurance premiums or guarantee fees. The Federal Housing Administration and Department of Veterans Affairs operate the two main federal programs that insure or guarantee mortgages.

Across all of these market segments, two types of loans are common: fixed-rate mortgages, which have interest rates that do not change over the life of the loan; and adjustable-rate mortgages (ARM), which have interest rates that can change periodically based on changes in a specified index. Additionally, loans are used for

<sup>10</sup>The DTI ratio is the borrower's total monthly debt service payments divided by monthly gross income.

<sup>11</sup>In comparison, as of the first quarter of 2007, active nonprime loans originated from 2000 through 2005 had a serious delinquency rate of 7.4 percent.



two general purposes: to finance the purchase of a home or refinance an existing loan.

The following categories are commonly used to describe the performance status of mortgages:

- *Current*—The borrower is meeting scheduled payments.
- *Delinquent*—The borrower has missed one or more scheduled monthly payments.
- *Default*—The borrower is 90 or more days delinquent.<sup>12</sup> At this point, foreclosure proceedings against the borrower become a strong possibility.
- *Foreclosure*—A legal, and often lengthy, process with several possible outcomes, including that the borrower sells the property or the lender repossesses the home.
- *Prepaid*—The borrower has paid off the entire loan balance before it is due. Prepayment often occurs as a result of the borrower selling the home or refinancing into a new mortgage.

The nonprime market segment featured a number of nontraditional products and characteristics:<sup>13</sup>

- *Hybrid ARM*—Interest rate is fixed during an initial period then “resets” to an adjustable rate for the remaining term of the loan.
- *Payment-option ARM*—Borrower has multiple payment options each month, which may include minimum payments lower than what would be needed to cover any of the principal or all of the accrued interest. This feature is known as “negative amortization” because the outstanding loan balance may increase over time.
- *Interest-only*—Allows the borrower to pay just the interest on the loan for a specified period, usually the first 3 to 10 years, thereby deferring principal payments.
- *Low and no documentation loans*—Requires little or no verification of a borrower’s income or assets.
- *High loan-to-value (LTV) ratios*—Borrower makes a small down payment, causing the ratio of the loan amount to the home value to be relatively high.
- *Prepayment penalties*—Borrower incurs a fee if he or she pays off the loan balance before it is due.

The nation’s economy has been in recession since December 2007. The rising rate of unemployment and declining home prices has worsened the financial circumstances for many families and, with it, their ability to make their mortgage payments.

<sup>12</sup>There is no uniform definition of default across the lending industry. For purposes of this report, we use the definition provided.

<sup>13</sup>For more information about some of these products, see GAO, *Alternative Mortgage Products: Impacts on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 16, 2006). As we reported in 2007, of the top 25 originators of nonprime loans in 2006—which accounted for over 90 percent of the dollar volume of all such originations—21 were nonbank lenders, including 14 independent lenders and 7 nonbank subsidiaries of banks, thrifts, or holding companies. See GAO-08-78R.

According to the Bureau of Labor Statistics, as of June 2009, the nationwide unemployment rate was 9.5 percent, the highest rate since 1983. Additionally, over the past 2 years, house prices have declined in many areas of the country. For example, according to the Federal Housing Finance Agency's (FHFA) house price index, from the first quarter of 2008 through the first quarter of 2009, home prices in California and Florida both fell 22 percent.<sup>14</sup>

**Nonprime Mortgage Lending Increased from 2000 through 2006 and Included Many Loans with Features Associated with Poor Loan Performance**

**Nonprime Mortgage Originations Increased Rapidly from 2000 to 2005**

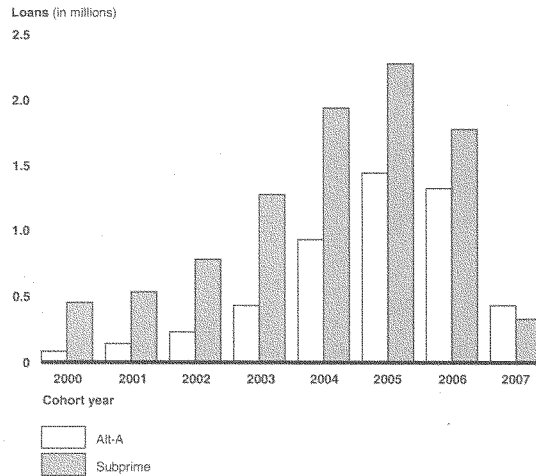
As shown in figure 1, nonprime lending increased rapidly earlier in the decade before abruptly declining in 2007 as the nation entered a financial crisis. In the data we analyzed, about two-thirds of the nonprime mortgages originated from 2000 through 2007 were subprime loans.<sup>15</sup> The number of subprime originations increased more than five-fold from 2000 through 2005—rising from approximately 457,000 to about 2.3 million—before declining somewhat in 2006 and falling off sharply in 2007. Despite this generally rising trend, subprime loans accounted for a declining share of the nonprime market over this period because the volume of Alt-A originations increased at an even faster rate. Specifically, Alt-A originations grew 18-fold from 2000 through 2005—rising from approximately 78,000 to about 1.4 million—before declining in 2006 and declining further in 2007. As a result, the Alt-A share of the nonprime market increased from about 15 percent in 2000 to 43 percent in 2006, and continued to increase to 57 percent in 2007.

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<sup>14</sup>Percentage is from FHFA's purchase-only house price index.

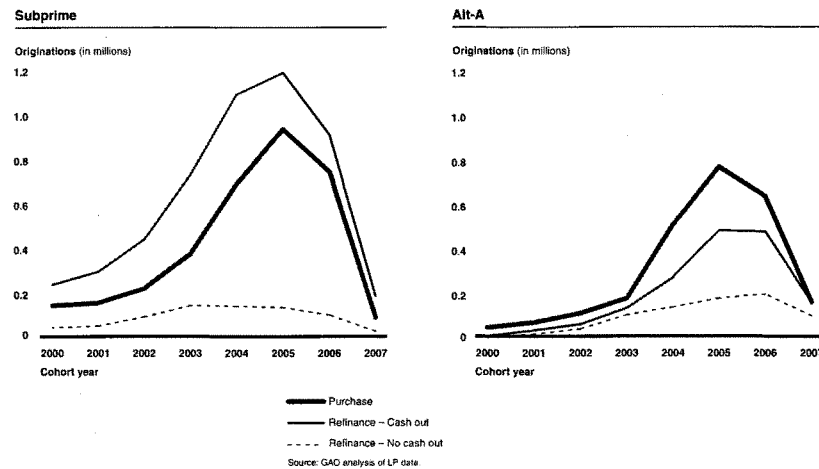
<sup>15</sup>As previously noted, the data we used for our analysis do not cover the entire nonprime market but do cover the large majority of nonagency securitized mortgages within that market.

Figure 1: Number of Subprime and Alt-A Originations by Cohort Year, 2000-2007



Source: GAO analysis of LP data.

The majority of nonprime loans originated from 2000 through 2007 were used to refinance an existing loan rather than to purchase a home. The combination of rising home values and historically low interest rates provided homeowners with opportunities to reduce their mortgage payments and access the equity in their homes through refinancing. A substantial proportion of nonprime borrowers refinanced their mortgages at a higher amount than the loan balance to convert their home equity into money for personal use (known as “cash-out refinancing”). Of the subprime mortgages originated from 2000 through 2007, 55 percent were for cash-out refinancing, 9 percent were for no-cash-out refinancing, and 36 percent were for a home purchase. In 2003, for example, the number of subprime mortgages for cash-out refinancing totaled more than 740,000, the number of no-cash-out refinance loans was about 152,000, and the number of home purchase loans was just over 380,000 (see fig. 2). In contrast, about one-third of Alt-A loans originated from 2000 through 2007 were for cash-out refinancing, 16 percent were for no-cash-out refinancing, and 50 percent were for home purchases.

**Figure 2: Number of Nonprime Purchase and Refinance Loans by Cohort Year, 2000-2007**

**Loan and Borrower Features Associated with a Higher Likelihood of Default and Foreclosure Became Common in 2000-2007**

As we reported in 2007, more aggressive lending practices—that is, an easing of underwriting standards and wider use of certain loan features associated with poorer loan performance—contributed to recent increases in default and foreclosure rates.<sup>16</sup> Many loans were originated with a number of these features, a practice known as risk layering. These practices reduced the likelihood that some borrowers would be able to meet their mortgage obligations, particularly in times of economic stress or declining house prices. Because nonprime loans were often considered more profitable than prime loans, mortgage market participants had incentives to originate and securitize these loans despite their higher risks. Additionally, research suggests that some borrowers did not understand the true costs and risks of these loans, while others were willing to take on these risks to tap accumulated home equity or to obtain larger homes.

**Loan-to-Value Ratios**

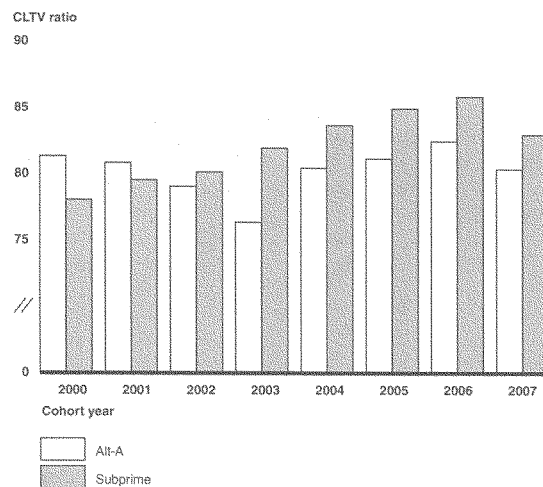
A substantial amount of research indicates that loan-to-value (LTV) ratio is one of the most important factors in assessing the default risk of the borrower.<sup>17</sup> The higher the LTV ratio when a loan is originated, the less equity borrowers will have in their homes and the more likely they are to default on mortgage obligations, especially

<sup>16</sup>See GAO-08-78R.

<sup>17</sup>LTV ratio is the amount of the loan divided by the value of the home at origination.

during times of financial stress. In recent years many borrowers used second liens, or “piggyback loans,” to finance all or part of their down payment. Piggyback loans can result in higher combined loan-to-value (CLTV) ratios—that is, the LTV ratio taking both the first mortgage and piggyback loan into account.<sup>18</sup> As shown in figure 3, the average CLTV ratio for subprime loans rose from 78.0 percent in 2000 to 85.8 percent in 2006, before dropping slightly to 82.9 percent in 2007. In 2000 and 2001, average CLTV ratios for Alt-A loans were higher than those for subprime loans, but in 2002 and thereafter the reverse was true. Average CLTV ratios for Alt-A loans trended downward from 2000 through 2003 (from 81.3 percent to 76.3 percent) but rose to 82.4 percent by 2006, before declining to 80.3 percent in 2007. Furthermore, the percentage of loans with a CLTV ratio of at least 100 percent increased over the time period we examined in both the subprime and Alt-A markets. In 2000, 2.4 percent of subprime loans had a CLTV ratio of at least 100 percent. By 2006, this percentage had increased to 29.3 percent before falling to 17.5 percent in 2007. Likewise, 8.6 percent of Alt-A loans had a CLTV ratio of at least 100 percent in 2000. This percentage reached 19.5 percent by 2006 before falling to 14.5 percent in 2007.

**Figure 3: Average CLTV Ratios for Nonprime Loans by Cohort Year, 2000-2007**



Source: GAO analysis of LP data.

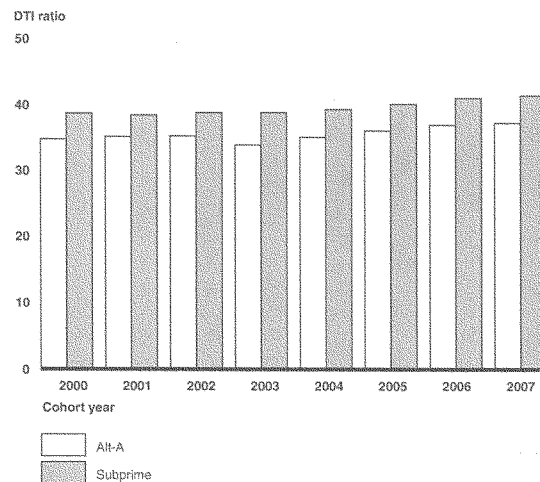
Note: The LP data do not capture all second liens. As a result, the average CLTV ratios presented are likely lower than the actual averages.

<sup>18</sup>The CLTV field in the LP data was frequently not populated, but the LTV field almost always was. In some cases, the CLTV field likely was blank because there was no piggyback loan associated with the mortgage, but in other cases there likely was a piggyback loan that was not captured in the data. We determined average CLTV ratios by using the CLTV field when it was populated and the LTV field when the CLTV field was blank. As a result, it is likely that the average CLTV ratios we present are somewhat lower than the actual averages.

## Debt Service-to-Income Ratios

The debt service-to-income (DTI) ratio represents the percentage of a borrower's income that goes toward all recurring debt payments, including the mortgage payment. The higher the ratio, the greater the risk that the borrower will have cash flow problems and will miss mortgage payments. In the subprime market, average DTI ratios rose from 38.8 percent to 41.5 percent from 2000 through 2007. In the Alt-A market, average DTI ratios increased somewhat from 2000 through 2002, then decreased in 2003 before increasing to 37.3 percent in 2007 (see fig. 4). Additionally, the percentage of subprime and Alt-A loans with DTI ratios over 41 percent—the value used as a guideline in underwriting mortgages insured by the Federal Housing Administration—rose over the period we examined. Specifically, in the subprime market this percentage increased from 47.1 percent in 2000 to 59.3 percent in 2007. In the Alt-A market this percentage rose from 22.9 percent to 36.8 percent over the same time frame.<sup>10</sup>

Figure 4: Average DTI Ratio for Nonprime Loans by Cohort Year, 2000-2007



Source: GAO analysis of LP data.

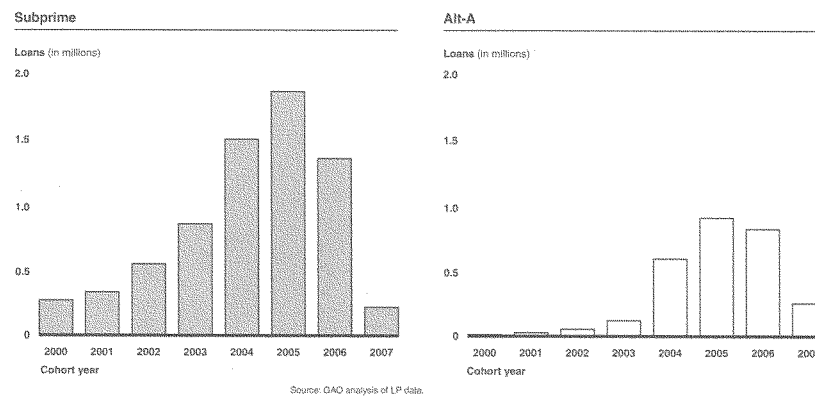
Note: The figures presented are for the 61 percent of nonprime loans for which the data contained DTI information.

<sup>10</sup>The figures presented are for the 61 percent of nonprime loans for which the data contained DTI information. Twenty-nine percent of the subprime loans and 56 percent of the Alt-A loans in the LP database did not contain DTI information.

## Adjustable Interest Rates

Mortgages with adjustable interest rates are generally considered to carry a higher default risk than comparable fixed-rate mortgages, in part because monthly payments increase when interest rates rise. In 2000, the number of subprime ARMs originated was about 262,000.<sup>20</sup> This number grew seven-fold to about 1.8 million originations in 2005, which represented the peak of the market for subprime ARMs. Likewise, originations of Alt-A ARMs increased substantially, growing from about 10,000 loans in 2000 to more than 893,000 in 2005. The largest increase occurred from 2003 to 2004, when the number of Alt-A ARMs grew almost five-fold, rising from about 117,000 to approximately 584,000 (see fig. 5).

**Figure 5: Number of Subprime and Alt-A Loans with Adjustable Interest Rates by Cohort Year, 2000-2007**

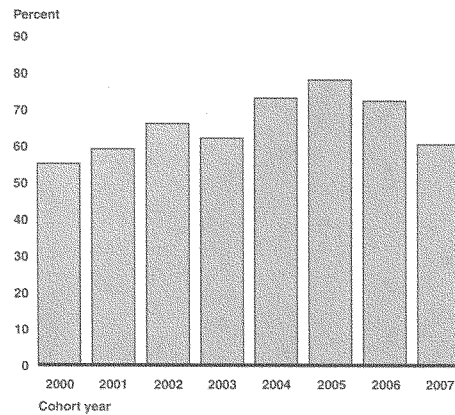


Some of these ARMs were “short-term hybrid” loans that can lead to payment shock—that is, large increases in monthly payments as a result of higher interest rates. In this type of mortgage, the interest rate is fixed and relatively low during an initial period and then “resets” to an adjustable rate for the remaining term of the loan. In the subprime market, 2/28 and 3/27 mortgages—that is, fixed rate for 2 or 3 years and adjustable rate for the next 28 or 27 years—were common types of short-term hybrids. As the number of subprime loans nearly doubled from 2003 through 2005, the share of short-term hybrids grew as well, reaching nearly 80 percent of all subprime originations in 2005, or more than 1.7 million mortgages (see fig. 6). Over the entire 2000 through 2007 period, 70 percent of subprime mortgage originations were short-term hybrids. In contrast, short-term hybrids were not a common product in the Alt-A market segment.

<sup>20</sup>Our analysis of ARMs excluded balloon mortgages, which can have a fixed or adjustable interest rate. A balloon mortgage does not fully amortize over the term of the loan, leaving a balance due at maturity. The final payment is called a balloon payment because it is generally much larger than the other payments.

Although short-term hybrid ARMs have the potential to produce payment shock, research suggests that most of the defaults for these loans have occurred well before the interest rate reset.<sup>21</sup> Nonetheless, interest rate resets may cause difficulties going forward, especially for borrowers whose loans were originated in more recent years. These borrowers may not be able to refinance to avoid payment shock because falling house prices and tightened underwriting standards may make it difficult for them to qualify for a new loan.

Figure 6: Short-Term Hybrid ARMs as a Share of Subprime Mortgages by Cohort Year, 2000-2007



Source: GAO analysis of LP data.

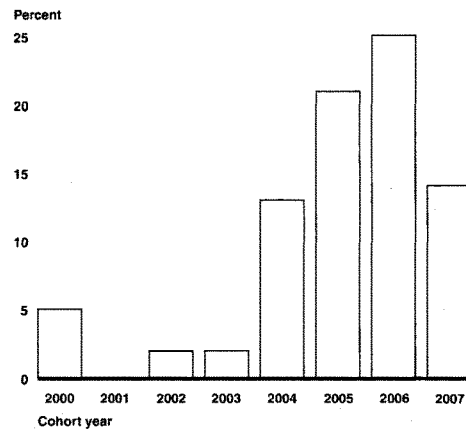
Approximately 17 percent of Alt-A loans originated from 2000 through 2007 were another type of ARM known as payment-option ARMs. For an initial period of typically 5 years or when the loan balance reaches a specified cap, this product provides the borrower with multiple payment options each month, including minimum payments that are lower than what would be needed to cover any of the principal or all of the accrued interest. After the initial period, payments are “recast” to include an amount that will fully amortize the outstanding balance over the remaining loan term. Consequently, payment-option ARMs can result in payment shock, especially if the loan balance increased because the borrower was making only the minimum payment. As we reported in 2006, payment-option ARMs were once specialized products for financially sophisticated borrowers but ultimately became more widespread. According to federal banking regulators and a range of industry participants, as home prices increased rapidly in some areas of the country, lenders began marketing payment-option ARMs as affordability products and made

<sup>21</sup>See, for example, Shane Sherlund, “The Past, Present, and Future of Subprime Mortgages,” Finance and Economics Discussion Series 2008-63, Federal Reserve Board (November 2008). See also, Christopher Foote, Kristopher Gerardi, Lorenz Goette, and Paul Willen, “Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don’t,” Working Papers No. 08-2, Federal Reserve Board (May 2008).



them available to less-creditworthy and lower-income borrowers.<sup>22</sup> As shown in figure 7, the percentage of Alt-A loans that were payment-option ARMs was 5 percent or less from 2000 to 2003, before rising sharply in 2004. From 2004 to 2006, that percentage increased from 13 percent to 25 percent, before dropping to 14 percent in 2007.

**Figure 7: Payment-Option ARMs as a Share of Alt-A Loans by Cohort Year, 2000-2007**



Source: GAO analysis of LP data.

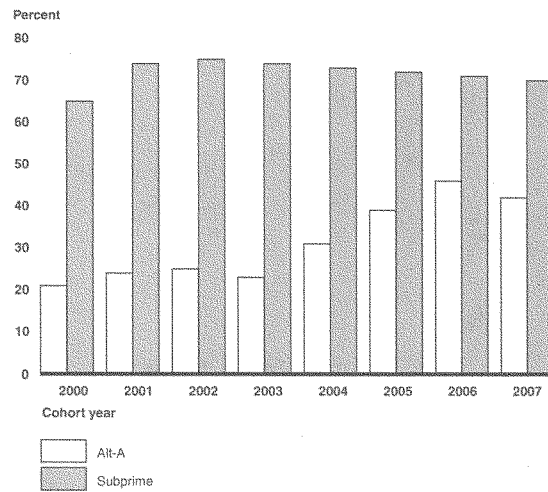
### Prepayment Penalties

Prepayment penalties are another mortgage feature that some research has associated with a higher likelihood of default.<sup>23</sup> Prepayment penalties can be an obstacle to refinancing into a more affordable loan because borrowers must pay the penalty if they pay off the original loan before the prepayment period expires. Further, research indicates that many borrowers may not have realized that their mortgages include a prepayment penalty. For the entire 8-year period we examined, the percentage of subprime loans with prepayment penalties exceeded 60 percent each year. In contrast, only 21 percent of Alt-A mortgages had prepayment penalties in 2000, but this percentage increased to 46 percent by 2006 (see fig. 8).

<sup>22</sup>See GAO-06-1021.

<sup>23</sup>See, for example, Roberto Quercia, Michael Stegman, and Walter Davis, "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments," *Housing Policy Debate*, vol. 18, no. 2 (2007), 311-346. However, other research has found that prepayment penalties are not associated with higher default rates. See, for example, Sherlund, "The Past, Present, and Future of Subprime Mortgages."

Figure 8: Percentage of Nonprime Loans with Prepayment Penalties by Cohort Year, 2000-2007



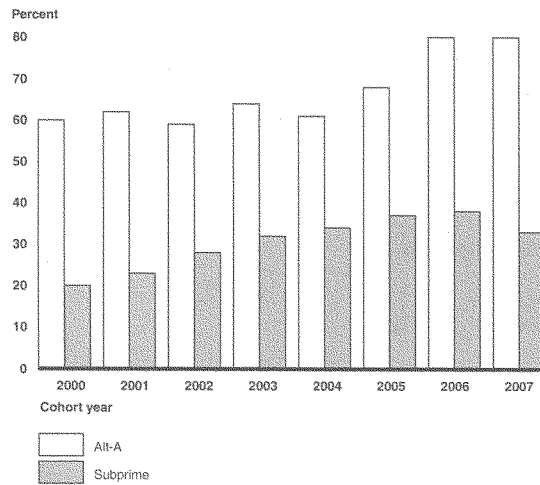
#### Low or No Documentation

Low or no documentation of income or assets allows borrowers to provide less detailed financial information than is traditionally required. This feature was originally intended for borrowers who may have difficulty documenting income, such as the self-employed, but eventually became more widespread.<sup>24</sup> Such loans can be problematic if borrowers or loan originators overstate income or assets to qualify borrowers for mortgages they cannot afford. From 2000 through 2007, the percentage of Alt-A mortgages that did not have full documentation of borrower income, assets, or both rose from 60 percent to 80 percent.<sup>25</sup> For subprime loans, the proportion of low and no documentation mortgages grew from 20 percent to 38 percent, then decreased to 33 percent over the same period (see fig. 9).

<sup>24</sup> Although typically associated with the Alt-A market, loans with low or no documentation of borrower income or assets were also offered in the subprime market, which serves borrowers with lower credit scores.

<sup>25</sup> According to the LP data, the overwhelming majority of nonprime mortgages with less than full documentation had low documentation rather than no documentation.

Figure 9: Percentage of Nonprime Loans with Low or No Documentation



Enclosures I and II provide more detailed information about the characteristics of nonprime loans originated from 2000 through 2007.

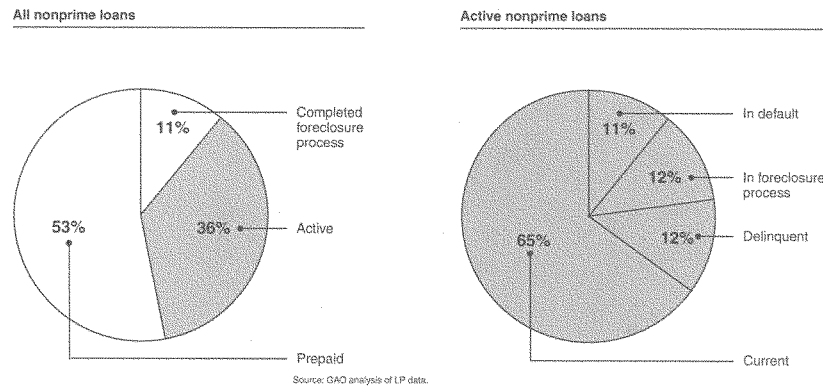
#### **Serious Delinquency Rates Were Highest for Subprime Loans, Certain Adjustable-Rate Mortgages, and Recent Loan Cohorts and Varied Widely across States and Regions**

As of March 31, 2009, approximately 1.6 million of the 14.4 million nonprime loans (11 percent) originated from 2000 through 2007 had completed the foreclosure process. Subprime mortgages accounted for about 80 percent of these loans and Alt-A mortgages accounted for the remaining 20 percent. Additionally, about 7.6 million of the 14.4 million loans (53 percent) originated had prepaid as of March 31, 2009 (see fig. 10). Because many of these prepaid loans were due to borrowers refinancing into new nonprime mortgages, the total number of originations over the period we examined far exceeds the number of individual borrowers. For the majority of the 5.2 million nonprime loans that were still active as of March 31, 2009, the borrowers were current on their payments. However, about 1.2 million, or 23 percent, of these active loans were seriously delinquent (either in default or in the foreclosure process), indicating that hundreds of thousands of additional nonprime borrowers are at risk of losing their homes in the near future.<sup>26</sup> Specifically, about 594,000 (11 percent) of active nonprime loans were in default and about 613,000 (12

<sup>26</sup>In comparison, as of the first quarter of 2007, active nonprime loans originated from 2000 through 2005 had a serious delinquency rate of 7.4 percent.

percent) were in the foreclosure process, as shown in figure 10. Within the subprime market segment, about 775,000 loans (28 percent) were seriously delinquent. Among active Alt-A mortgages, approximately 433,000 (17 percent) were seriously delinquent.

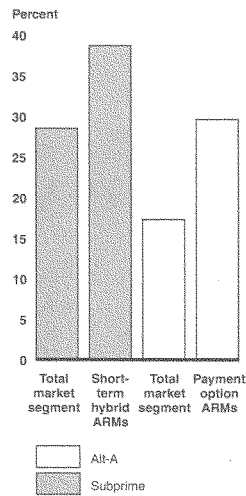
**Figure 10: Percentage of All Nonprime Loans and All Active Nonprime Loans Originated from 2000 through 2007, by Performance Status as of March 31, 2009**



Note: We considered a loan to be delinquent if the borrower was 30 to 89 days late on his or her mortgage payments. We considered a loan to be in default if the borrower was 90 or more days late.

Serious delinquency rates were higher for certain adjustable-rate products common in the subprime and Alt-A market segments than they were for the market segments as a whole. As previously discussed, short-term hybrid ARMs accounted for the majority of subprime mortgage originations in recent years (e.g., 72 percent in 2006). As of March 31, 2009, 38 percent (about 584,000) of active short-term hybrid ARMs were seriously delinquent, a rate 10 percentage points higher than that for the entire subprime market (see fig. 11). In the Alt-A market segment, payment-option ARMs became a prominent product, accounting for about 25 percent of Alt-A loans originated in 2006. As of March 31, 2009, approximately 30 percent (about 122,000) of active payment-option ARMs were seriously delinquent, a rate about 13 percentage points higher than for the Alt-A market segment as a whole.

Figure 11: Percentage of Short-Term Hybrid ARMs and Payment-Option ARMs That Were Seriously Delinquent as of March 31, 2009



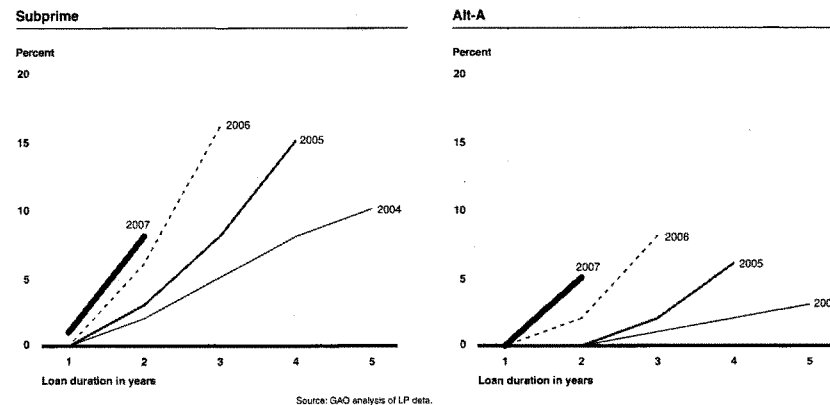
#### Performance of Nonprime Loans by Cohort

Mortgages originated from 2004 through 2007 accounted for the majority of troubled loans. Of the active subprime loans originated from 2000 through 2007, 92 percent of those that were seriously delinquent as of March 31, 2009, were from those four cohorts. Furthermore, loans from those cohorts made up 71 percent of the subprime mortgages that had completed the foreclosure process. This pattern was even more pronounced in the Alt-A market. Among active Alt-A loans, almost all (98 percent) of the loans that were seriously delinquent as of March 31, 2009, were from the 2004 through 2007 cohorts. Likewise, 93 percent of the loans that had completed the foreclosure process as of that date were from those cohorts.

Cumulative foreclosure rates show that the percentage of mortgages completing the foreclosure process increased for each successive loan cohort (see fig. 12). Within 2 years of loan origination, 2 percent of the subprime loans originated in 2004 had completed the foreclosure process, compared with 3 percent of the 2005 cohort, 6 percent of the 2006 cohort, and 8 percent of the 2007 cohort. Within 3 years of loan origination, 5 percent of the 2004 cohort had completed the foreclosure process, compared with 8 percent and 16 percent of the 2005 and 2006 cohorts, respectively. The trend was similar for Alt-A loans, although Alt-A loans foreclosed at a slower rate than subprime loans. For example, within 3 years of origination, 1 percent of Alt-A loans originated in 2004 had completed the foreclosure process, compared with

2 percent of the loans originated in 2005, and 8 percent of the loans originated in 2006.<sup>27</sup>

**Figure 12: Cumulative Percentage of Subprime and Alt-A Loans That Completed the Foreclosure Process by Cohort Year, 2004-2007**



This trend is partly attributable to a stagnation or decline in home prices in much of the country beginning in 2005 and worsening in subsequent years. This situation made it more difficult for some borrowers to sell or refinance their homes to avoid default or foreclosure. In addition, borrowers who purchased homes (particularly for investment purposes) but now owed more than the properties were worth, had incentives to stop making mortgage payments in order to minimize their financial losses. The deterioration in credit quality for the successive cohorts may also reflect an increase in riskier loan and borrower characteristics, such as less than full documentation of borrower income and higher DTI ratios.

Enclosures III and IV provide more detailed information about the performance of nonprime loans by cohort year and product type.

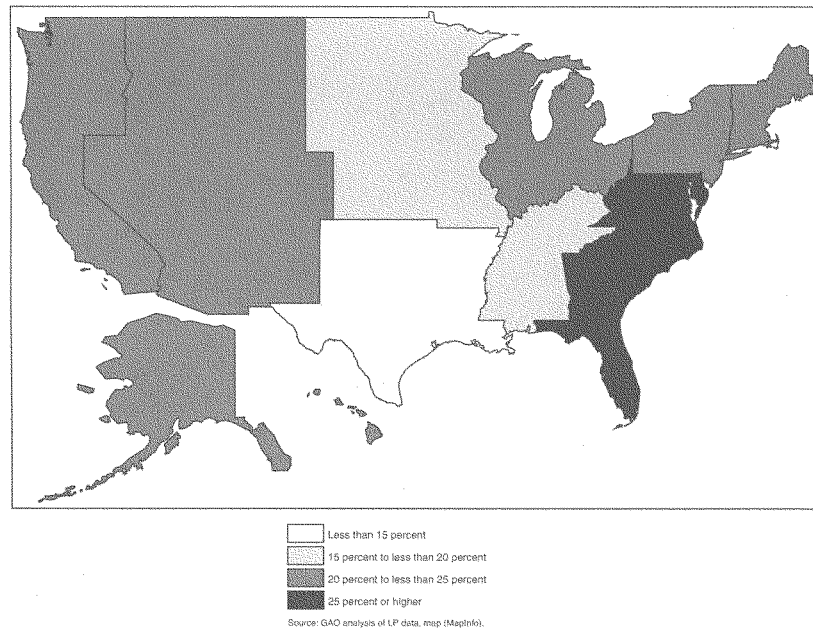
#### Performance of Nonprime Loans by Census Division, State, and Congressional District

The proportion of active nonprime mortgages that were seriously delinquent as of March 31, 2009, varied across Census divisions and states (see fig. 13). Among the nine Census divisions, the South Atlantic had the highest rate of seriously delinquent

<sup>27</sup>Three-year foreclosure rates for the 2007 cohort will not be available until 2010. However, as of March 31, 2009, the subprime and Alt-A cumulative foreclosure rates for the 2007 cohort were 10 percent and 7 percent, respectively.

loans (28 percent) and the West South Central had the lowest rate (13 percent).<sup>28</sup> Only three regions—West South Central, West North Central, and East South Central—had serious delinquency rates of less than 20 percent.

Figure 13: Serious Delinquency Rates by Census Division as of March 31, 2009



At the state level, six states—California, Florida, Illinois, Massachusetts, Nevada, and New Jersey—had the highest serious delinquency rates as of March 31, 2009 (see fig. 14). Each state had rates above 25 percent, and Florida's rate of 38 percent was the highest in the country. Twelve states had serious delinquency rates between 20 and 25 percent, and 21 states and the District of Columbia had serious delinquency rates between 15 and 20 percent. The remaining 12 states had serious delinquency rates of less than 15 percent, including Wyoming's rate of 9 percent, which was the lowest in the country.

<sup>28</sup>The nine Census divisions include Pacific (Hawaii, Alaska, Washington, Oregon, and California); Mountain (Montana, Idaho, Wyoming, Nevada, Utah, Colorado, Arizona, and New Mexico); West North Central (North Dakota, South Dakota, Minnesota, Nebraska, Iowa, Kansas, and Missouri); West South Central (Oklahoma, Arkansas, Texas, and Louisiana); East North Central (Michigan, Wisconsin, Illinois, Indiana, and Ohio); East South Central (Kentucky, Tennessee, Mississippi, and Alabama); New England (Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut); Mid Atlantic (New York, New Jersey, and Pennsylvania); and South Atlantic (Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida).

Of the 6 states with the highest serious delinquency rates, the “Sunbelt” states—California, Florida, and Nevada—have been more dramatically affected by the changes in the nonprime mortgage market than other regions of the country. These states experienced particularly large drop-offs in house price appreciation after a period of strong growth. In addition to high rates of seriously delinquent loans, these states accounted for a substantial proportion of active nonprime loans nationwide. More specifically, as of March 31, 2009, these three states combined represented 34 percent of all active nonprime loans and 45 percent of all seriously delinquent nonprime loans. In contrast, Illinois, Massachusetts, and New Jersey together accounted for about 7 percent of active nonprime loans and 9 percent of seriously delinquent nonprime loans as of March 31, 2009.

Figure 14: Serious Delinquency Rates by State as of March 31, 2009





Serious delinquency rates also varied by congressional district within each state, as shown in figure 15 below.<sup>20</sup> For more detailed data on the performance of nonprime loans by Census division, state, and congressional district, see enclosures V and VI.

Figure 15: Estimated Serious Delinquency Rates by Congressional District as of March 31, 2009



<sup>20</sup> According to data from the 2000 Census, the United States has 435 congressional districts. Each congressional district elects a member to the United States House of Representatives. California has the most districts with 53, and seven states (Alaska, Delaware, Montana, North Dakota, South Dakota, Vermont, and Wyoming) have just one district.

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William B. Shear  
Director, Financial Markets and Community Investment

Enclosures

**Enclosure I****Characteristics of Nonprime Loans by Cohort Year, 2000-2007**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on loan and borrower characteristics for nonprime mortgages originated from 2000 through 2007. Tables 1 and 2 show the percentage and number, respectively, of nonprime mortgages that were subprime and Alt-A loans.<sup>30</sup> Tables 3 and 4 provide the percentage and number, respectively, of nonprime mortgages by loan purpose (purchase or refinance) and loan type (adjustable-rate mortgage [ARM] or fixed-rate mortgage). Table 5 shows the proportion of subprime loans that were short-term hybrid ARMs and the proportion of Alt-A loans that were payment-options ARMs. Tables 6 and 7 provide the percentage and number, respectively, of nonprime mortgages with selected loan and borrower characteristics, as well as mean values for a number of variables such as loan amount at origination and borrower FICO score at origination.

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<sup>30</sup>As previously discussed, we defined subprime loans as loans in subprime pools and Alt-A loans as loans in Alt-A pools.

Enclosure I

Table 1: Percentage of Nonprime Loans by Market Segment, 2000-2007

Market segment	2000	2001	2002	2003	2004	2005	2006	2007	Total
Subprime	85%	80%	77%	75%	68%	61%	57%	43%	65%
Alt-A	15%	20%	23%	25%	32%	39%	43%	57%	35%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: GAO analysis of LF data.

Table 2: Number of Nonprime Loans by Market Segment, 2000-2007

Market segment	2000	2001	2002	2003	2004	2005	2006	2007	Total
Subprime	456,631	537,734	784,963	1,281,732	1,947,427	2,284,420	1,782,677	330,514	9,406,088
Alt-A	76,183	138,645	231,404	435,703	836,667	1,447,782	1,325,629	436,078	5,034,091
Total	534,814	676,379	1,016,367	1,717,435	2,884,094	3,732,202	3,112,306	766,592	14,440,189

Source: GAO analysis of LF data.

Table 3: Percentage of Nonprime Loans by Purpose and Type, 2000-2007

Loan purpose	2000	2001	2002	2003	2004	2005	2006	2007	Total
Purchase									
Subprime share of purchase	39%	36%	34%	33%	42%	46%	45%	34%	41%
Alt-A share of purchase	74%	68%	66%	68%	58%	55%	54%	37%	58%
Refinance									
Subprime share of refinance	26%	32%	34%	32%	45%	45%	46%	69%	42%
Cash out	61%	64%	66%	67%	58%	54%	55%	66%	59%
No cash out									
Unknown									
Alt-A share of refinance	93%	86%	83%	78%	75%	67%	60%	46%	70%
Cash out	81%	81%	81%	82%	68%	89%	89%	84%	85%
No cash out	16%	16%	16%	17%	12%	11%	11%	16%	14%
Unknown	2%	3%	1%	1%	0%	0%	0%	0%	0%
Loan type									
ARM									
Subprime share of ARM	7%	14%	17%	22%	25%	33%	40%	54%	30%
Cash out	67%	63%	59%	58%	65%	73%	70%	61%	67%
No cash out	31%	36%	41%	44%	34%	27%	29%	39%	33%
Unknown	2%	0%	0%	0%	1%	0%	0%	0%	0%
Alt-A share of ARM	51%	52%	58%	56%	72%	73%	69%	60%	66%
Cash out	96%	93%	91%	88%	72%	67%	62%	46%	71%
Alt-A share of ARM	4%	7%	9%	12%	28%	33%	38%	54%	29%

Enclosure 1

	2000	2001	2002	2003	2004	2005	2006	2007	Total
Fixed-rate mortgage	42%	43%	40%	43%	28%	26%	27%	35%	32%
Subprime share of fixed rate	70%	62%	57%	58%	57%	43%	42%	33%	51%
Alt-A share of fixed rate	30%	38%	43%	42%	43%	57%	58%	67%	49%
Other	8%	5%	2%	1%	0%	0%	4%	4%	2%
Subprime share of other	96%	90%	89%	51%	36%	98%	77%	79%	80%
Alt-A share of other	4%	10%	17%	49%	64%	8%	23%	21%	20%

Source: GAO analysis of CFP data.

Note: Percentages for ARMs and fixed-rate mortgages do not include balloon mortgages, which account for most of the "other" category. Balloon mortgages can have fixed or adjustable interest rates.

Table 4: Number of Nonprime Loans by Purpose and Type, 2000-2007

Loan purpose	2000	2001	2002	2003	2004	2005	2006	2007	Total
Purchase	206,020	240,156	345,338	567,899	1,210,349	1,719,131	1,396,567	264,018	5,949,478
Subprime share of purchase	152,312	164,460	228,531	383,789	699,278	943,877	754,552	98,913	3,424,712
Alt-A share of purchase	53,708	75,696	116,807	184,110	512,071	775,254	642,015	165,105	2,594,766
Refinance	328,794	438,223	671,029	1,149,536	1,673,745	2,013,071	1,715,739	502,574	8,490,711
Subprime share of refinance	304,319	373,274	556,432	897,943	1,249,149	1,340,543	1,028,125	231,601	5,981,386
Cash out	246,365	303,143	448,038	740,483	1,098,698	1,196,493	917,552	194,871	5,145,624
No cash out	53,248	60,752	101,679	152,131	149,906	143,723	109,595	36,705	808,239
Unknown	4,605	9,379	6,715	5,319	575	327	578	25	27,523
Alt-A share of refinance	24,475	62,949	114,597	251,593	424,596	672,528	687,614	270,973	2,509,325
Cash out	16,484	39,958	67,923	140,426	276,758	487,753	482,900	165,237	1,677,438
No cash out	7,611	22,969	46,524	110,523	144,656	183,841	202,696	105,728	824,548
Unknown	380	22	150	644	3,182	934	2,018	8	7,338
Loan type ARM	272,048	349,910	590,558	958,430	2,066,473	2,737,410	2,146,756	462,172	9,583,767
Subprime share of ARM	261,975	325,047	537,893	841,067	1,462,569	1,844,167	1,399,129	219,672	6,845,459

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	2000	2001	2002	2003	2004	2005	2006	2007	Total
Fixed-rate mortgage	222,649	281,084	403,665	738,652	807,994	977,629	851,171	271,284	4,564,138
Alt-A share of ARM	10,073	24,863	52,725	117,363	583,904	893,243	807,627	246,500	2,738,298
Subprime share of fixed rate	155,992	180,742	229,828	430,208	461,372	424,407	395,315	90,698	2,327,562
Alt-A share of fixed rate	68,657	110,242	174,837	308,454	346,622	553,222	495,856	180,536	2,236,576
Other	46,117	35,365	22,144	20,343	9,627	17,163	114,379	33,136	292,294
Subprime share of other	38,684	31,945	18,302	10,457	3,486	15,846	88,233	26,144	233,077
Alt-A share of other	1,453	3,440	3,842	9,886	6,141	1,317	26,146	6,992	59,217

Source: GAO analysis of LP data.

Note: Numbers for ARMs and fixed-rate mortgages do not include balloon mortgages, which account for most of the "other" category. Balloon mortgages can have fixed or adjustable interest rates.

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Table 5: Short-term Hybrid ARMs as a Percentage of Subprime Market and Payment-option ARMs as a Percentage of Alt-A Market, 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007	Total
Number of subprime short-term hybrid ARMs	248,964	316,119	516,804	798,136	1,439,475	1,787,984	1,290,983	198,240	6,586,705
Short-term hybrid ARMs as a percentage of subprime market	55%	59%	66%	62%	73%	78%	72%	60%	70%
Number of Alt-A payment-option ARMs	4,217	682	4,570	7,572	123,202	310,140	326,298	60,523	837,204
Payment-option ARMs as a percentage of Alt-A market	5%	0%	2%	2%	13%	21%	25%	14%	17%

Source: GAO analysis of LP data.

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Table 6: Percentage of Subprime and Alt-A Loans with Selected Loan and Borrower Characteristics and Mean Values for Key Variables, 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007	Total
<b>Low or no documentation of borrower assets or income</b>									
Subprime	20%	23%	28%	32%	34%	37%	38%	33%	33%
Alt-A	60%	62%	59%	64%	61%	65%	60%	60%	70%
<b>Prepayment penalty</b>									
Subprime	65%	74%	75%	74%	73%	72%	71%	70%	70%
Alt-A	21%	24%	25%	23%	31%	35%	46%	42%	37%
<b>Negative amortization feature</b>									
Subprime	0%	0%	0%	0%	0%	0%	0%	0%	0%
Alt-A	7%	3%	2%	2%	15%	25%	30%	31%	21%
<b>Owner-occupant</b>									
Subprime	91%	92%	92%	92%	92%	92%	92%	92%	92%
Alt-A	78%	85%	77%	69%	73%	74%	76%	76%	75%
<b>Mean loan amount at origination</b>									
Subprime	\$103,607	\$125,545	\$145,213	\$164,204	\$179,520	\$199,488	\$211,773	\$216,482	\$180,130
Alt-A	\$219,543	\$283,053	\$250,274	\$228,621	\$259,784	\$290,963	\$324,220	\$376,106	\$292,350
<b>Mean unpaid balance as of March 31, 2009</b>									
Subprime	\$58,745	\$80,927	\$85,081	\$126,088	\$146,205	\$183,110	\$204,672	\$217,694	\$183,028
Subprime number	62,050	59,788	79,755	180,589	382,823	740,157	986,353	246,744	2,718,359
Alt-A	\$129,653	\$185,629	\$186,854	\$180,395	\$225,842	\$279,133	\$322,093	\$379,044	\$295,237
Alt A number	9,982	16,720	37,621	144,142	313,548	747,545	882,924	354,027	2,506,509
<b>Mean borrower FICO score at origination</b>									
Subprime	592	600	608	618	618	621	618	614	616
Alt-A	700	701	705	711	708	711	706	712	709
<b>Mean combined loan-to-value ratio at origination</b>									
Subprime	78.0	79.5	80.1	81.9	83.6	84.9	85.8	82.9	83.3
Alt-A	81.3	80.8	79.0	76.3	80.4	81.1	82.4	80.3	80.7
<b>Mean debt service-to-income ratio at origination</b>									
Subprime	38.8	38.5	38.9	38.9	39.4	40.2	41.1	41.5	39.9
Alt-A	34.8	35.2	35.3	33.9	35.1	36.1	37.0	37.3	36.1

Source: GAO analysis of LP data.

Note: The LP data do not capture all second liens. As a result, the average combined loan-to-value ratios presented are likely lower than the actual averages. Also, 29 percent of the subprime loans and 56 percent of the Alt-A loans in the LP database did not contain information on the debt service-to-income ratio.

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Table 7: Number of Subprime and Alt-A Loans with Selected Loan and Borrower Characteristics and Mean Values for Key Variables, 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007	Total
<b>Low or no documentation of borrower assets or income</b>									
Subprime	91,351	122,431	220,782	405,280	652,603	836,791	672,090	109,920	3,111,448
Alt-A	45,535	65,732	136,499	276,760	571,692	991,704	1,051,630	345,937	3,575,960
<b>Prepayment penalty</b>									
Subprime	299,079	399,567	597,047	944,735	1,416,439	1,655,200	1,266,051	231,417	6,798,564
Alt-A	15,041	32,955	57,956	102,275	203,737	585,703	612,818	182,073	1,953,559
<b>Negative amortization feature</b>									
Subprime	168	92	124	94	140	598	269	22	1,497
Alt-A	5,761	4,402	5,276	10,131	136,390	355,230	397,196	136,954	1,051,340
<b>Owner-occupant</b>									
Subprime	415,913	492,220	721,559	1,177,982	1,785,929	2,094,209	1,635,348	303,421	8,626,590
Alt-A	60,715	117,252	179,190	299,683	686,744	1,074,917	1,014,307	331,494	3,763,292

Sources: GAO analysis of LP data.



**Enclosure II****Distribution of Initial Interest Rates for Nonprime Loans by Cohort Year,  
2000-2007**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on the distribution of initial interest rates at loan origination for nonprime mortgages originated from 2000 through 2007. Tables 8 and 9 provide information in percentages and total numbers, respectively.

## Enclosure II

Table 8: Percentage of Nonprime Loans in Different Initial Interest Rate Ranges by Cohort Year, 2000-2007

	Interest rate range	2000	2001	2002	2003	2004	2005	2006	2007	Totals
Subprime fixed rate	0.1% - 5.0%	34%	34%	28%	34%	24%	19%	20%	27%	25%
	5.1% - 6.0%	0%	1%	0%	2%	2%	1%	0%	0%	1%
	6.1% - 7.0%	0%	1%	3%	16%	16%	24%	4%	4%	13%
	7.1% - 8.0%	1%	9%	20%	34%	35%	30%	22%	18%	26%
	8.1% - 9.0%	5%	18%	30%	27%	26%	26%	30%	25%	25%
	9.1% - 10.0%	14%	21%	23%	13%	10%	12%	24%	23%	18%
Subprime short-term hybrid ARM	Greater than 10%	21%	21%	13%	5%	3%	4%	13%	17%	9%
	0.1% - 5.0%	59%	59%	66%	69%	73%	78%	72%	60%	70%
	5.1% - 6.0%	3%	1%	2%	1%	3%	1%	0%	1%	1%
	6.1% - 7.0%	0%	0%	2%	12%	21%	16%	2%	3%	11%
	7.1% - 8.0%	0%	3%	13%	30%	34%	34%	18%	15%	25%
	8.1% - 9.0%	2%	14%	27%	31%	26%	28%	33%	28%	27%
Subprime other ARM	Greater than 10%	12%	28%	23%	17%	11%	14%	28%	28%	18%
	0.1% - 5.0%	23%	26%	10%	5%	9%	2%	14%	15%	10%
	5.1% - 6.0%	53%	28%	38%	32%	34%	26%	18%	8%	32%
	6.1% - 7.0%	4%	5%	11%	18%	15%	7%	1%	1%	9%
	7.1% - 8.0%	2%	6%	9%	17%	32%	33%	10%	10%	20%
	8.1% - 9.0%	4%	11%	14%	27%	31%	34%	30%	27%	27%
Subprime other	Greater than 10%	13%	21%	23%	22%	16%	17%	30%	22%	20%
	0.1% - 5.0%	23%	19%	13%	11%	5%	6%	17%	20%	12%
	5.1% - 6.0%	45%	23%	8%	3%	1%	2%	8%	14%	7%
	6.1% - 7.0%	8%	6%	2%	1%	0%	1%	4%	13%	6%
	7.1% - 8.0%	0%	0%	0%	1%	0%	1%	5%	8%	2%
	8.1% - 9.0%	0%	0%	2%	10%	30%	19%	4%	0%	4%
Alt-A fixed rate	Greater than 10%	0%	0%	0%	0%	0%	0%	0%	0%	0%
	0.1% - 5.0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
	5.1% - 6.0%	0%	2%	15%	53%	57%	61%	12%	26%	3%
	6.1% - 7.0%	0%	22%	40%	27%	31%	29%	57%	53%	37%
	7.1% - 8.0%	10%	42%	30%	8%	6%	7%	23%	15%	15%
	8.1% - 9.0%	47%	25%	11%	2%	1%	1%	6%	4%	6%
Greater than 10%	9.1% - 10.0%	35%	7%	3%	0%	0%	0%	1%	2%	2%
	Greater than 10%	8%	2%	1%	0%	0%	0%	0%	1%	0%

Source: GAO analysis of LP data.

## Enclosure II

Table 9: Number of Nonprime Loans in Different Initial Interest Rate Ranges by Cohort Year, 2000-2007

	Interest rate range	2000	2001	2002	2003	2004	2005	2006	2007	Total
Subprime fixed rate	0.1% - 5.0%	155,992	180,742	224,828	430,308	461,372	424,407	355,315	90,899	2,327,552
	5.1% - 6.0%	100	100	910	8,216	6,097	3,734	1,326	58	24,339
	6.1% - 7.0%	213	1,484	7,980	69,675	112,784	84,258	14,951	3,456	295,001
	7.1% - 8.0%	1,229	16,956	45,172	146,914	163,308	145,963	76,904	15,967	612,413
	8.1% - 9.0%	7,813	32,520	67,868	117,937	108,395	110,702	107,444	22,432	575,101
	9.1% - 10.0%	21,407	37,394	52,410	55,851	47,449	52,721	83,535	21,165	371,532
	Greater than 10%	32,768	36,007	29,877	21,511	15,423	19,069	45,188	15,598	217,441
Subprime short-term hybrid ARM	0.1% - 5.0%	248,964	316,119	516,804	798,136	1,423,475	1,797,984	1,290,983	198,240	6,586,705
	5.1% - 6.0%	6,655	1,996	9,392	9,392	43,131	21,154	525	2,370	94,098
	6.1% - 7.0%	813	400	11,702	94,297	296,392	283,511	26,126	5,536	718,767
	7.1% - 8.0%	911	10,225	68,333	240,971	491,613	612,867	209,368	29,640	1,663,728
	8.1% - 9.0%	4,973	43,088	139,553	244,252	371,576	501,701	427,209	56,040	1,788,392
	9.1% - 10.0%	30,236	81,772	148,706	138,028	162,516	254,383	366,393	54,950	1,236,384
	Greater than 10%	71,264	88,211	87,993	50,074	47,272	86,912	186,433	33,723	651,882
Subprime other ARM	0.1% - 5.0%	13,011	8,928	21,029	42,331	53,094	56,189	48,146	15,432	258,754
	5.1% - 6.0%	468	444	2,237	7,623	7,726	3,791	464	149	22,901
	6.1% - 7.0%	309	506	1,890	7,465	16,952	18,635	4,662	1,526	51,985
	7.1% - 8.0%	540	941	3,014	11,667	16,235	19,146	14,338	3,048	68,929
	8.1% - 9.0%	1,058	1,361	4,606	9,386	8,472	9,422	14,308	3,393	52,046
	9.1% - 10.0%	2,962	1,713	4,901	4,712	2,743	3,430	8,368	3,132	30,933
	Greater than 10%	5,903	2,067	1,590	1,490	758	1,279	3,978	2,235	17,226
Subprime other	0.1% - 5.0%	38,664	31,945	18,302	10,457	3,486	15,846	88,233	26,144	233,077
	5.1% - 6.0%	40	16	30	113	356	130	28	12	726
	6.1% - 7.0%	13	119	277	1,056	1,033	2,975	3,748	1,023	10,244
	7.1% - 8.0%	74	746	1,870	2,510	1,190	6,568	26,615	5,293	45,228
	8.1% - 9.0%	485	3,299	5,031	3,441	571	4,111	31,923	7,592	58,453
	9.1% - 10.0%	2,751	6,595	5,197	1,816	223	1,504	17,300	6,338	41,735
	Greater than 10%	8,112	8,289	3,406	808	107	432	6,229	3,679	31,072
Alt-A fixed rate	0.1% - 5.0%	66,957	110,342	174,537	309,454	346,622	553,222	495,856	180,588	2,236,576
	5.1% - 6.0%	105	111	708	32,749	17,411	8,239	637	46	80,696
	6.1% - 7.0%	82	1,883	26,600	12,253	107,470	338,029	61	46,351	833,359
	7.1% - 8.0%	24,638	64,935	149,851	81,637	107,624	289,552	289,552	24,795	839,661
	8.1% - 9.0%	6,706	49,239	52,651	21,634	19,874	39,511	113,852	26,795	359,162
	9.1% - 10.0%	21,276	27,630	19,520	5,869	3,771	6,792	29,767	7,882	132,183
	Greater than 10%	23,128	6,086	5,438	523	528	664	5,647	2,949	46,863
		5,049	1,878	987	49	148	71	1,365	930	10,457

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	Interest rate range											Total
Payment-option ARM	0.1% - 5.0%	2000	2001	2002	2003	2004	2005	2006	2007			
		4,217	662	4,570	7,572	123,202	310,140	326,298	60,523			837,204
	5.1% - 6.0%	4,207	679	4,549	7,369	121,617	309,147	305,422	55,039			806,228
	6.1% - 7.0%	7	3	8	151	789	293	5,002	209			6,399
	7.1% - 8.0%	2	-	13	46	769	293	12,266	2,911			15,223
	8.1% - 9.0%	1	-	-	-	2	43	2,891	2,263			5,183
	9.1% - 10.0%	-	-	-	-	-	9	52	60			112
	Greater than 10%	-	-	-	-	-	-	-	-			1
Alt-A other ARM	0.1% - 5.0%	5,856	24,161	48,155	103,791	460,702	563,103	481,329	187,977			1,901,094
		1,648	4,541	10,374	48,411	202,178	113,296	60,063	48,640			489,171
	5.1% - 6.0%	131	3,076	16,246	39,905	190,345	276,396	88,778	32,369			647,246
	6.1% - 7.0%	274	8,297	13,095	15,617	56,519	148,557	216,100	83,486			523,945
	7.1% - 8.0%	778	5,231	6,032	5,042	9,966	39,470	96,715	31,227			194,461
	8.1% - 9.0%	1,913	2,102	1,876	714	1,458	4,828	15,390	8,672			36,953
	9.1% - 10.0%	745	675	443	93	194	484	1,933	2,553			7,120
	Greater than 10%	367	259	89	9	42	72	330	1,030			2,198
Alt-A other	0.1% - 5.0%	1,453	3,440	3,842	9,886	6,141	1,317	26,146	6,992			59,217
		1	-	20	3,648	3,920	176	8,732	1,277			17,774
	5.1% - 6.0%	3	11	30	3,132	1,507	207	1,053	763			6,706
	6.1% - 7.0%	-	54	575	1,720	480	508	7,978	2,862			14,176
	7.1% - 8.0%	9	1,028	1,670	1,107	134	298	5,896	1,508			11,650
	8.1% - 9.0%	310	1,450	1,110	239	42	97	1,967	454			5,689
	9.1% - 10.0%	766	634	394	37	52	23	434	123			2,393
	Greater than 10%	364	263	63	3	36	10	66	5			850

Source: GAO analysis of LP data.

**Enclosure III****Status of Nonprime Loans Originated from 2000 through 2007 by Cohort Year and Product Type as of March 31, 2009**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on the status of nonprime mortgages originated from 2000 through 2007, as of March 31, 2009. Tables 10 and 11 provide information in percentages and total numbers, respectively.

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Table 10: Percentage of Nonprime Loans in Different Status Categories by Cohort Year as of March 31, 2009

	Subprime															
	ARM (excluding short-term hybrids)										Fixed rate					
	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total
	2000	73%	9%	2%	1%	1%	14%	100%	2000	64%	13%	4%	2%	1%	16%	100%
	2001	79%	6%	2%	1%	1%	11%	100%	2001	69%	13%	3%	1%	1%	13%	100%
	2002	80%	7%	2%	1%	1%	9%	100%	2002	72%	15%	3%	1%	1%	9%	100%
	2003	61%	9%	1%	1%	1%	7%	100%	2003	65%	24%	3%	1%	1%	6%	100%
	2004	72%	16%	2%	2%	2%	7%	100%	2004	52%	34%	5%	3%	2%	6%	100%
	2005	46%	30%	5%	4%	5%	10%	100%	2005	34%	43%	8%	5%	3%	7%	100%
	2006	23%	36%	9%	9%	10%	14%	100%	2006	21%	47%	11%	8%	6%	7%	100%
	2007	15%	41%	11%	16%	10%	8%	100%	2007	13%	52%	13%	11%	6%	5%	100%
	Total	56%	22%	4%	4%	4%	10%	100%	Total	49%	32%	6%	4%	2%	8%	100%

	Other															
	Short-term hybrid ARM										Other					
	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total
	2000	72%	5%	2%	1%	1%	19%	100%	2000	60%	11%	3%	2%	1%	23%	100%
	2001	76%	4%	1%	1%	1%	17%	100%	2001	67%	10%	2%	1%	1%	18%	100%
	2002	81%	3%	1%	1%	1%	13%	100%	2002	69%	14%	2%	1%	1%	13%	100%
	2003	84%	3%	1%	1%	1%	10%	100%	2003	64%	21%	3%	1%	1%	9%	100%
	2004	78%	5%	2%	2%	1%	12%	100%	2004	53%	35%	3%	2%	2%	5%	100%
	2005	57%	11%	4%	5%	5%	18%	100%	2005	32%	37%	8%	6%	6%	11%	100%
	2006	29%	20%	8%	10%	11%	21%	100%	2006	16%	38%	11%	9%	10%	14%	100%
	2007	17%	32%	12%	14%	13%	13%	100%	2007	11%	43%	15%	10%	13%	9%	100%
	Total	61%	10%	4%	4%	4%	16%	100%	Total	38%	28%	7%	6%	6%	15%	100%

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Alt-A													
Cohort year	ARM (excluding payment-option ARMs)						Fixed rate						Total
	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	
2000	87%	9%	1%	0%	0%	3%	82%	11%	1%	0%	1%	5%	100%
2001	87%	8%	1%	0%	0%	3%	83%	11%	1%	0%	0%	4%	100%
2002	83%	13%	1%	0%	0%	2%	79%	16%	1%	0%	0%	4%	100%
2003	81%	14%	1%	1%	0%	2%	58%	35%	1%	1%	0%	2%	100%
2004	72%	20%	2%	1%	1%	4%	47%	45%	2%	1%	1%	2%	100%
2005	45%	33%	4%	3%	5%	9%	31%	55%	4%	2%	3%	4%	100%
2006	24%	39%	6%	7%	10%	14%	23%	54%	6%	4%	6%	7%	100%
2007	12%	52%	5%	6%	12%	9%	12%	65%	6%	5%	5%	4%	100%
Total	47%	31%	4%	4%	6%	8%	42%	46%	3%	2%	3%	4%	100%

Other													
Cohort year	Payment-option ARM						Other						Total
	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	
2000	86%	13%	0%	0%	0%	1%	80%	9%	2%	0%	0%	9%	100%
2001	94%	4%	0%	0%	0%	1%	80%	8%	1%	1%	0%	9%	100%
2002	92%	7%	0%	0%	0%	0%	82%	6%	1%	1%	0%	7%	100%
2003	84%	12%	1%	1%	1%	1%	74%	21%	1%	1%	1%	3%	100%
2004	77%	15%	2%	2%	2%	2%	65%	28%	1%	1%	1%	2%	100%
2005	54%	25%	4%	6%	6%	6%	37%	33%	4%	5%	7%	15%	100%
2006	25%	37%	7%	10%	11%	9%	19%	39%	6%	9%	13%	12%	100%
2007	12%	51%	9%	10%	12%	5%	9%	53%	9%	8%	14%	8%	100%
Total	44%	30%	9%	7%	7%	7%	41%	32%	5%	5%	8%	9%	100%

Source: GAO analysis of LP data.



Enclosure III

Table 11: Number of Nonprime Loans in Different Status Categories by Cohort Year as of March 31, 2009

Subprime															
ARM (excluding short-term hybrids)							Fixed rate								
Cohort year	Prepaid	Current	Delinquent	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In foreclosure process	Completed foreclosure process			
2000	9,463	1,159	302	155	98	13,099	2000	99,773	20,887	5,538	2,874	1,803			
2001	7,038	570	161	104	53	8,826	2001	124,281	22,822	5,145	2,653	1,583			
2002	16,916	1,513	365	185	169	21,024	2002	164,268	34,282	5,883	2,957	1,866			
2003	34,742	3,804	635	444	326	42,858	2003	279,722	102,819	13,075	6,225	3,890			
2004	38,020	8,310	1,322	999	855	53,040	2004	238,370	156,218	21,557	11,772	7,253			
2005	26,024	18,609	2,737	2,188	2,710	56,112	2005	146,167	183,160	32,612	21,115	13,410			
2006	11,033	17,144	4,106	4,203	6,941	48,127	2006	74,715	167,737	37,397	28,726	19,683			
2007	2,271	6,324	1,672	2,415	1,529	15,429	2007	12,240	46,831	11,953	5,822	4,313			
Total	145,907	55,633	11,300	10,673	10,440	258,525	Total	1,139,536	734,556	133,160	86,853	55,130			
														177,351	2,326,586

Other															
Short-term hybrid ARM							Other								
Cohort year	Prepaid	Current	Delinquent	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In foreclosure process	Completed foreclosure process			
2000	179,375	13,140	4,161	3,226	2,260	202,062	2000	23,196	4,179	1,099	635	534			
2001	239,338	12,973	4,150	3,014	1,912	261,387	2001	21,426	3,270	689	406	273			
2002	419,959	15,664	6,050	4,554	3,088	449,315	2002	12,646	2,478	438	265	180			
2003	689,013	25,843	8,843	7,265	4,308	726,232	2003	6,741	2,161	34	152	132			
2004	1,110,764	75,756	27,470	28,199	20,601	1,242,829	2004	1,849	1,219	115	72	65			
2005	1,010,676	202,262	77,351	86,860	90,136	1,367,025	2005	5,111	5,603	1,341	915	879			
2006	377,417	283,574	103,539	130,821	144,233	1,039,680	2006	16,870	33,714	9,461	7,803	6,230			
2007	33,351	63,065	23,731	26,765	25,234	188,225	2007	2,756	11,257	3,901	2,575	2,353			
Total	4,039,490	872,377	255,295	291,264	293,217	5,081,794	Total	89,585	94,081	17,399	12,903	14,888			
														34,920	232,886

Enclosure III

Alt-A																		
ARM (excluding payment-option ARMs)										Fixed rate								
Cohort year	Prepaid			Current			Delinquent			In default			In foreclosure process			Completed foreclosure process		
	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total			
2000	5,095	514	50	30	7	159	5,854	2000	54,812	7,020	866	370	404	3,133	66,805			
2001	21,066	1,969	157	102	72	715	24,081	2001	91,319	11,936	1,113	545	439	4,804	110,156			
2002	40,161	6,125	379	209	143	1,102	48,119	2002	137,930	27,099	1,534	809	583	6,674	174,829			
2003	89,229	15,740	976	624	544	2,578	109,691	2003	179,367	115,671	3,662	1,849	1,424	6,188	308,361			
2004	329,623	91,257	7,058	5,763	6,770	19,659	460,130	2004	163,933	159,743	7,372	4,050	3,619	7,868	346,585			
2005	264,475	193,609	20,396	20,215	29,018	54,241	582,156	2005	171,696	310,079	19,862	13,005	16,517	21,945	553,104			
2006	113,795	188,761	28,715	34,963	49,421	65,254	480,909	2006	112,250	267,654	28,667	22,274	31,705	33,196	495,746			
2007	22,320	97,102	14,399	15,396	21,622	17,218	187,966	2007	22,540	118,565	11,407	9,162	11,148	7,762	180,584			
Total	885,773	595,277	72,032	77,302	107,597	160,925	1,898,906	Total	933,847	1,017,767	74,683	52,064	65,839	91,770	2,235,970			

Cohort year	Payment-option ARM										Other						Total
	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Total	Cohort year	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process			
2000	3,636	539	6	9	2	25	4,217	2000	1,164	127	24	7	7	124	1,453		
2001	642	30	2	-	1	7	682	2001	2,761	267	51	22	14	325	3,440		
2002	4,203	322	7	6	11	20	4,569	2002	3,159	310	40	28	16	288	3,841		
2003	6,326	940	107	51	63	77	7,564	2003	7,307	2,036	119	66	70	273	9,871		
2004	94,676	19,175	2,270	2,343	2,203	2,522	123,169	2004	4,078	1,735	89	40	61	138	6,141		
2005	166,421	75,092	11,581	19,182	17,145	19,680	310,101	2005	482	437	47	63	95	193	1,317		
2006	82,726	121,819	22,703	32,503	35,696	30,761	326,208	2006	4,938	10,180	2,007	2,406	3,450	3,153	26,134		
2007	7,199	31,080	5,173	6,115	7,131	3,805	60,503	2007	612	3,674	662	547	944	553	6,992		
Total	365,829	249,997	41,449	60,209	82,252	56,897	837,033	Total	24,501	18,766	3,039	3,179	4,657	5,047	59,169		

Source: GAO analysis of UH data.

**Enclosure IV****Status of Nonprime Loans Originated from 2004 through 2007 by Year and Quarter as of March 31, 2009**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on the annual and quarterly status of nonprime mortgages originated from 2004 through 2007, as of March 31, 2009. Tables 12 and 13 provide information in percentages and total numbers, respectively.

Table 12: Percentage of Nonprime Loans Originated in 2004 through 2007 in Different Status Categories as of March 31, 2009

Status date	2007 Cohort						2008 Cohort					
	Subprime			Alt-A			Subprime			Alt-A		
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total
December 31, 2007	15%	41%	15%	11%	8%	100%	15%	41%	15%	11%	8%	100%
December 31, 2008	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%
March 31, 2009	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%

Status date	2007 Cohort						2008 Cohort					
	Subprime			Alt-A			Subprime			Alt-A		
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total
December 31, 2007	15%	41%	15%	11%	8%	100%	15%	41%	15%	11%	8%	100%
December 31, 2008	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%
March 31, 2009	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%

Status date	2008 Cohort						2009 Cohort					
	Subprime			Alt-A			Subprime			Alt-A		
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total
December 31, 2008	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%
December 31, 2009	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%

Status date	2009 Cohort						2010 Cohort					
	Subprime			Alt-A			Subprime			Alt-A		
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Total
December 31, 2009	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%
December 31, 2010	15%	39%	15%	11%	10%	100%	15%	39%	15%	11%	10%	100%

Source: GAO analysis of LP data.

Enclosure IV

Table 13: Number of Nonprime Loans Originated in 2004 through 2007 in Different Status Categories as of March 31, 2009

Status date	2007 Cohort									
	Subprime					Alt-A				
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)
December 31, 2007	18,102	20,735	48,316	13,477	328,548	20,513	376,372	21,186	6,536	433,895
December 31, 2008	44,058	155,117	51,256	37,274	32,844	46,301	273,614	36,288	25,055	22,524
March 31, 2009	47,707	126,118	40,744	41,125	36,437	50,918	255,421	31,541	31,220	30,000
										434,845

Status date	2008 Cohort									
	Subprime					Alt-A				
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)
December 31, 2008	91,519	1,048,377	153,186	27,841	24,897	58,318	944,169	35,999	3,673	1,047
December 31, 2007	308,751	882,179	234,132	109,807	132,853	232,681	920,896	76,839	30,737	26,384
December 31, 2006	445,971	699,886	198,891	85,708	107,891	233,681	640,339	27,493	89,107	39,811
March 31, 2009	452,656	479,918	153,650	17,875	216,293	250,571	366,111	34,926	129,212	13,572
										1,529,974

Status date	2005 Cohort									
	Subprime					Alt-A				
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)
December 31, 2005	122,108	1,438,997	140,861	22,176	14,074	69,222	1,073,961	23,659	2,592	177
December 31, 2006	697,611	1,211,085	210,943	63,501	2,442,828	392,557	1,055,768	49,776	7,152	10,284
December 31, 2007	1,051,092	417,842	181,598	39,159	135,526	593,128	611,363	50,076	52,484	5,524
December 31, 2008	1,149,463	402,072	112,319	110,844	105,797	595,903	580,417	51,888	52,465	62,775
March 31, 2009					35,621					97,339
										1,440,787

Status date	2004 Cohort									
	Subprime					Alt-A				
	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)	Prepaid (cumulative)	Current	Delinquent	In foreclosure process	Completed foreclosure process (cumulative)
December 31, 2004	93,670	1,294,270	97,242	11,653	8,467	37,168	687,791	12,295	968	133
December 31, 2005	667,504	1,002,601	142,532	46,117	36,363	260,603	651,707	19,096	4,275	2,653
December 31, 2006	1,145,083	500,481	103,751	41,055	46,527	542,259	563,605	19,864	3,803	4,459
December 31, 2007	1,309,425	400,425	102,500	39,500	44,000	576,517	281,303	18,657	10,129	10,637
December 31, 2008	1,369,266	240,074	50,395	41,600	27,986	588,386	271,699	16,775	12,643	28,001
March 31, 2009	1,382,146	236,097	49,766	41,607	28,399					30,444
										836,142

Source: GAO analysis of LP data.

**Enclosure V****Status of Nonprime Loans Originated from 2000 through 2007 by Census Division and State as of March 31, 2009**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on the status of nonprime mortgages by Census division and state. The analysis covers mortgages originated from 2000 through 2007, as of March 31, 2009. Tables 14 and 15 provide information in percentages and total numbers, respectively.

## Enclosure V

Table 14: Percentage of 2000-2007 Nonprime Loans in Different Status Categories by Census Division and State as of March 31, 2009

State	Market segment	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Unknown	Total
Connecticut	Subprime	61.50%	16.45%	4.53%	3.70%	3.98%	9.12%	0.72%	123,057
	Alt-A	46.10%	40.00%	4.01%	2.52%	3.69%	3.28%	0.41%	44,759
Maine	Subprime	62.21%	16.28%	4.41%	2.99%	4.81%	8.24%	1.06%	36,312
	Alt-A	46.73%	38.84%	3.96%	1.99%	4.71%	3.27%	0.50%	9,706
Massachusetts	Subprime	65.55%	11.76%	3.62%	4.75%	2.97%	10.06%	1.29%	201,130
	Alt-A	50.71%	33.78%	3.56%	3.25%	3.33%	4.53%	0.85%	85,185
New Hampshire	Subprime	60.91%	16.61%	4.80%	4.07%	2.07%	10.88%	0.65%	41,435
	Alt-A	48.67%	39.03%	3.99%	2.46%	1.76%	5.52%	0.57%	15,002
Rhode Island	Subprime	69.07%	10.53%	3.12%	2.71%	2.40%	11.04%	1.14%	62,616
	Alt-A	50.18%	32.24%	3.97%	2.87%	3.23%	6.87%	0.65%	15,764
Vermont	Subprime	63.92%	17.70%	4.18%	3.08%	3.97%	6.13%	1.02%	9,758
	Alt-A	47.93%	41.47%	3.04%	1.94%	3.01%	1.74%	0.87%	3,914
New England	Subprime	64.17%	13.77%	3.98%	4.01%	3.26%	9.77%	1.04%	464,508
	Alt-A	48.84%	36.15%	3.78%	2.86%	3.34%	4.38%	0.67%	174,930
New Jersey	Subprime	67.69%	11.54%	3.58%	3.59%	5.42%	6.62%	1.46%	264,731
	Alt-A	50.66%	33.04%	3.89%	2.91%	6.00%	2.90%	0.66%	143,788
New York	Subprime	57.61%	18.78%	4.85%	5.01%	5.37%	7.51%	0.86%	384,925
	Alt-A	40.82%	42.66%	4.43%	4.47%	4.60%	2.65%	0.37%	166,080
Pennsylvania	Subprime	50.80%	24.58%	6.13%	5.21%	3.48%	9.16%	0.62%	262,683
	Alt-A	42.14%	46.18%	3.71%	2.37%	2.47%	2.73%	0.41%	81,623
Mid Atlantic	Subprime	58.58%	18.35%	4.85%	4.69%	4.84%	7.73%	0.97%	912,339
	Alt-A	44.71%	39.86%	4.06%	3.46%	4.67%	2.76%	0.48%	391,491
Illinois	Subprime	61.49%	13.01%	3.90%	3.50%	4.45%	12.38%	1.27%	450,147
	Alt-A	50.23%	32.75%	3.50%	2.75%	4.81%	5.13%	0.81%	147,636
Indiana	Subprime	61.53%	21.08%	5.35%	4.44%	4.38%	22.67%	0.55%	176,216
	Alt-A	36.49%	43.34%	3.58%	2.70%	4.15%	9.37%	0.37%	38,381
Michigan	Subprime	47.07%	14.74%	4.97%	4.74%	1.94%	25.78%	0.76%	373,310
	Alt-A	35.94%	40.41%	4.42%	3.29%	2.37%	13.12%	0.44%	94,707
Ohio	Subprime	43.56%	19.89%	5.05%	4.51%	4.80%	21.47%	0.72%	319,389
	Alt-A	34.31%	48.41%	3.76%	2.73%	4.27%	8.17%	0.34%	73,621
Wisconsin	Subprime	62.05%	13.26%	3.69%	3.91%	3.53%	12.78%	0.98%	131,068
	Alt-A	45.79%	39.72%	3.14%	2.30%	3.49%	4.91%	0.68%	29,608
East North Central	Subprime	51.45%	15.97%	4.58%	4.14%	3.82%	19.12%	0.91%	1,450,128
	Alt-A	41.94%	38.85%	3.76%	2.84%	3.94%	8.09%	0.57%	383,953
Iowa	Subprime	55.11%	17.72%	4.34%	2.89%	3.47%	15.85%	0.62%	52,627
	Alt-A	41.13%	46.93%	2.73%	1.48%	2.44%	4.80%	0.48%	10,536
Kansas	Subprime	53.72%	19.40%	4.70%	3.32%	2.30%	15.86%	0.71%	49,747
	Alt-A	41.53%	47.95%	2.60%	1.85%	1.48%	4.68%	0.31%	16,854
Minnesota	Subprime	59.31%	12.19%	3.49%	2.88%	2.52%	18.70%	0.91%	162,906
	Alt-A	36.96%	40.80%	3.84%	2.93%	3.53%	11.54%	0.39%	67,357
Missouri	Subprime	53.19%	16.22%	4.95%	4.10%	1.47%	19.29%	0.78%	180,305
	Alt-A	43.24%	41.86%	3.16%	2.11%	1.28%	7.88%	0.47%	48,859
Nebraska	Subprime	49.52%	22.70%	5.05%	3.71%	2.41%	16.23%	0.39%	29,602
	Alt-A	38.41%	49.61%	3.05%	1.52%	1.80%	5.30%	0.31%	6,987
North Dakota	Subprime	57.13%	22.87%	4.82%	2.91%	2.37%	9.34%	0.56%	4,465
	Alt-A	41.33%	49.89%	2.33%	1.08%	2.00%	3.14%	0.22%	1,846
South Dakota	Subprime	55.28%	20.23%	4.48%	2.72%	2.91%	13.88%	0.51%	7,321
	Alt-A	41.94%	46.94%	2.32%	1.90%	1.90%	4.80%	0.21%	2,418
West North Central	Subprime	55.35%	15.87%	4.36%	3.43%	2.21%	18.01%	0.77%	486,973
	Alt-A	39.92%	42.93%	3.34%	2.31%	2.40%	8.69%	0.41%	154,857
Delaware	Subprime	58.48%	18.91%	5.49%	4.62%	4.68%	7.09%	0.73%	24,645
	Alt-A	44.89%	42.40%	3.46%	2.30%	3.60%	2.82%	0.54%	11,764
District of Columbia	Subprime	68.90%	11.44%	3.69%	3.95%	2.82%	7.90%	1.54%	17,372
	Alt-A	49.31%	38.25%	3.27%	2.64%	2.17%	3.66%	0.69%	15,469
Florida	Subprime	54.97%	14.76%	4.35%	4.69%	10.21%	10.25%	0.76%	935,244
	Alt-A	35.88%	35.23%	4.39%	5.07%	13.72%	5.20%	0.51%	528,708
Georgia	Subprime	47.11%	17.53%	6.09%	6.14%	2.55%	19.82%	0.76%	267,382
	Alt-A	36.67%	43.60%	4.55%	3.25%	2.37%	9.16%	0.41%	157,997
Maryland	Subprime	66.36%	12.26%	3.98%	4.18%	3.11%	6.66%	1.46%	255,118
	Alt-A	47.50%	36.28%	4.15%	4.42%	3.45%	3.56%	0.64%	135,923
North Carolina	Subprime	51.34%	20.14%	6.43%	5.00%	1.96%	14.32%	0.79%	179,453
	Alt-A	43.12%	44.15%	3.69%	2.41%	1.51%	4.68%	0.45%	86,827
South Carolina	Subprime	48.76%	20.80%	6.04%	3.95%	3.64%	16.10%	0.71%	94,146
	Alt-A	43.77%	41.75%	3.52%	2.06%	3.14%	5.15%	0.60%	48,943
Virginia	Subprime	63.49%	14.77%	4.25%	4.05%	1.90%	10.52%	1.03%	213,215
	Alt-A	42.59%	37.82%	3.62%	3.47%	2.75%	9.10%	0.70%	162,599
West Virginia	Subprime	50.41%	22.78%	6.79%	4.80%	2.73%	11.84%	0.63%	16,904
	Alt-A	37.60%	43.45%	4.82%	3.45%	3.28%	6.83%	0.54%	4,819
South Atlantic	Subprime	56.04%	15.67%	4.82%	4.74%	6.16%	11.89%	0.89%	2,003,479
	Alt-A	39.46%	37.96%	4.17%	4.12%	7.74%	6.02%	0.54%	1,152,849

## Enclosure V

State	Market segment	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Unknown	Total
Alabama	Subprime	47.86%	21.96%	6.74%	6.32%	1.79%	14.80%	0.54%	84,284
	Alt-A	41.08%	44.79%	3.70%	2.37%	1.63%	5.98%	0.46%	27,202
Kentucky	Subprime	47.30%	21.56%	5.42%	3.74%	3.94%	17.46%	0.58%	71,589
	Alt-A	38.94%	46.58%	3.27%	1.98%	3.07%	5.84%	0.33%	18,430
Mississippi	Subprime	40.70%	24.15%	7.69%	7.61%	2.45%	16.64%	0.75%	53,230
	Alt-A	38.86%	44.97%	4.45%	2.84%	1.96%	6.20%	0.72%	9,470
Tennessee	Subprime	44.30%	22.28%	6.96%	6.98%	1.78%	17.60%	0.57%	168,271
	Alt-A	38.97%	47.05%	3.68%	2.42%	1.37%	6.14%	0.38%	46,066
East South Central	Subprime	45.16%	22.33%	6.54%	6.30%	2.27%	16.61%	0.59%	377,374
	Alt-A	39.52%	46.16%	3.66%	2.36%	1.80%	6.05%	0.42%	101,168
Arkansas	Subprime	43.77%	27.28%	6.62%	5.39%	2.16%	14.26%	0.51%	37,687
	Alt-A	35.78%	50.64%	3.39%	2.17%	1.77%	5.93%	0.32%	11,345
Louisiana	Subprime	49.75%	24.62%	6.27%	5.22%	3.28%	10.21%	0.65%	89,817
	Alt-A	44.17%	44.17%	3.25%	2.27%	2.22%	3.47%	0.44%	19,390
Oklahoma	Subprime	42.64%	26.73%	5.93%	3.77%	3.52%	16.93%	0.49%	66,160
	Alt-A	34.51%	53.97%	2.91%	1.34%	2.26%	4.75%	0.25%	18,235
Texas	Subprime	39.30%	31.57%	7.11%	4.94%	2.09%	14.54%	0.45%	570,001
	Alt-A	34.34%	52.39%	3.27%	1.98%	1.32%	6.44%	0.25%	185,969
West South Central	Subprime	41.04%	30.12%	6.88%	4.89%	2.36%	14.23%	0.48%	763,665
	Alt-A	35.23%	51.75%	3.25%	1.97%	1.49%	6.04%	0.27%	234,939
Arizona	Subprime	59.83%	12.70%	3.93%	4.59%	3.98%	14.08%	0.88%	300,678
	Alt-A	45.06%	33.62%	3.86%	3.56%	4.31%	9.83%	0.77%	233,624
Colorado	Subprime	53.47%	15.91%	3.67%	2.95%	2.22%	21.03%	0.74%	188,769
	Alt-A	43.87%	42.07%	2.66%	1.75%	2.10%	7.10%	0.45%	138,558
Idaho	Subprime	59.83%	17.02%	4.49%	3.72%	3.16%	11.19%	0.60%	36,247
	Alt-A	45.77%	40.86%	3.30%	2.40%	3.32%	3.88%	0.47%	31,997
Montana	Subprime	62.31%	17.50%	4.12%	3.44%	2.40%	9.63%	0.60%	12,973
	Alt-A	50.51%	41.08%	2.54%	1.60%	1.67%	2.27%	0.32%	8,848
Nevada	Subprime	56.73%	12.06%	3.70%	5.07%	4.94%	16.92%	0.88%	152,588
	Alt-A	36.40%	33.88%	4.87%	5.92%	6.29%	12.07%	0.57%	152,154
New Mexico	Subprime	61.98%	17.44%	4.25%	2.69%	2.64%	10.01%	0.93%	40,494
	Alt-A	48.11%	41.64%	2.72%	1.59%	2.88%	2.58%	0.48%	22,326
Utah	Subprime	64.23%	14.06%	3.77%	2.91%	2.17%	12.12%	0.74%	60,323
	Alt-A	52.74%	35.04%	2.71%	1.80%	2.69%	4.44%	0.58%	56,986
Wyoming	Subprime	63.58%	20.34%	4.22%	2.41%	1.24%	7.83%	0.38%	9,748
	Alt-A	51.91%	42.33%	1.93%	1.02%	0.69%	1.95%	0.18%	4,519
Mountain	Subprime	58.42%	14.05%	3.86%	3.96%	3.38%	15.53%	0.82%	823,820
	Alt-A	43.71%	36.41%	3.64%	3.40%	4.00%	8.24%	0.60%	649,024
Alaska	Subprime	61.76%	19.19%	4.56%	3.21%	2.12%	8.70%	0.47%	9,435
	Alt-A	45.05%	45.15%	3.07%	1.52%	1.34%	3.50%	0.36%	3,942
California	Subprime	65.94%	10.36%	2.68%	3.55%	3.39%	12.90%	1.17%	1,745,539
	Alt-A	46.87%	32.39%	3.82%	5.04%	4.61%	6.80%	0.47%	1,530,897
Hawaii	Subprime	64.27%	19.51%	3.80%	3.40%	4.09%	4.42%	0.71%	42,054
	Alt-A	46.51%	42.40%	3.13%	2.64%	3.45%	1.51%	0.38%	28,469
Oregon	Subprime	62.13%	17.14%	4.03%	3.31%	3.12%	9.69%	0.58%	106,926
	Alt-A	47.44%	41.27%	3.02%	2.09%	2.67%	3.11%	0.41%	78,525
Washington	Subprime	63.91%	15.86%	3.85%	3.70%	2.54%	9.46%	0.68%	204,705
	Alt-A	48.73%	40.74%	3.05%	2.37%	2.20%	2.50%	0.43%	144,262
Pacific	Subprime	65.50%	11.46%	2.89%	3.55%	3.30%	12.22%	1.08%	2,108,659
	Alt-A	47.03%	33.64%	3.71%	4.65%	4.30%	6.20%	0.46%	1,786,095
United States	Subprime	56.62%	16.25%	4.44%	4.28%	3.97%	13.55%	0.89%	9,390,945
	Alt-A	43.44%	37.34%	3.80%	3.63%	4.78%	6.30%	0.59%	5,029,306
	Total Nonprime	52.02%	23.61%	4.22%	4.12%	4.25%	11.02%	0.76%	14,420,251

Source: GAO analysis of LP data.

Note: For some loans, the data were insufficient to classify into a status category. These "unknown" loans are included in the total column. This table does not include data for Guam, Puerto Rico, and the Virgin Islands.



## Enclosure V

Table 15: Number of 2000-2007 Nonprime Loans in Different Status Categories by Census Division and State as of March 31, 2009

State	Market segment	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Unknown	Total
Connecticut	Subprime	75,685	20,245	5,576	4,550	4,900	11,221	880	123,057
	Alt-A	20,633	17,904	1,794	1,127	1,652	1,466	183	44,759
Maine	Subprime	22,590	5,911	1,601	1,086	1,745	2,993	386	36,312
	Alt-A	4,536	3,770	384	193	457	317	49	9,706
Massachusetts	Subprime	131,848	23,656	7,278	9,552	5,980	20,229	2,587	201,130
	Alt-A	43,195	28,772	3,029	2,768	2,538	3,860	723	85,185
New Hampshire	Subprime	25,238	5,384	1,989	1,688	856	4,509	271	41,435
	Alt-A	7,281	6,090	623	383	275	861	89	15,602
Rhode Island	Subprime	36,480	5,581	1,647	1,431	1,265	5,830	602	52,816
	Alt-A	7,910	5,082	626	452	509	1,083	102	15,764
Vermont	Subprime	6,237	1,727	408	301	387	598	100	9,758
	Alt-A	1,876	1,623	119	76	118	68	34	3,914
New England	Subprime	296,078	63,984	18,499	18,608	15,133	48,390	4,828	464,506
	Alt-A	85,431	63,241	5,575	4,999	5,849	7,655	1,180	174,930
New Jersey	Subprime	179,200	30,541	9,482	9,763	14,353	17,536	3,856	264,731
	Alt-A	72,842	47,514	5,507	4,183	8,624	4,178	942	143,788
New York	Subprime	221,768	72,301	18,665	19,303	20,665	28,897	3,326	384,925
	Alt-A	67,797	70,833	7,355	7,431	7,842	4,405	617	166,080
Pennsylvania	Subprime	133,454	64,577	16,110	13,691	9,138	24,073	1,640	262,683
	Alt-A	34,392	37,681	3,025	1,934	2,015	2,232	334	81,623
Mid Atlantic	Subprime	534,422	187,419	44,257	42,757	44,156	70,506	8,822	912,338
	Alt-A	175,031	158,038	15,887	13,540	18,281	10,813	1,893	391,491
Illinois	Subprime	276,788	58,563	17,549	15,769	20,022	55,737	5,719	450,147
	Alt-A	74,160	48,349	5,196	4,062	7,098	7,569	1,202	147,636
Indiana	Subprime	73,177	37,150	9,429	7,826	7,712	39,947	975	176,216
	Alt-A	14,006	16,634	1,375	1,035	1,591	3,597	143	38,381
Michigan	Subprime	175,706	55,012	18,547	17,712	7,242	96,238	2,851	373,310
	Alt-A	34,038	38,267	4,189	3,120	2,249	12,430	414	94,707
Ohio	Subprime	139,124	63,540	16,125	14,407	15,325	66,668	2,300	319,389
	Alt-A	25,262	34,166	2,765	2,024	3,141	6,016	247	73,621
Wisconsin	Subprime	81,332	17,382	4,834	4,338	5,153	16,745	1,282	131,066
	Alt-A	13,557	11,759	929	681	1,034	1,454	194	29,608
East North Central	Subprime	746,129	221,647	66,484	60,052	55,484	277,235	13,127	1,490,128
	Alt-A	161,023	149,175	14,454	10,922	15,113	31,086	2,200	383,953
Iowa	Subprime	29,004	9,324	2,284	1,519	1,827	8,343	326	52,627
	Alt-A	4,333	4,945	288	156	257	506	51	10,536
Kansas	Subprime	26,725	9,650	2,336	1,652	1,145	7,884	355	49,747
	Alt-A	6,999	8,081	438	244	250	789	53	16,854
Minnesota	Subprime	96,626	19,852	5,661	4,699	4,109	30,463	1,467	162,906
	Alt-A	24,897	27,482	2,585	1,972	2,380	7,775	266	67,357
Missouri	Subprime	95,912	29,242	8,920	7,384	2,659	34,775	1,413	180,305
	Alt-A	21,128	20,454	1,543	1,033	624	3,848	229	48,859
Nebraska	Subprime	14,658	6,720	1,494	1,098	714	4,803	115	29,602
	Alt-A	2,684	3,466	213	106	128	370	22	6,987
North Dakota	Subprime	2,551	1,021	215	130	106	417	25	4,466
	Alt-A	763	921	43	20	37	58	4	1,846
South Dakota	Subprime	4,047	1,481	328	199	213	1,016	37	7,321
	Alt-A	1,014	1,135	56	46	46	116	5	2,418
West North Central	Subprime	269,523	77,300	21,238	16,680	10,773	87,701	3,758	486,973
	Alt-A	61,818	66,484	5,166	3,577	3,720	13,462	630	154,857
Delaware	Subprime	14,413	4,660	1,352	1,138	1,154	1,748	180	24,645
	Alt-A	5,281	4,988	407	270	423	332	63	11,764
District of Columbia	Subprime	11,970	1,987	635	566	455	1,372	267	17,372
	Alt-A	7,627	5,917	506	408	336	569	106	15,489
Florida	Subprime	514,128	138,079	40,673	43,849	95,513	95,878	7,124	935,244
	Alt-A	189,699	186,239	23,222	26,792	72,561	27,514	2,681	528,708
Georgia	Subprime	125,957	46,883	16,289	16,412	6,809	52,996	2,036	267,382
	Alt-A	57,842	68,880	7,191	5,140	3,737	14,465	642	157,997
Maryland	Subprime	174,396	31,268	10,147	10,667	7,936	16,993	3,721	265,118
	Alt-A	64,565	49,311	5,646	6,004	4,883	4,839	875	135,923
North Carolina	Subprime	92,134	38,149	11,542	8,980	3,522	25,702	1,424	179,453
	Alt-A	37,350	38,247	3,198	2,089	1,307	4,050	356	86,627
South Carolina	Subprime	45,907	19,582	5,681	3,718	3,427	15,157	664	94,146
	Alt-A	21,422	20,433	1,725	1,007	1,538	2,523	295	48,943
Virginia	Subprime	135,378	31,496	9,051	8,629	4,047	22,421	2,195	213,215

## Enclosure V

State	Market segment	Prepaid	Current	Delinquent	In default	In foreclosure process	Completed foreclosure process	Unknown	Total
West Virginia	Alt-A	69,161	61,489	5,893	5,650	4,478	14,797	1,131	162,599
	Subprime	8,522	3,853	1,148	811	461	1,968	141	16,904
	Alt-A	1,812	2,094	237	164	157	329	26	4,819
<b>South Atlantic</b>		<b>1,122,803</b>	<b>313,957</b>	<b>95,528</b>	<b>94,890</b>	<b>123,324</b>	<b>234,225</b>	<b>17,752</b>	<b>2,003,479</b>
Alabama	Alt-A	454,859	437,598	48,025	47,524	89,220	65,418	5,205	1,152,849
	Subprime	40,340	18,506	5,677	5,329	1,507	12,471	454	84,284
	Alt-A	11,175	12,194	1,036	644	443	1,638	122	27,202
Kentucky	Subprime	33,862	15,436	3,881	2,679	2,818	12,500	413	71,589
	Alt-A	7,177	8,585	602	364	565	1,076	61	18,430
	Subprime	21,667	12,857	4,096	4,049	1,306	8,858	397	53,230
Mississippi	Alt-A	3,680	4,259	421	269	186	587	68	9,470
	Subprime	74,550	37,465	11,037	11,705	2,940	29,610	964	168,271
	Alt-A	17,951	21,073	1,695	1,114	630	2,330	173	46,066
<b>East South Central</b>		<b>170,419</b>	<b>84,264</b>	<b>24,691</b>	<b>23,762</b>	<b>8,571</b>	<b>53,439</b>	<b>2,228</b>	<b>377,374</b>
Arkansas	Alt-A	39,983	46,701	3,724	2,391	1,824	6,121	424	101,168
	Subprime	16,495	10,282	2,495	2,033	614	5,374	194	37,687
	Alt-A	4,059	5,745	385	246	201	673	36	11,345
Louisiana	Subprime	44,686	22,109	5,629	4,684	2,950	9,174	585	89,817
	Alt-A	8,565	8,585	631	441	430	672	86	19,390
	Subprime	28,210	17,684	3,823	2,491	2,327	11,205	323	68,160
Oklahoma	Alt-A	6,292	9,842	531	245	413	867	45	18,235
	Subprime	223,983	179,930	40,519	28,153	11,940	82,898	2,578	570,001
	Alt-A	63,863	97,432	6,088	3,688	2,452	11,981	465	185,969
<b>West South Central</b>		<b>313,374</b>	<b>230,005</b>	<b>52,566</b>	<b>37,361</b>	<b>18,031</b>	<b>108,648</b>	<b>3,680</b>	<b>763,665</b>
Arizona	Alt-A	82,779	121,584	7,635	4,620	3,496	14,193	632	234,939
	Subprime	179,889	38,185	11,613	13,807	11,982	42,347	2,655	300,678
	Alt-A	105,273	78,546	9,007	8,306	10,066	20,628	1,798	233,624
Colorado	Subprime	100,940	30,026	6,532	5,578	4,189	39,700	1,404	188,769
	Alt-A	60,787	58,288	3,694	2,422	2,906	9,843	628	138,558
	Subprime	22,883	6,509	1,718	1,421	1,207	4,281	228	38,247
Idaho	Alt-A	14,644	13,075	1,055	769	1,062	1,243	149	31,997
	Subprime	8,084	2,270	535	446	311	1,249	78	12,973
	Alt-A	4,469	3,635	225	142	148	201	28	8,648
Nevada	Subprime	86,561	18,400	5,847	7,736	7,078	25,625	1,340	152,549
	Alt-A	55,379	51,552	7,407	9,009	9,578	18,363	866	152,154
	Subprime	25,098	7,062	1,722	1,090	1,068	4,052	402	40,494
New Mexico	Alt-A	10,741	9,296	608	355	643	578	107	22,328
	Subprime	51,593	11,290	3,030	2,335	1,743	9,739	593	80,323
	Alt-A	30,058	19,973	1,543	1,027	1,534	2,528	333	56,996
Utah	Subprime	6,198	1,983	411	235	121	763	37	9,748
	Alt-A	2,346	1,913	87	46	31	88	8	4,519
<b>Mountain</b>		<b>481,246</b>	<b>115,725</b>	<b>31,608</b>	<b>32,648</b>	<b>27,700</b>	<b>127,956</b>	<b>6,737</b>	<b>623,820</b>
Alaska	Alt-A	283,697	235,280	23,616	22,076	25,968	53,470	3,917	648,024
	Subprime	5,827	1,811	429	303	200	821	44	9,435
	Alt-A	1,776	1,780	121	60	53	138	14	3,942
California	Subprime	1,151,089	180,836	46,811	62,001	59,237	225,176	20,389	1,745,539
	Alt-A	717,507	495,851	58,487	77,151	70,519	104,149	7,223	1,530,867
	Subprime	27,028	8,203	1,516	1,429	1,721	1,858	299	42,054
Hawaii	Alt-A	13,242	12,071	892	752	982	431	99	28,469
	Subprime	66,431	18,324	4,313	3,540	3,333	10,364	621	106,926
	Alt-A	37,249	32,408	2,369	1,641	2,093	2,446	319	78,525
Washington	Subprime	130,836	32,457	7,672	7,581	5,196	19,372	1,391	204,705
	Alt-A	70,293	59,778	4,393	3,412	3,169	3,803	614	144,262
	Subprime	1,381,211	241,631	80,941	74,854	69,687	237,691	22,744	2,108,659
Pacific	Alt-A	840,067	600,888	66,272	83,016	76,818	110,767	8,269	1,786,095
	Subprime	5,317,205	1,525,932	417,012	401,612	372,829	1,272,661	83,674	9,390,945
	Alt-A	2,184,688	1,877,989	191,354	192,673	240,287	316,965	25,350	5,029,306
<b>Total</b>		<b>7,501,893</b>	<b>3,403,921</b>	<b>608,366</b>	<b>594,285</b>	<b>613,116</b>	<b>1,589,646</b>	<b>109,024</b>	<b>14,420,251</b>
<b>Nonprime</b>									

Source: GAO analysis of LP data.

Note: For some loans, the data were insufficient to classify into a status category. These "unknown" loans are included in the total column. This table does not include data for Guam, Puerto Rico, and the Virgin Islands.

**Enclosure VI****Status of Nonprime Loans Originated from 2000 through 2007 by Congressional District as of March 31, 2009**

This enclosure contains the results of our analysis of LoanPerformance (LP) data on the status of nonprime mortgages by congressional district. The analysis covers mortgages originated from 2000 through 2007, as of March 31, 2009. All figures reported are estimated.

## Enclosure VI

Table 16: Estimated Percentage of 2000-2007 Active Nonprime Loans Seriously Delinquent by Congressional District as of March 31, 2009

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
Alabama	01	8,367	1,734	20.72%
	02	4,524	740	16.35%
	03	5,628	953	16.94%
	04	3,964	553	13.96%
	05	5,574	752	13.49%
	06	9,457	1,595	16.86%
	07	7,691	1,582	20.56%
Alaska	00	4,670	596	12.76%
Arizona	01	12,891	2,474	19.19%
	02	32,646	8,472	25.95%
	03	23,809	5,430	22.81%
	04	22,956	7,916	34.48%
	05	19,344	3,523	18.21%
	06	31,421	7,638	24.31%
	07	24,909	6,669	26.77%
	08	13,671	2,032	14.86%
Arkansas	01	4,120	610	14.80%
	02	7,471	1,134	15.18%
	03	6,273	916	14.60%
	04	4,055	576	14.21%
California	01	16,356	2,862	17.50%
	02	17,818	3,931	22.06%
	03	27,505	7,581	27.56%
	04	24,450	4,872	19.93%
	05	20,660	6,171	29.87%
	06	19,568	2,844	14.53%
	07	23,011	6,714	29.18%
	08	9,323	943	10.11%
	09	14,626	3,325	22.73%
	10	26,103	6,659	25.51%
	11	31,137	8,889	28.55%
	12	14,667	2,153	14.68%
	13	16,658	4,230	25.39%
	14	13,966	1,711	12.25%
	15	11,997	2,075	17.30%
	16	18,700	4,850	25.94%
	17	15,290	4,091	26.75%
	18	18,044	6,602	36.59%
	19	22,336	6,443	28.84%
	20	12,913	3,402	26.34%
	21	21,783	5,251	24.11%
	22	29,435	8,355	28.38%
	23	12,095	2,524	20.87%
	24	25,447	5,033	19.78%
	25	36,255	12,686	34.99%
	26	21,200	4,782	22.56%
	27	19,602	5,607	28.60%
	28	15,676	4,274	27.26%
	29	13,626	2,369	17.39%
	30	15,796	2,242	14.20%
	31	9,282	2,237	24.10%
	32	13,972	3,624	25.94%
	33	13,452	3,193	23.74%
	34	10,804	3,012	27.88%
	35	17,473	4,860	27.81%
	36	13,844	1,842	13.30%
	37	18,406	5,346	29.04%
	38	17,539	5,144	29.33%
	39	16,028	4,536	28.30%
	40	15,680	3,841	24.49%

## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
	41	35,210	11,458	32.54%
	42	22,547	4,957	21.99%
	43	25,205	9,484	37.63%
	44	32,885	10,704	32.55%
	45	38,044	12,526	32.93%
	46	18,151	3,200	17.63%
	47	12,117	4,093	33.77%
	48	20,978	3,738	17.82%
	49	30,461	9,358	30.72%
	50	20,962	3,579	17.07%
	51	24,279	7,412	30.53%
	52	19,513	3,918	20.08%
	53	15,425	2,838	18.40%
Colorado	01	16,233	2,359	14.53%
	02	16,549	1,859	11.23%
	03	12,852	1,419	11.04%
	04	14,775	1,909	12.92%
	05	15,318	2,003	13.08%
	06	21,362	2,860	13.39%
	07	16,790	2,665	15.87%
Connecticut	01	10,304	2,022	19.62%
	02	9,488	1,885	19.87%
	03	12,358	2,842	22.99%
	04	13,751	2,859	20.79%
	05	11,250	2,513	22.34%
Delaware	00	14,349	2,976	20.74%
District of Columbia	98	10,935	1,887	17.25%
Florida	01	13,098	3,090	23.59%
	02	12,460	3,169	25.43%
	03	21,417	7,332	34.24%
	04	17,258	4,406	25.53%
	05	23,869	8,064	33.78%
	06	16,795	4,945	29.44%
	07	24,034	7,874	32.76%
	08	29,026	11,119	38.31%
	09	23,329	7,702	33.02%
	10	19,003	5,878	30.93%
	11	22,936	8,523	37.16%
	12	23,967	8,476	35.37%
	13	22,404	8,552	38.17%
	14	36,735	17,596	47.90%
	15	30,652	12,338	40.25%
	16	24,874	10,471	42.10%
	17	28,296	11,748	41.52%
	18	26,230	11,279	43.00%
	19	28,875	12,142	42.05%
	20	31,603	12,476	39.48%
	21	25,895	10,602	40.94%
	22	28,409	11,063	38.94%
	23	31,435	13,738	43.70%
	24	26,958	9,396	34.86%
	25	34,801	15,924	45.76%
Georgia	01	6,076	944	15.54%
	02	4,061	682	17.03%
	03	17,662	3,561	20.16%
	04	18,611	4,008	21.54%
	05	15,359	3,013	19.62%
	06	14,440	2,003	13.87%
	07	21,907	4,102	18.73%
	08	9,016	1,770	19.64%
	09	11,905	1,993	16.74%
	10	7,396	1,097	14.83%
	11	15,467	2,778	17.96%
	12	6,597	1,117	16.94%

## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
	13	22,406	4,939	22.04%
Hawaii	01	9,483	1,283	13.53%
	02	17,315	3,485	20.12%
Idaho	01	17,686	3,277	18.53%
	02	9,073	1,170	12.90%
Illinois	01	13,612	4,150	30.49%
	02	21,197	6,484	30.59%
	03	11,283	3,421	30.32%
	04	9,039	2,830	31.31%
	05	8,970	2,625	29.26%
	06	9,539	2,453	25.72%
	07	12,361	3,632	29.38%
	08	11,944	2,844	23.81%
	09	7,119	1,875	26.33%
	10	7,989	1,803	22.56%
	11	8,939	2,188	24.48%
	12	5,723	1,279	22.35%
	13	11,309	2,777	24.56%
	14	12,691	3,643	28.71%
	15	3,749	632	16.87%
	16	8,727	1,958	22.44%
	17	3,817	699	18.30%
	18	4,095	744	18.17%
	19	3,815	734	19.25%
Indiana	01	12,258	3,027	24.69%
	02	9,193	1,998	21.74%
	03	8,244	1,744	21.16%
	04	8,696	1,752	20.15%
	05	10,409	2,082	20.01%
	06	8,361	1,667	19.93%
	07	12,689	3,177	25.04%
	08	6,283	1,305	20.76%
	09	6,335	1,353	21.36%
Iowa	01	3,718	651	17.50%
	02	3,360	624	18.57%
	03	6,014	1,223	20.34%
	04	3,608	608	16.84%
	05	3,873	648	16.74%
Kansas	01	3,048	369	12.10%
	02	5,577	819	14.69%
	03	8,862	1,357	15.32%
	04	6,284	741	11.80%
Kentucky	01	3,373	552	16.35%
	02	5,704	1,008	17.68%
	03	9,120	1,943	21.31%
	04	6,907	1,299	18.81%
	05	2,789	431	15.46%
	06	6,982	1,185	16.98%
Louisiana	01	7,513	1,400	18.63%
	02	7,596	1,676	22.07%
	03	5,707	1,047	18.35%
	04	5,860	1,106	18.88%
	05	4,130	782	18.94%
	06	10,026	1,840	18.35%
	07	4,573	641	14.02%
Maine	01	8,314	1,918	23.07%
	02	6,665	1,528	22.93%
Maryland	01	12,430	2,349	18.90%
	02	12,252	2,568	20.96%
	03	14,397	2,736	19.00%
	04	22,254	6,462	29.04%
	05	24,167	6,566	27.17%
	06	12,321	2,645	21.47%
	07	13,249	2,771	20.91%

## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
Massachusetts	08	13,580	2,984	21.97%
	01	6,878	1,749	25.44%
	02	9,489	2,577	27.15%
	03	8,504	2,269	26.68%
	04	7,506	1,740	23.18%
	05	8,748	2,248	25.70%
	06	7,650	1,887	24.67%
	07	7,190	1,758	24.46%
	08	6,456	1,491	23.09%
	09	10,443	2,832	27.12%
Michigan	10	10,370	2,427	23.40%
	01	5,296	751	14.18%
	02	6,836	1,194	17.46%
	03	7,862	1,441	18.32%
	04	6,363	1,089	17.11%
	05	8,810	1,905	21.62%
	06	7,818	1,217	15.56%
	07	8,675	1,693	19.52%
	08	10,022	1,743	17.39%
	09	10,264	1,949	18.99%
	10	8,998	1,633	18.15%
	11	10,934	2,171	19.86%
	12	13,307	2,792	20.98%
	13	13,412	3,619	26.98%
	14	16,734	4,749	28.38%
Minnesota	15	10,579	2,293	21.68%
	01	4,569	706	15.45%
	02	11,674	2,121	18.17%
	03	10,514	2,036	19.36%
	04	8,264	1,747	21.15%
	05	9,615	2,003	20.83%
	06	11,823	2,391	20.22%
	07	4,434	688	15.74%
Mississippi	08	7,766	1,439	18.53%
	01	8,106	1,783	21.99%
	02	7,266	1,768	24.33%
	03	5,213	993	19.04%
Missouri	04	6,485	1,168	18.01%
	01	14,888	3,191	21.43%
	02	6,904	979	14.18%
	03	8,552	1,381	16.15%
	04	5,133	732	14.26%
	05	13,148	2,285	17.38%
	06	7,865	1,092	13.89%
	07	6,791	946	13.93%
Montana	08	3,539	440	12.44%
	09	4,899	639	13.05%
	00	7,701	1,046	13.58%
	01	4,342	646	14.89%
Nebraska	02	6,699	1,032	15.40%
	03	2,861	353	12.34%
	01	38,333	12,115	31.60%
Nevada	02	23,034	5,213	22.63%
	03	54,884	16,040	29.23%
	01	9,890	1,641	16.59%
New Hampshire	02	8,627	1,479	17.14%
	01	10,062	2,803	27.86%
New Jersey	02	12,509	3,397	27.15%
	03	11,487	3,021	26.30%
	04	11,284	2,911	25.79%
	05	9,355	2,108	22.53%
	06	8,952	2,586	28.89%
	07	7,940	1,955	24.62%
	08	10,106	3,381	33.45%

## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
	09	8,965	2,460	27.44%
	10	11,301	4,766	42.17%
	11	7,763	1,700	21.90%
	12	9,340	2,184	23.38%
	13	9,978	3,443	34.51%
New Mexico	01	9,376	1,402	14.95%
	02	5,125	687	13.40%
	03	7,338	1,066	14.52%
New York	01	18,727	5,201	27.77%
	02	16,540	5,482	33.14%
	03	12,470	3,110	24.94%
	04	14,778	4,511	30.52%
	05	7,139	1,268	17.76%
	06	15,363	5,313	34.58%
	07	6,888	1,758	25.52%
	08	3,453	421	12.18%
	09	7,808	1,809	23.16%
	10	9,920	3,490	35.18%
	11	5,371	1,477	27.51%
	12	4,838	1,375	28.42%
	13	9,060	1,951	21.54%
	14	3,219	234	7.28%
	15	985	180	18.25%
	16	1,950	618	31.68%
	17	8,573	2,154	25.13%
	18	8,835	1,539	17.42%
	19	12,330	2,643	21.44%
	20	8,407	1,838	21.86%
	21	6,651	1,453	21.85%
	22	7,582	1,848	24.38%
	23	3,547	622	17.54%
	24	4,539	736	16.21%
	25	4,950	832	16.81%
	26	4,680	709	15.14%
	27	4,642	690	14.86%
	28	5,926	1,013	17.09%
	29	4,256	660	15.50%
North Carolina	01	4,239	717	16.91%
	02	7,425	1,248	16.80%
	03	7,881	1,065	13.51%
	04	8,815	1,138	12.91%
	05	5,634	830	14.73%
	06	7,976	1,245	15.61%
	07	7,973	1,119	14.03%
	08	7,607	1,197	15.74%
	09	14,259	2,139	15.00%
	10	6,922	1,117	16.14%
	11	6,196	816	13.17%
	12	11,330	1,901	16.77%
	13	8,447	1,315	15.57%
North Dakota	00	2,481	290	11.69%
Ohio	01	9,532	2,085	21.87%
	02	6,999	1,312	18.74%
	03	8,958	2,218	24.76%
	04	6,735	1,409	20.92%
	05	5,328	1,055	19.81%
	06	5,041	1,119	22.20%
	07	8,565	1,884	21.99%
	08	7,822	1,685	21.55%
	09	9,034	2,088	23.11%
	10	9,930	2,324	23.40%
	11	13,342	4,109	30.79%
	12	10,983	2,386	21.72%
	13	9,804	2,384	24.32%



## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
	14	8,263	1,693	20.49%
	15	8,502	1,854	21.80%
	16	7,789	1,661	21.33%
	17	8,974	2,418	26.94%
	18	5,500	1,109	20.16%
Oklahoma	01	9,529	1,472	15.45%
	02	5,062	774	15.29%
	03	5,446	727	13.35%
	04	7,708	1,001	12.99%
	05	9,651	1,496	15.51%
Oregon	01	13,437	1,991	14.81%
	02	14,031	2,496	17.79%
	03	16,537	2,574	15.57%
	04	11,041	1,540	13.95%
	05	12,880	1,995	15.49%
Pennsylvania	01	12,226	2,255	18.44%
	02	11,155	2,038	18.27%
	03	5,052	674	17.30%
	04	7,401	1,289	17.42%
	05	3,580	595	16.61%
	06	8,070	1,315	16.29%
	07	8,034	1,387	17.26%
	08	8,129	1,491	18.34%
	09	5,079	863	16.99%
	10	6,834	1,330	19.47%
	11	11,295	2,571	22.76%
	12	5,125	919	17.94%
	13	8,836	1,501	16.99%
	14	8,259	1,520	18.41%
	15	9,816	1,894	19.29%
	16	5,987	977	16.32%
	17	6,963	1,121	16.10%
	18	8,376	1,447	17.28%
	19	7,703	1,363	17.69%
Rhode Island	01	7,267	1,498	20.61%
	02	9,067	2,126	23.45%
South Carolina	01	16,401	2,892	17.63%*
	02	12,169	2,080	17.09%
	03	5,860	847	14.46%
	04	8,321	1,401	16.83%
	05	7,294	1,220	16.73%
	06	6,968	1,234	17.71%
South Dakota	00	3,505	503	14.35%
Tennessee	01	5,972	870	14.56%
	02	8,734	1,392	15.93%
	03	8,693	1,574	18.11%
	04	6,106	1,010	16.54%
	05	12,653	2,042	16.14%
	06	10,089	1,723	17.07%
	07	11,883	2,094	17.62%
	08	8,122	1,732	21.33%
	09	15,837	3,923	24.77%
Texas	01	5,318	565	10.63%
	02	15,268	2,259	14.80%
	03	13,982	1,594	11.40%
	04	11,611	1,383	11.91%
	05	11,169	1,494	13.37%
	06	14,352	1,963	13.62%
	07	13,066	1,521	11.64%
	08	10,785	1,348	12.50%
	09	15,203	2,094	13.77%
	10	18,637	2,504	13.43%
	11	5,472	450	8.22%
	12	13,779	1,672	12.13%

## Enclosure VI

State	Congressional district	Estimated number of active loans	Estimated number of seriously delinquent loans	Estimated percentage of seriously delinquent loans
	13	4,554	468	10.29%
	14	11,070	1,537	13.88%
	15	8,246	1,002	12.16%
	16	8,392	785	9.35%
	17	8,071	855	10.59%
	18	14,554	2,175	14.95%
	19	5,106	463	9.06%
	20	10,036	1,205	12.00%
	21	13,993	1,480	10.57%
	22	18,852	2,743	14.55%
	23	11,230	1,367	12.18%
	24	14,862	2,029	13.65%
	25	10,872	1,015	9.33%
	26	17,265	2,109	12.21%
	27	9,244	1,039	11.24%
	28	9,775	1,232	12.60%
	29	11,207	1,472	13.14%
	30	14,193	2,326	16.39%
	31	10,650	1,064	9.99%
	32	8,257	894	10.82%
Utah	01	12,831	1,733	13.51%
	02	14,794	2,493	16.85%
	03	14,745	2,406	16.32%
Vermont	00	4,721	878	18.60%
Virginia	01	14,898	2,941	19.74%
	02	11,582	1,535	13.25%
	03	12,125	2,023	16.68%
	04	11,878	1,985	16.71%
	05	6,234	764	12.26%
	06	5,922	788	13.30%
	07	11,408	1,839	16.11%
	08	12,230	1,869	15.28%
	09	3,058	358	11.69%
	10	21,147	4,282	20.25%
	11	19,809	4,351	21.96%
Washington	01	13,812	2,017	14.61%
	02	15,324	2,467	16.10%
	03	15,426	2,811	18.22%
	04	8,885	953	10.72%
	05	8,316	1,014	12.20%
	06	15,119	2,594	17.16%
	07	11,318	1,372	12.12%
	08	17,651	2,966	16.80%
	09	16,478	3,101	18.82%
West Virginia	01	2,310	343	14.86%
	02	4,329	899	20.77%
	03	2,286	345	15.09%
Wisconsin	01	7,233	1,758	24.30%
	02	4,740	1,046	22.07%
	03	4,097	958	23.39%
	04	11,517	3,299	28.65%
	05	5,498	1,245	22.65%
	06	4,459	1,010	22.64%
	07	4,024	863	21.46%
	08	4,375	984	22.48%
Wyoming	00	4,823	432	8.96%

Source: GAO analysis of LP data.

**Enclosure VII**

**GAO Contact and Staff Acknowledgments**

GAO Contact: William B. Shear, (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov)

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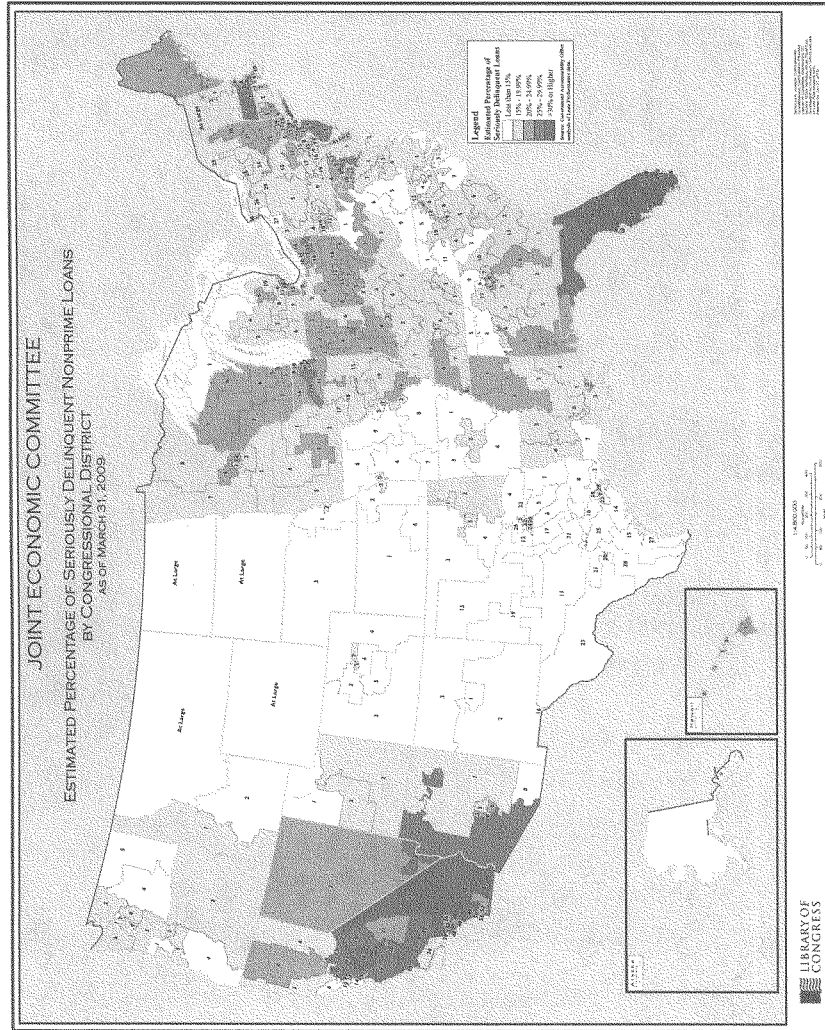
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## PREPARED STATEMENT OF SENATOR SAM BROWNBAC, RANKING REPUBLICAN

I wish to thank Chair Maloney for arranging today's hearing and to thank today's expert panel on home foreclosures and foreclosure mitigation.

American households are suffering in the current deep recession: many have experienced large losses in their retirement and housing wealth; millions of workers have lost their jobs and unemployment is expected to continue to rise; and a large and growing number of families have faced foreclosures on their homes. We are observing the painful effects of the collapse of the housing bubble.

As is well known, home foreclosures are not only devastating for an individual homeowner, but also for neighborhoods and communities. Unfortunately, given the depth of our current post-bubble recession, foreclosures continue to grow at a rapid pace and at a faster pace than home retention and loan modification efforts. We hear reports that the capacities of loan servicers to modify mortgage loans are strained; that struggling homeowners find it difficult to negotiate the maze of steps necessary to execute a mortgage modification; that loan servicers fear possible legal repercussions from modifying a mortgage when a borrower has more than one mortgage; and that some unscrupulous borrowers and lenders may be trying to game the loan modification initiatives. I look forward to hearing from our panel today about impediments to stepping up the pace of mortgage loan modification efforts for struggling American families.

There are numerous private and government-sponsored initiatives aimed at increasing the pace of loan modifications and keeping creditworthy borrowers in their homes. However, it does not appear that the government-sponsored initiatives have had much of an impact on the large and growing number of home foreclosures. And in too many instances, even when a mortgage has been modified, re-default rates are high—close to 50% of loans modified in the first two quarters of 2008 were in default again nine months after the modifications. Some of the re-defaults likely arise because of the depth of the recession, which has pushed a large number of American workers into unemployment, making it difficult or impossible for them to keep up on even a modified mortgage. Re-defaults also arise because of continued declines in home prices, which push borrowers further underwater, even under modified loan terms.

We are in a difficult economic situation in which continuing declines in home prices are pushing more borrowers underwater on their mortgages and in which growing unemployment prevents an increasing number of homeowners from keeping current on their mortgages. There have been some signs of late that the housing market may be bottoming out. If so, an arrest of the plunge in home prices may help reduce the growth in foreclosures. At the same time, most forecasts are for continued increases in the unemployment rate for some time to come, which will contribute to more foreclosure activity ahead.

Some argue that the lackluster performance of loan modification efforts to date calls for a sledgehammer approach of modifying the bankruptcy code to allow judges to “cram down” modifications of loans. This would be the wrong answer. Given that mortgage loan servicers are struggling to handle the large volumes of modifications they are facing, it is difficult to imagine that bankruptcy judges would have an easier time. More importantly, allowing for cram down, even if sold as a temporary solution only for loans made over the past few years, would lead to higher interest rates on future mortgages and fewer mortgage loans. Lenders, quite simply and rationally, would have to build into the rates they charge an expectation of a possible future mortgage modification in a bankruptcy proceeding. Cram down would lead to higher interest rates on mortgages and effectively would penalize the vast majority of Americans who did not overextend themselves or speculate during the bubble but, rather, lived within their means.

Loan modification efforts to stem the tide of foreclosures have been progressing at an increasing pace. Yet that pace is not keeping up with the rate of growth of new foreclosures and loan defaults and re-defaults. Unfortunately, the Administration's latest effort to provide mortgage relief, called the “Making Home Affordable” program that was launched on February 18 of this year, has yet to show any significant results. I wish to note that, according to a June 2009 report by the Congressional Budget Office, while \$50 billion of TARP funds have been committed to the Administration's foreclosure mitigation plan, the Treasury has not yet disbursed any of the funds allocated, as of June 17, 2009, for foreclosure mitigation. Given the gravity of the foreclosure problem, this delay is unacceptably long. If this is an example of the efficiency of a government that is supposed to be able to operate a “competitive” health care plan to keep private health care providers efficient, I am highly skeptical.

While our focus today will be on residential foreclosures and mortgage modifications, we need also to keep in mind the deteriorating market for commercial real estate, a topic that we considered in an earlier Joint Economic Committee hearing. Given recent warnings by Federal Reserve Chairman Bernanke of possible future need for Federal action to help stem a growing tide of commercial foreclosures, it would be helpful for the Fed, Treasury, and the Administration to provide a contingency plan and to provide information about whether TARP funds might be used and under what conditions. Looking forward and planning would be a welcome change from a recent atmosphere of hurried reaction.

I look forward to the testimony of today's expert panelists.

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PREPARED STATEMENT OF KEVIN BRADY, SENIOR HOUSE REPUBLICAN

I am pleased to join in welcoming the witnesses testifying before us today on the rapidly escalating number of home foreclosures.

A number of policy blunders during the last twenty years inflated an unsustainable housing bubble. On a macro level, the Federal Reserve pursued an overly accommodative monetary policy for far too long after the 2001 recession. This policy along with huge capital inflows arising from international imbalances kept long-term U.S. interest rates far too low during much of this decade.

On a micro level, both the Clinton and Bush administrations pursued a National Home Ownership Strategy to increase the home ownership rate among historically disadvantaged groups. After 1992, federal officials pressed commercial banks, thrifts, and mortgage banks to weaken loan underwriting standards, reduce down-payments, and develop exotic loan products such as interest only and negatively amortizing loans to help low income families qualify for mortgage loans to buy homes. After 2000, Fannie Mae and Freddie Mac spurred the explosive growth in subprime mortgage lending by purchasing millions and millions of dollars of privately issued subprime mortgage-backed securities.

As in previous bubbles, swindlers took advantage of the unwary as the housing bubble neared its zenith. On the one hand, some home buyers misled lenders about their income and net worth to secure mortgage credit to speculate in housing. On the other, some builders, realtors, and lenders deceived home buyers about the obligations that they were assuming.

The housing bubble burst in July 2006. House prices have subsequently fallen by 32 percent according to the S&P/Case-Shiller Home Price Index. Falling housing prices created uncertainty about the value of mortgage-backed securities that triggered a global financial crisis and the subsequent recession.

As history proves again and again, good intentions do not necessarily produce good results. Today, many Americans, especially historically disadvantaged families that federal officials intended to help, are suffering. Interest resets on adjustable rate mortgage loans, falling housing prices that make refinancing difficult or impossible, and a rapidly escalating unemployment rate caused many families to fall behind on their mortgage payments, default, and face the possibility of foreclosure.

Consequently, home mortgage loan delinquency and foreclosure rates are ballooning. A cascade of foreclosures may have serious negative externalities. Dumping millions of foreclosed homes on the market may keep housing prices depressed for years, reducing household wealth, upending the budgets of localities that depend on property taxes, and muting any economic recovery.

On February 18, 2009, President Obama announced the Making Home Affordable initiative to refinance or modify existing mortgage loans to prevent unnecessary foreclosures. So far, neither this initiative nor earlier programs under President Bush have produced significant results. For example, the Hope for Homeowners program, enacted in 2008, helped only 25 homeowners through February 3, 2009. About 4,000 loans were refinanced through the FHA-Secure program that expired on December 31, 2008. Only 13,000 loans were modified under the FDIC's conservatorship of IndyMac.

Given the enormity of the home foreclosure problem, I look forward to hearing from today's witnesses about what can be done to ameliorate it.



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United States Government Accountability Office

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Testimony  
Before the Joint Economic Committee  
U.S. Congress

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For Release on Delivery  
Expected at 10:00 a.m. EDT  
Tuesday, July 28, 2009

## HOME MORTGAGES

### Recent Performance of Nonprime Loans Highlights the Potential for Additional Foreclosures

Statement of William B. Shear, Director  
Financial Markets and Community Investment



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GAO-09-922T

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Chair Maloney and Members of the Joint Committee:

I am pleased to be here today to discuss the performance of the nonprime mortgage market as of March 31, 2009, which includes subprime and Alt-A loans.<sup>1</sup> Nonprime loans accounted for an increasing share of the overall mortgage market from 2000 through 2006, rising from 12 percent to 34 percent. Over this period, the dollar volume of nonprime mortgages originated annually climbed from \$100 billion to \$600 billion in the subprime market and from \$25 billion to \$400 billion in the Alt-A market.<sup>2</sup> However, in the summer of 2007, the subprime and Alt-A market segments contracted sharply, partly in response to a dramatic increase in default and foreclosure rates for these mortgages. As of the first quarter of 2009, approximately 1 in 8 nonprime mortgages were in the foreclosure process. These developments have prompted greater scrutiny of lending practices in the nonprime market, a number of government efforts to modify troubled loans, and proposals to strengthen federal regulation of the mortgage industry.

My statement is based on a report being released at this hearing, titled *Characteristics and Performance of Nonprime Mortgages*.<sup>3</sup> To prepare the report, we analyzed data from LoanPerformance's (LP) Asset-backed Securities database for nonprime loans originated from 2000 through 2007. The database contains loan-level data on nonagency securitized mortgages in subprime and Alt-A pools.<sup>4</sup> About three-quarters of nonprime mortgages have been securitized in recent years, and the LP data cover the vast majority of them. The report includes a detailed description of our scope and methodology. We conducted our work in accordance with all sections

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<sup>1</sup>Although the categories are not rigidly defined, subprime loans feature higher interest rates and fees and are generally made to borrowers who have tarnished credit histories. Alt-A loans are generally for borrowers whose credit histories are close to prime, but the loans have one or more high-risk features such as limited documentation of income or assets.

<sup>2</sup>See Inside Mortgage Finance, *The 2009 Mortgage Market Statistical Annual*, (Bethesda, Md., 2009), 4.

<sup>3</sup>GAO, *Characteristics and Performance of Nonprime Mortgages*, GAO-09-548R (Washington, D.C.: July 28, 2009).

<sup>4</sup>LP is a unit of First American CoreLogic, Incorporated. Nonagency mortgage-backed securities (MBS), also known as private-label MBS, are backed by nonconforming conventional mortgages securitized primarily by investment banks. Nonconforming mortgages are those that do not meet the purchase requirements of Fannie Mae or Freddie Mac because they are too large or do not meet certain underwriting criteria.

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of GAO's Quality Assurance Framework that are relevant to our objectives.

My statement discusses (1) trends in the loan and borrower characteristics of nonprime mortgages originated from 2000 through 2007; (2) the performance of these mortgages by market segment, product type, and geographic location as of March 31, 2009; and (3) the performance of recent nonprime loan cohorts as of that date.<sup>5</sup>

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### Nonprime Mortgage Lending Increased from 2000 through 2006 and Included Many Loans with Features Associated with Poor Loan Performance

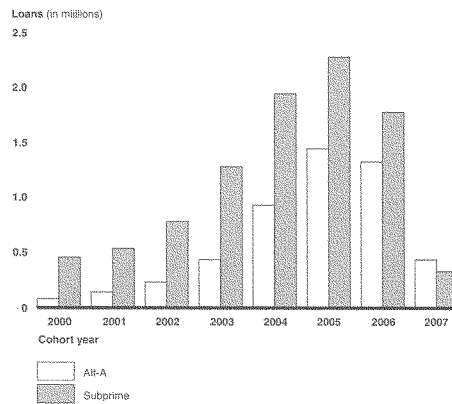
Nonprime mortgage originations grew rapidly from 2000 through 2005 before sharply contracting in mid-2007 (see fig. 1). Subprime mortgages accounted for approximately two-thirds of the increase in nonprime originations over that period rising from 457,000 in 2000 to 2.3 million in 2005 before declining somewhat in 2006.<sup>6</sup> Alt-A originations, although a smaller share of the nonprime market, increased at an even faster rate than subprime originations, increasing 18-fold from 2000 through 2005. From 2000 through 2007, an increasing proportion of subprime and Alt-A mortgages had loan and borrower characteristics that have been associated with a higher likelihood of default and foreclosure. These characteristics include adjustable interest rates, less than full documentation of borrower income and assets, and higher borrower debt burdens. For example, from 2000 through 2007, the percentage of Alt-A mortgages that did not have full documentation rose from 60 percent to 80 percent. For subprime loans, the proportion of such mortgages grew from 20 percent to 38 percent, then decreased to 33 percent. This loan feature was originally intended for borrowers who have difficulty documenting their income, such as the self-employed, but it eventually became more widespread. Such loans can be problematic if borrowers or loan originators overstate income or assets to qualify borrowers for mortgages they may not be able to afford.

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<sup>5</sup>A loan cohort is a group of loans originated in the same year.

<sup>6</sup>As previously noted, the data we used for our analysis do not cover the entire nonprime market but do cover the large majority of nonagency securitized mortgages within that market. Nonprime mortgages that were not securitized (i.e., mortgages that lenders held in their portfolios) may have different characteristics and performance histories than those that were securitized.

**Figure 1: Number of Subprime and Alt-A Originations by Cohort Year, 2000-2007**



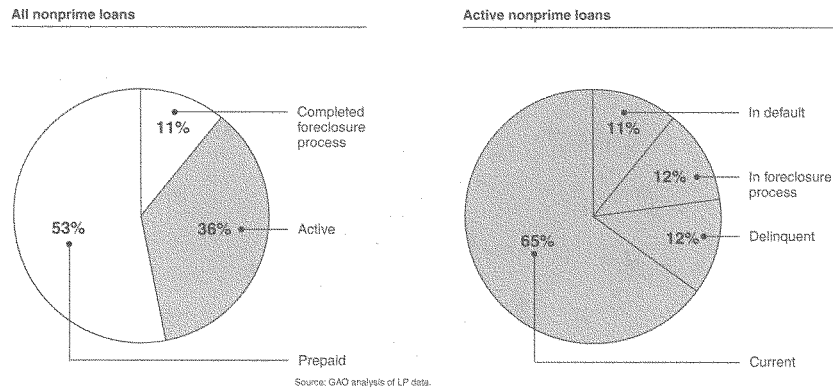
### Serious Delinquency Rates Were Highest for Subprime Loans and Certain Adjustable Rate Mortgages and Varied by State

Approximately 1.6 million of the 14.4 million nonprime loans originated from 2000 through 2007 had completed the foreclosure process as of March 31, 2009. Of the 5.2 million loans that were still active at the end of March—that is, that had not been prepaid or completed the foreclosure process—almost one-quarter were seriously delinquent, meaning they were either 90 or more days behind in payments or already in the foreclosure process (see fig. 2).<sup>7</sup> As a result, hundreds of thousands of additional nonprime borrowers are at risk of losing their homes in the near future. Within the subprime market segment, about 28 percent of active loans were seriously delinquent, and within the active Alt-A segment, the serious delinquency rate was about 17 percent. Within both segments, serious delinquency rates were even higher for certain adjustable-rate

<sup>7</sup>In comparison, as of the first quarter of 2007, active nonprime loans originated from 2000 through 2005 had a serious delinquency rate of 7.4 percent.

mortgages (ARM). For example, in the subprime market the serious delinquency rate for short-term hybrid ARMs—which feature a fixed interest rate for 2 or 3 years and an adjustable rate thereafter—was 38 percent as of March 31, 2009. In the Alt-A market, the serious delinquency rate for payment-option ARMs—which allow borrowers to make payments lower than what would be needed to cover any of the principal or all of the accrued interest—was approximately 30 percent. The rates varied widely by location. At the state level, California, Florida, Illinois, Massachusetts, Nevada, and New Jersey had the highest rates as of March 31, 2009. Each state had rates above 25 percent, and Florida's rate of 38 percent was the highest in the country. In contrast, 12 states had serious delinquency rates of less than 15 percent, including Wyoming's rate of 9 percent, which was the lowest in the country.

Figure 2: Percentage of All Nonprime Loans and All Active Nonprime Loans Originated from 2000 through 2007, by Performance Status, as of March 31, 2009



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**Recent Loan Cohorts  
Accounted for Most of  
the Serious  
Delinquencies and  
Had Successively  
Higher Cumulative  
Foreclosure Rates**

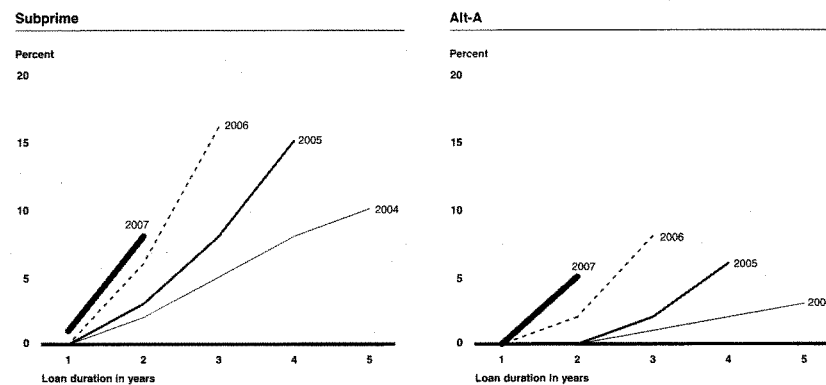
Mortgages originated from 2004 through 2007 accounted for the majority of troubled loans. Of the active subprime loans originated from 2000 through 2007, 92 percent of those that were seriously delinquent as of March 31, 2009, were from those four cohorts. Furthermore, loans from those cohorts made up 71 percent of the subprime mortgages that had completed the foreclosure process. This pattern was even more pronounced in the Alt-A market. Among active Alt-A loans, almost all (98 percent) of the loans that were seriously delinquent as of March 31, 2009, were from the 2004 through 2007 cohorts. Likewise, 93 percent of the loans that had completed the foreclosure process as of that date were from those cohorts.

Cumulative foreclosure rates show that the percentage of mortgages completing the foreclosure process increased for each successive loan cohort (see fig. 3). Within 2 years of loan origination, 2 percent of the subprime loans originated in 2004 had completed the foreclosure process, compared with 3 percent of the 2005 cohort, 6 percent of the 2006 cohort, and 8 percent of the 2007 cohort. Within 3 years of loan origination, 5 percent of the 2004 cohort had completed the foreclosure process, compared with 8 percent and 16 percent of the 2005 and 2006 cohorts, respectively. The trend was similar for Alt-A loans, although Alt-A loans foreclosed at a slower rate than subprime loans. For example, within 3 years of origination, 1 percent of Alt-A loans originated in 2004 had completed the foreclosure process, compared with 2 percent of the loans originated in 2005, and 8 percent of the loans originated in 2006.<sup>8</sup>

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<sup>8</sup>Three-year foreclosure rates for the 2007 cohort will not be available until 2010. However, as of March 31, 2009, the subprime and Alt-A cumulative foreclosure rates for the 2007 cohort were 10 percent and 7 percent, respectively.

**Figure 3: Cumulative Percentage of Subprime and Alt-A Loans that Completed the Foreclosure Process by Cohort Year, 2004-2007**



Source: GAO analysis of LP data.

This trend is partly attributable to a stagnation or decline in home prices in much of the country beginning in 2005 and worsening in subsequent years. This situation made it more difficult for some borrowers to sell or refinance their homes to avoid default or foreclosure. In addition, borrowers who purchased homes (particularly for investment purposes) but now owed more than the properties were worth, had incentives to stop making mortgage payments in order to minimize their financial losses. The deterioration in credit quality for the successive cohorts may also reflect an increase in riskier loan and borrower characteristics, such as less than full documentation of borrower income and higher borrower debt burdens.

Our full report provides additional information on the performance of nonprime loans, including breakdowns by Census division and congressional district. In two subsequent reports we are preparing at the request of the Chair and Vice Chair of the Joint Committee, we will provide additional information on the condition of the nonprime mortgage market. These reports will include examinations of the extent of negative home equity among nonprime borrowers; the influence of different loan,

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borrower, and economic variables on the likelihood of default; and sources of data on nonprime loans. The reports will also update the information we are issuing today on the performance of nonprime loans.

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Madam Chair, this concludes my prepared statement. I would be happy to answer any questions you or other members of the Joint Committee may have.

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### **Contacts and Staff Acknowledgements**

For further information about this testimony, please contact William B. Shear, Director, at 202-512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov). Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Steve Westley (Assistant Director), Eric Charles, Colleen Moffatt, Jamila Kennedy, DuEwa Kamara, John Mingus, and Marc Molino.





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## PREPARED STATEMENT OF SUSAN M. WACHTER

Chairwoman Maloney, Vice Chairman Schumer, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on "Current Trends in Foreclosure and What More Can Be Done to Prevent Them." It is my honor to be here today to discuss the continuing wave of foreclosures for nonprime borrowers in the residential housing market and current policy options to reduce foreclosure rates and modify mortgages.

Today according to the MBA, the foreclosure rate is 4.00%, four times the historical average and the highest it has ever been since the Great Depression.

It is fair to say that the considerable response to date by the federal government has not yet worked to stem this crisis. Why is this? While much has been done and more can be done, there is a fundamental problem that is difficult to address through policy initiatives. In my comments today, I will discuss this, the causes behind the difficult situation we are in today, and what might be done going forward.

The problem of foreclosed homes and mortgages in default started in a wave of foreclosures of subprime loans; in the coming years there will be another wave of foreclosures, in part, due to the so-called recasting of payment option mortgages. These and other complex nontraditional mortgages were a very small part of the mortgage market until they grew at an alarming rate starting in 2003; by 2006, they were almost half of the total volume of mortgage originations. As these untested, seemingly affordable, but unsustainable mortgages were originated, they fueled an artificial house price boom which inevitably collapsed. While the initial source of the problem was recklessly underwritten nontraditional mortgages, the asset bubble this created, the artificially and unsustainably inflated house prices, has been and is now a problem for many who borrowed for homes in the years 2004 and beyond. Homeowners who borrowed conservatively, putting 20% down using tried and tested mortgages with steady mortgage payments are in trouble; if they must sell due to job loss, for example, these owners who purchased at inflated prices will be forced into foreclosure.

Americans are now increasingly threatened with loss of their homes and their jobs and the problem will get worse before it gets better.

The chart that is attached, showing the growth in foreclosures and the decline in house prices, demonstrates the role of plummeting house prices in the worsening foreclosure problem. As average home prices fall, for more and more households, the amount for which they could sell their homes is less than what they owe on their mortgages. A loss of a job, illness, or increases in required mortgage payments will force owners to sell and will force foreclosure, since homes cannot be sold for the amount of the mortgage due. Today the threat of job loss is worsening as unemployment grows, and there will be a new wave of rises in mortgage payments required for option ARMs in the coming years.

Are there additional steps we can take now to mitigate the crisis? The crisis will abate when home prices stop falling. A key fundamental factor is growing unemployment, thus the importance of fiscal stimulus that is currently in place. It is also critical that mortgage rates remain affordable, thus the importance of continuing federal support for FHA and the GSEs and the maintenance of today's historically low mortgage rates. In addition, it is important to stem excess foreclosures which are adding to the forces driving home prices down. In an adverse feedback loop, more homes on the market pull down prices, which results in even more homes that cannot sell for the mortgage amount. This feeds an expectation that prices will fall more, further foreclosures, and a downward spiral.

Losses upon foreclosure are extreme. However, if mortgage amounts due exceed home values, loan modifications based on lowering or postponing interest rate payments alone may not be able to stem the growing problem. The Administration's Home Affordable Modification Plan (HAMP) is attempting to address the lack of incentives and capacity of mortgage servicers to respond to the foreclosure problem. The recently issued GAO report has a number of suggestions and in fact the administration is convening a meeting today to encourage further efforts. In addition, it would be useful, as suggested in the Penn IUR Task Force Report to HUD, to monitor the progress of the HAMP program spatially, since as documented by research (see Wachter 2009 and Wachter, forthcoming, and Bernstein et al.) there is an important spatial component to the problem. Further loan modifications with principal write-downs may also be necessary. This involves marking mortgages, especially second mortgages held by banks, to market.

The financial system that triggered the crisis encouraged the production and securitization of uneconomic loans which eventually brought the system down. As I have written elsewhere, private-label securitization itself failed, since these securi-

ties were not in fact subject to market discipline. Is a less pro-cyclical financial system an achievable goal? I have written with co-authors and wish to enter into the record an article to appear in the *Yale Journal on Regulation* which addresses the underlying failure of the regulatory and market structure. There we address the incentives to dismantle lending standards and the artificial housing boom which made it seem that the loans being made were indeed safe when they were lethal. Going forward regulatory supervision needs to be put into place to prevent this.

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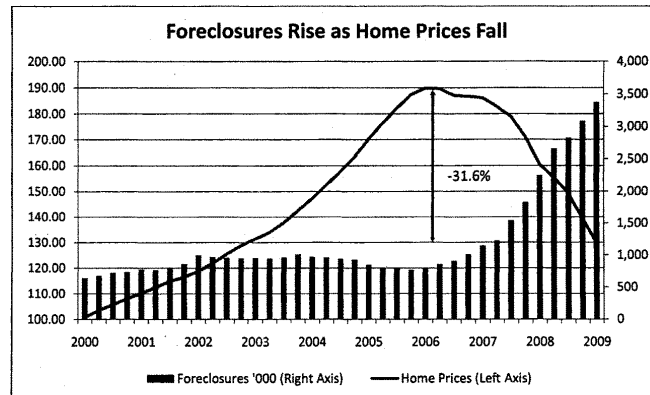
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Source: Case-Shiller, Moody's

## Systemic Risk and Market Institutions

Andrey D. Pavlov<sup>†</sup> and Susan M. Wachter<sup>‡</sup>

### Abstract

With private-label mortgage-backed securities (MBS), investors bore default risk; while this risk should have been priced, as systemic risk grew, the pricing of risk did not increase. This paper attempts to explain why this happened. We point to market institutions' incentive misalignments that cause asset prices to rise above fundamentals, producing systemic risk. The model attributes the asset price inflation to the provision of underpriced credit as lending institutions misprice risk to gain market share. The resulting asset price inflation itself then generates further expansion of underpriced credit.

Published in Yale Journal on Regulation Volume 26, Number 2, pp. 445-455

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<sup>†</sup> Associate Professor of Finance, Simon Fraser University, Vancouver, Canada.

<sup>‡</sup> Richard B. Worley Professor of Financial Management and Professor of Real Estate, Finance and City and Regional Planning at the Wharton School, University of Pennsylvania.

### 1. Introduction

Today's financial crisis is the result of market institutions' "rules of the game" that produce systemic risk. In efficient markets, asset prices follow a random walk. We point to market institutions' incentive misalignments that cause asset prices to rise above fundamentals, producing systemic risk. We first describe the pro-cyclical expansion of underpriced credit in the U.S. that drove asset prices up. We then briefly present the basics of a model which explains that this outcome is inevitable, given incentives to take risk to gain short-term profits. The model attributes the asset price inflation to the provision of underpriced credit as lending institutions misprice risk to gain market share. The resulting asset price inflation itself then generates further expansion of underpriced credit. We conclude with a discussion of why markets fail to contain inflated asset prices through the short-selling of assets or indices of assets and offer implications for market institutions going forward.

### 2. The Recent Deterioration of Lending Standards

The US housing mortgage and housing markets are at the center of the worldwide credit bubble and the subsequent financial crisis. The volatility adjusted run-up in US housing prices, particularly after 2003, exceeded price increases among all the major trading partners of the US. Similarly, the recent volatility-adjusted price decline is also more severe in the US relative to its major trading partners.<sup>1</sup> The price and price-rent ratios that were increasing in the US before 2003

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<sup>1</sup> For a discussion of why this occurred in 2003 and the role of fundamentals in the pricing of homes prior to 2003 but not after, see Andrey D. Pavlov, Zoltan Poznar & Susan M. Wachter, *Subprime Lending and Real Estate Markets*, in MORTGAGE AND REAL ESTATE FINANCE (2008). Appendix Figure 1 displays the volatility-adjusted price indices for 8 international markets; Jesse M. Abraham, Andrey Pavlov & Susan M. Wachter, *Explaining the United States' Uniquely Bad Housing Market*, 12 WHARTON REAL ESTATE REV. 24 (2008). The U.S. housing market is a clear outlier in terms of its price run-up and subsequent decline. For a history of the evolution of mortgage markets and their regulation, see Richard K. Green & Susan M. Wachter, *The Housing Finance Revolution*, 31 ECON. POL'Y SYMP.: HOUSING, HOUSING FIN., & MONETARY POL'Y, FED. RES. BANK OF KANSAS CITY (2007); Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSP. 93 (2005); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, Systemic Risk Through Securitization: The Result of

were attributable to interest rate declines and income increases, but not so after 2003. The US house price run-up post-2003 was accompanied by a credit bubble as subprime and other nontraditional mortgage lending took off in 2003. These loans differed from previously prevalent securitized agency debt in their lower lending standards, which, in turn, permitted constrained borrowers to overcome credit barriers and increased the demand for homes.

As the amount of nonprime lending increased, both absolutely and as a share of overall lending, the price of risk imbedded in these loans, rather than increasing, as might have been expected, decreased, both relatively and absolutely. For example, many of these loans were “teaser rate” adjustable rate mortgages (ARMs)<sup>2</sup> and as such were priced off of LIBOR.<sup>3</sup> Over time the margin over LIBOR decreased, despite the fact that as marginal borrowers became homeowners, the average borrower became riskier.

As the demand for homes increased, with the marginal borrower now able to overcome credit barriers, prices increased. Default rates, driven by loan-to-value ratios, thus remained low. With rising home prices it might have seemed reasonable that with the resetting of teaser rate loans and recasting of option ARMs<sup>4</sup>, it would not be a problem to refinance, since home prices would rise and exceed debt levels.

Each non-recourse mortgage loan contains an imbedded put option that allows the borrower to “put” the property to the lender for the outstanding balance of the loan by defaulting on the loan. In other words, the borrower owns a put option that they can exercise against the

Deregulation and Regulatory Failure (2009) (unpublished working paper, on file with Yale Journal on Regulation).

<sup>2</sup> Teaser rate ARMs are adjustable-rate mortgages with a low introductory rate, “teaser rate,” which is reset after two or three years to a higher interest rate.

<sup>3</sup> The London Interbank Offer Rate (LIBOR) is an exchange-settled interest rate for low-risk borrowers that is often used as a benchmark for risk-free lending.

<sup>4</sup> Option ARMs are adjustable-rate loans that allow the borrower to choose the monthly payment depending on their financial situation at the time. In particular, borrowers are allowed to make payments that do not even cover the interest rate on the mortgage, thus allowing the balance of the mortgage to increase over time.

lender to effectively sell the asset for the outstanding loan balance. The increased availability of lending at lower borrowing costs is reflected in the lower price of these loans and the underpricing of the put option embedded in these loans over time. This underpricing allowed an increase in demand and an increase in the price of the housing asset collateralized by the newly affordable lending. A housing price increase of unprecedented magnitude made refinancing possible, forestalling inevitable defaults and foreclosures and making nonprime lending appear safe.<sup>5</sup>

The market share of nonprime loans grew from under 15% in 2001 to almost half of originations by 2006 (the sum of the market share of Helocs, Alt-A, and subprime as shown in *Table 1*).<sup>6</sup> Within loan types, consolidated transaction price-based loan-to-value ratios (CLTV) also increased, as shown in *Table 2*. This implies borrowers were able to obtain financing with smaller and smaller downpayment at the same or declining borrowing costs. Also, *Table 2* shows, as systemic risk increased with higher CLTVs and with the growth in overall market share of riskier loans, the price of risk did not increase. Poorly underwritten teaser rate and pay-option or interest-only loans in particular took over 50% or more of the subprime origination market in many states. Such loans were extended disproportionately in states where mortgages were previously not affordable, as shown in Figures 1-4, thus temporarily expanding the market for homeownership and driving up prices.

When in the spring of 2007, credit conditions reversed, it was the markets where nonprime had expanded the most that were particularly vulnerable to the seizing up of nontraditional credit. Thus it was in the high priced, difficult to develop "sand states" where

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<sup>5</sup> See Andrey Pavlov & Susan M. Wachter, *The Inevitability of Marketwide Underpricing of Mortgage Default Risk*, 34 REAL EST. ECON. 479 (2006).

<sup>6</sup> "Heloc" stands for Home Equity Loan, "Alt-A" denotes alternative documentation loans, i.e., loans with limited documentation of income, asset value, or both, and "subprime" generally denotes mortgage loans extended to borrowers with prior credit problems or who are riskier in some other fashion.



housing was initially non-affordable that housing prices exploded with the wave of aggressive mortgage product and imploded as credit dried up (see *Figure 5*).

The problems of falling house prices and mortgage defaults and foreclosures, however, are no longer confined to the nonprime market. The extension of credit to marginal buyers increased the price of all homes and the subsequent withdrawal of credit reversed this change. Using reasonable 80% loan-to-value ratios, homes that were originally carefully underwritten are now also underwater. As home prices fall and unemployment rises, borrowers are defaulting on these loans as well, although defaults and foreclosures are greatest in markets where “aggressive lending” expanded loan demand.

### **3. *Loan Underpricing and Asset Prices***

In what follows we offer a model that links loan risk underpricing with real estate asset prices to explain why underpricing occurs. We identify the conditions under which asset price rises are not incidental or accidental but inevitable in the face of deteriorating lending standards. In other words, as the risk premium on residential mortgages drops to an artificially low level, this causes the asset price of houses to go up, leading to an asset value appreciation. This appreciation creates a false sense of security in the lenders and generates further deterioration of lending standards and asset price increases.

#### **3.1. *Lending Standards and Asset Prices***

Following our previous work,<sup>7</sup> we note that the transaction price of an asset financed through a non-recourse loan is the composite of the fundamental value of the asset,  $V$ , the market value of the mortgage loan,  $M$ , and the face value of the adjustable-rate mortgage loan,  $B$ :

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<sup>7</sup> Andrey D. Pavlov & Susan M. Wachter, *Mortgage Put Options and Real Estate Markets*, 38 J. REAL EST. FIN. & ECON. 89 (2009).

$$P = V(\sigma) - M(\sigma, s(\sigma)) + B, \quad (1)$$

where  $\sigma$  denotes the expected future volatility of the asset and  $s$  denotes the option-adjusted spread of lending over risk-free interest rates.<sup>8</sup> This spread compensates the lender for the default risk of the mortgage. If this default risk is priced correctly, then the market value and the face value of the mortgage are the same,  $M(\sigma, s(\sigma)) = B$ , and the transaction price equals the fundamental value of the asset. If the risk of default is underpriced, then the transaction price of the real estate asset reflects not only the fundamental value of the asset, but also the mispricing of the mortgage,  $B - M(\sigma, s(\sigma))$ . If the market value of the mortgage is below the face value of the mortgage, then the transaction price exceeds the fundamental value of the asset because efficient equity markets take advantage of the mispricing and the asset is assumed to be of fixed supply.

A change in the spread,  $s$ , between lending rates of the bank cost of capital may in some cases be a rational response to declines in the volatility of the underlying asset. In this case,

$$\frac{\partial P}{\partial \sigma} = \frac{\partial V}{\partial \sigma} - \frac{\partial M}{\partial \sigma} - \frac{\partial M}{\partial s} \frac{\partial s}{\partial \sigma} \quad (2)$$

Assuming the volatility of the asset is fully diversifiable i.e.,  $\frac{\partial V}{\partial \sigma} = 0$ , the right hand side of Equation (2) equals to zero because the spread adjusts to compensate the lender for the changes in the value of the put option embedded in the mortgage loan,  $\frac{\partial M}{\partial \sigma} + \frac{\partial M}{\partial s} \frac{\partial s}{\partial \sigma} = 0$ . If the increase

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<sup>8</sup> Option-adjusted spread denotes the spread of a lending rate over the risk-free rate adjusted for the leverage with which the asset is purchased ("loan-to-value ratio") and other characteristics of the asset that capture property-specific risks. The option-adjusted spread in our model accounts for the market risk in the loan outside the property and loan-specific characteristics.

in volatility affects the covariance of the asset return with the market, then  $\frac{\partial V}{\partial \sigma} < 0$ , but still relatively small.<sup>9</sup>

The response of the asset price to the spread is:

$$\frac{\partial P}{\partial s} = \frac{\partial P / \partial \sigma}{\partial s / \partial \sigma} = \frac{\partial V / \partial \sigma}{\partial s / \partial \sigma} = 0 \quad (3)$$

Therefore, the correlation between transaction prices and lending spread is zero if the increase in asset volatility is diversifiable, and close to zero if it affects the covariance between the asset and the overall market.

If, on the other hand, the spread declines because of underpricing, not in response to changes in expected future asset volatility, the response of the price to the spread is very different:

$$\frac{\partial s}{\partial \sigma} = 0, \quad \frac{\partial V}{\partial s} = 0, \quad \frac{\partial M}{\partial s} > 0, \quad (4)$$

therefore,

$$\frac{\partial P}{\partial s} = \frac{\partial V}{\partial s} - \frac{\partial M}{\partial s} = -\frac{\partial M}{\partial s} < 0. \quad (5)$$

In other words, if the decline in the spread of lending rates over the risk-free interest rate is due to lender underpricing of credit risk, asset prices move above fundamental levels.

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<sup>9</sup> The price impact of real estate volatility changes through the covariance with the overall market are likely to be far smaller than the impact through changing the value of the option to default.

The increase in price due to underpriced lending is magnified in a market with a large concentration of credit-constrained borrowers. Underpriced financing induces borrowers not only to over-pay for the assets because they obtain cheap financing, but also to demand more assets because they are now less constrained. The interplay of these two effects magnifies the price increases, especially in supply-constrained markets.

### ***3.2. Lender Response to Rising Asset Prices***

Consider next a lender who needs to maintain a zero expected rate of return on the entire portfolio, including old and new loans.<sup>10</sup> Such incentives can arise from a reserve requirement based on the risk of the entire portfolio or any other regulatory risk management requirement based on the entire portfolio. It can also arise from short-term focus of the loan or security originators who can use the institution's apparently strong balance sheet to cover poor underwriting standards on new originations (see footnote 10). Let  $\alpha$  denote the proportion of new loans relative to the entire portfolio. Assume that the weighted average option-adjusted spread on the entire portfolio needs to be above a certain regulatory or shareholder-imposed minimum level  $s^*$ . The lender then needs to set the spread on the new loans  $s^n$  so that the weighted average spread on the entire portfolio is  $s^*$ :

$$(1-\alpha)s^o + \alpha s^n \geq s^* \quad (6)$$

where  $s^o$  denotes the weighted average option-adjusted spread on the existing old loans.

As underlying real estate asset prices rise, the equity cushion of the existing loans increases,

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<sup>10</sup> Since we assume a risk-neutral lender, zero expected rate of return on the portfolio is the goal of the lender. This rate of return is after costs are covered and capital in the business is compensated. In a competitive market and under the risk-neutral investor assumption, all firms target zero expected rate of return.

making them safer. In loan pricing terms, this means the option-adjusted spread on the old loans increases:<sup>11</sup>

$$\frac{\partial s^o}{\partial P} \geq 0 \quad (7)$$

This allows the lender to charge a lower spread on the new loans and still maintain the overall weighted option-adjusted spread at the regulatory-required minimum  $s^*$ . The spread on new loans then is determined by Equation (6):

$$s^n \geq \frac{s^* - (1 - \alpha)s^o}{\alpha} \quad (8)$$

And since the option-adjusted spread on old loans,  $s^o$ , increases with asset prices, the spread on new loans,  $s^n$ , decreases with an increase in current asset prices:

$$\frac{\partial s^n}{\partial P} = -\frac{(1 - \alpha)}{\alpha} \frac{\partial s^o}{\partial P} \leq 0 \quad (9)$$

In other words, the spread on *new* loans declines as current asset prices increase. At the same time prices increase as the spread on new loans falls (see Equation (5)), leading to further decrease in spread and even higher asset prices. In a steady state, the spread of lending rates over the risk-free rate approaches zero, and asset prices are as if the investment is risk-free.

#### 4. Potential Solutions

In what follows we explore why short-selling did not contain asset mispricing and potential market mechanisms that could break the cycle set by Equations (5) and (9).

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<sup>11</sup> The option-adjusted spread increases even if the interest rate on the loans remains the same because the loans are now safer and the original spread is too high relative to the risk of those loans.

#### ***4.1. Short-selling the underlying asset***

One such possibility is to allow investors to short-sell the underlying real estate asset. Since the asset price takes the best outcomes as certain, the most a short-seller would lose is the risk-free rate of return. The upside for a short-seller, however, is large, as all outcomes but the absolute best result in positive, and sometimes substantial, payoffs to a short position. Real estate is difficult to sell short, however, so this potential solution is purely theoretical.

#### ***4.2. Short-selling the lender***

Short-selling the lender can potentially mitigate and even break the cycle of Equations (5) and (9), but is unlikely to be effective because the entire bank book, including old and new loans, appears to have proper capital reserves. Of course this is just an illusion, as the increase in the option-adjusted spread on old loans is purely artificial and due to the availability of underpriced lending, not on real estate market fundamentals. Once underpriced lending is eliminated, the artificially increased option-adjusted spreads on the old loans are also eliminated, and the lender finds itself in reserve shortfall position. But going short on the bank loans requires the ability to maintain the short position until underpriced lending is eliminated from the market place, which may take a very long time. Therefore, the effectiveness of short-selling the lender shares works only for investors who can maintain the short position through a period of substantial bank share increases.

Furthermore, as Green, Mariano, Pavlov, and Wachter show, bank shares tend to decline to a far smaller extent than real estate prices because banks have diverse investments and lines of

business.<sup>12</sup> Therefore, short-selling bank shares creates a basis risk for the investor even if they correctly detect the over-pricing of real estate assets.

#### 4.3. *Short-selling of specific loans or loan pools*

The last possibility is that investors are able to short-sell specific loans (or loan pools), in particular the new loans made by the lender. These loans offer little or no compensation for risk, thus the losses to a short-seller are limited to the risk-free rate of return.<sup>13</sup> Gains, on the other hand, are potentially significant as the new loans under-perform relative to the risk-free assets or even relative to older loans. This strategy is not without risk, as even the new loans can perform well for extended periods of time, but they are most exposed to elimination of underpriced loans in the market. In other words, the latest loans are most vulnerable to unwinding of the positions banks have taken over the years.

While attractive in theory, this mechanism cannot occur without a directed market regulation. Individual players have incentives to keep trades private and over the counter, and see no need to report prices or pool details to the broad markets. Therefore, to benefit from the ability to short-sell specific loans or pools, the market requires trade reporting requirements similar to stocks and many bonds, as well as an established and transparent mechanism for investors to express negative views and place negative market bets.

In summary, of the three possibilities listed above, short-selling of individual loans, or loan pools of similar vintage and characteristics, is the most effective ways for investors to break the cycle set off by lenders and real estate investors acting according to Equations (5) and (9).

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<sup>12</sup> Richard Green, Robert Mariano, Andrey Pavlov, & Susan Wachter, *Misaligned Incentives and Mortgage Lending in Asia* (Univ. of Pa. Law School Inst. for Law & Econ. Research, Working Paper No. 08-27, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1287687#](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1287687#).

<sup>13</sup> If a loan does not account for any risk, its rate of return is just the risk-free rate of return. If the loan repays with no loss, a short-seller of that loan would have to pay the original owner of the loan the risk-free rate on the loan.

### 5. Conclusion

Today's crisis in the U.S. emerged from a tectonic shift in the source and pricing for funding mortgage backed securities (MBS). While, historically, securitization has played a large role in the U.S. in the trading of MBS, investors have been exposed to interest rate risk only. Mortgage default risk was contained by underwriting, not priced, and not borne by investors. With the growth of a private-label subprime market, this changed. With private-label MBS, investors bore default risk; while this risk should have been priced, as systemic risk grew, the pricing of risk did not increase. This paper attempts to explain why this happened.

During the market evolution, fees drove the demand for securitization at every stage of the newly functionally differentiated production of mortgages. Banks received fees to originate and to distribute loans, the secondary market received fees to bundle mortgages, rating agencies received fees to rate the pools, and insurers received fees for issuing credit default swaps (CDS) used to hedge holdings of MBS. At each stage, entities were able to book fees without exposure to long term risks.

Due to incomplete markets, asset prices increase with the pro-cyclical production of loans. This lowers the perceived risk and the price of risk, inaccurately reflecting the risk of real estate loans on banks' balance sheets. In the absence of instruments to short sell fundamentally mispriced but marked-to-model rather than marked-to-market assets, it is not possible to counter the positive impact of additional (though temporary) mortgage supply on the demand for housing. As Herring and Wachter show,<sup>14</sup> real estate booms and banking busts tend to go together. The current financial upheaval is only the most recent in a series of financial crises in which property-based asset booms are accompanied by increases in systemic risk. Asset bubbles, in the absence

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<sup>14</sup> Richard Herring & Susan M. Wachter, *Real Estate Booms and Banking Busts: An International Perspective* (Group of Thirty, Working Paper No. 99-27, 1999), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=175348](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=175348).



of arbitrage, occur pro-cyclically and the result is production of systemic risk as liquidity providers increase their lending based on current above-market-fundamentals pricing of these assets.

Historically the credit induced asset price bubble covers up the deterioration in credit standards with the result of a more extended period in which the bubble forms, in the absence of downward price pressure through short-selling. If they had been in place, both tradable indexes (and derivatives and other market tradable instruments) to short sell mispriced assets and prudential oversight of difficult-to-short products could have countered the production of systemic risk.

Table 1: Mortgage Origination by Product

	FHA/VA ↓	Conv/Conf ↓	Jumbo ↓	Subprime ↑	Alt A ↑	HEL ↑
2001	8%	57%	20%	7%	2%	5%
2002	7%	63%	21%	1%	2%	6%
2003	6%	62%	16%	8%	2%	6%
2004	4%	41%	17%	18%	6%	12%
2005	3%	35%	18%	20%	12%	12%
2006	3%	33%	16%	20%	13%	14%
2007	4%	48%	14%	8%	11%	15%

Table 2A: Deterioration of Lending Standards, 2002 – 2006

ARMs										
Only Yr	CLTV	CLTV>80	Second	Full Doc	DTI	FICO>700	DTI	FICO>700	DTI	WAC
Prime	2002	66.4	4.1	1.9	56.0	46	31.9	28.7	8.7	5.3
	2003	64.2	10.1	10.9	48.6	39	31.9	21.8	1.6	4.6
	2004	73.5	28.7	25.1	51.2	71	35.5	22.8	2.1	4.5
	2005	74.1	21.7	26.8	47.5	61	35.6	18.9	1.9	5.4
	2006	75.5	26.2	35.3	51.6	91	37.2	19.5	2.3	6.2
Alt A	2002	74.3	20.8	2.7	29.3	26	35.4	46.4	9.9	6.3
	2003	78.0	53.3	23.4	28.1	56	35.3	44.7	12.9	5.6
	2004	82.6	46.9	39.1	32.6	73	38.2	44.3	15.3	5.3
	2005	83.5	49.6	46.9	28.3	83	37.0	40.5	16.5	6.0
	2006	85.0	55.4	55.4	19.0	87	38.3	44.2	15.3	6.8
Subprime	2002	81.2	46.8	3.7	66.9	1	40.0	95.4	4.7	8.5
	2003	83.5	53.6	9.9	63.5	5	40.2	91.8	4.9	7.5
	2004	85.5	61.1	19.1	59.9	20	40.6	90.6	5.5	7.1
	2005	86.6	64.4	28.1	55.9	53	41.2	89.7	5.4	7.5
	2006	86.7	64.8	31.8	54.6	20	42.1	91.8	5.7	8.2

Source: Loan Performance Data as of November 2006. CTR, April 16, 2007. \*Based on "How Did We Do Then and What Lies Ahead?"

↑ % Full Doc declined

↑ Not much change in FICO or DTI

Spreads declined

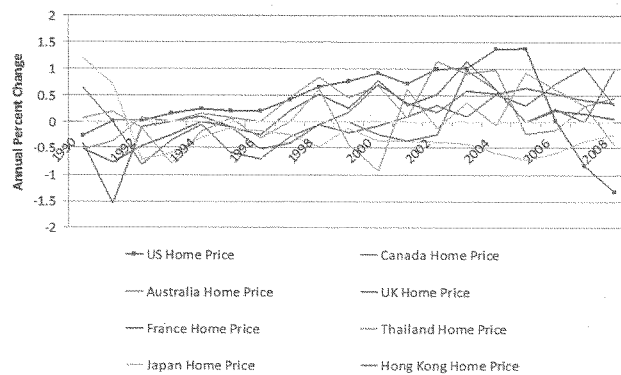
[AU: Please identify and provide the sources for the above tables]

Table 2B:

<b>Mortgage Information</b>				
Year of Origination		1999	2003	2006
Subprime Loans		512,476	1,426,503	2,376,949
Alt-A Loans		84,233	413,494	872,208
<b>Total Number of Loans</b>		<b>596,710</b>	<b>1,840,040</b>	<b>3,251,355</b>
ARM Loans		187,219	920,304	1,723,079
ARM Margin		6	6	5
ARM Teaser (% of ARM loans)		0.92	0.39	0.95
Interest-Only Loans		1,169	95,870	725,317

**Source:** Raphael Bostic et al, Mortgage Product Substitution and State Anti-Predatory Lending Laws: Better Loans and Better Borrowers?, (2009) (unpublished working paper, on file with the Yale Journal on Regulation).

Appendix Figure 1: Price Appreciation Controlled for Volatility



**Source:** Jesse M. Abraham, Andrey Pavlov & Susan M. Wachter, *Explaining the United States'*

*Uniquely Bad Housing Market*, 12 WHARTON REAL ESTATE REV. 24 (2008).

## PREPARED STATEMENT OF KEITH S. ERNST, CENTER FOR RESPONSIBLE LENDING

Good morning Chairwoman Maloney, Vice Chair Schumer, ranking members Brady and Brownback, and members of the committee. Thank you for your continued efforts to address the foreclosure crisis and for the invitation to participate today.

I serve as Director of Research for the Center for Responsible Lending (CRL), a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund. For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get affordable home loans. Self-Help's lending record includes a secondary market program that encourages other lenders to make sustainable loans to borrowers with weak credit. In total, Self-Help has provided over \$5.6 billion of financing to 62,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

In September 2007, our CEO Martin Eakes testified before this committee about the wave of coming subprime foreclosures and about some ways to prevent the crisis from escalating. As it turned out, our predictions—dismissed by some as pessimistic—actually *underestimated* the dimensions of the crisis. In light of what has happened, it is more essential than ever that Congress take immediate, strong steps to prevent foreclosures and bar the return of abusive, unsustainable lending that otherwise might once again fundamentally disrupt our economy.

We recommend several key actions to mitigate the continued flood of foreclosures and avert similar crises in the future:

- (1) Create a Consumer Financial Protection Agency as outlined in H.R. 3126;
- (2) Pass legislation requiring mortgage originators to determine a consumer's ability to repay the mortgage and encourage the Federal Reserve Board to finalize its proposed rules banning yield spread premiums;
- (3) Ensure that the Administration's current efforts to prevent foreclosures—the Home Affordable Program and the Hope for Homeowners Program—work as effectively as possible, including ameliorating the tax consequences of loan modification and principal reduction; and
- (4) Lift the ban on judicial loan modifications of mortgages on principal residences.

## I. FORECLOSURES CONTINUE TO SOAR AND THE MORTGAGE MARKET CONTINUES TO SUFFER.

Our most recent report on subprime mortgages shows that over 1.5 million homes have already been lost to foreclosure, and another two million families with subprime loans are currently delinquent and in danger of losing their homes in the near future.<sup>1</sup> Projections of foreclosures on all types of mortgages during the next five years estimate 13 million defaults (over the time period 2008Q4 to 2014).<sup>2</sup> Right now, more than one in ten homeowners is facing mortgage trouble.<sup>3</sup> Nearly one in five homes is underwater.<sup>4</sup>

The spillover costs of the foreclosure crisis are massive. Tens of millions of homes—households where, for the most part, the owners have paid their mortgages on time every month—are suffering a decrease in their property values that amounts to hundreds of billions of dollars in lost wealth.<sup>5</sup> These losses, in turn, cost states and localities enormous sums of money in lost tax revenue and increased costs for fire, police, and other services. As property values decline further, the cycle of reduced demand and reduced mortgage origination continues to spiral downward.

As a result of the foreclosure crisis, the mortgage market itself is in deep trouble. Overall mortgage activity has plummeted. For 2008, residential loan production

<sup>1</sup> Center for Responsible Lending, *Continued Decay and Shaky Repairs: The State of Subprime Loans Today*, p.2 (Jan. 8, 2009) [hereinafter "Continued Decay"], available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/continued-decay-and-shaky-repairs-the-state-of-subprime-loans-today.html>.

<sup>2</sup> Goldman Sachs Global ECS Research, Home Prices and Credit Losses: Projections and Policy Options (Jan. 13, 2009), p. 16; see also Credit Suisse Fixed Income Research, Foreclosure Update: Over 8 Million Foreclosures Expected, p.1 (Dec. 4, 2008).

<sup>3</sup> Mortgage Bankers Association National Delinquency Study (March 5, 2009).

<sup>4</sup> First American Core Logic (March 4, 2009).

<sup>5</sup> *Continued Decay*, p. 3.

cratered: \$1.61 trillion compared to \$2.65 trillion in 2007.<sup>6</sup> Originations of subprime and Alt-A, (nonprime) mortgages all but stopped in 2008. Only an estimated \$64 billion in such mortgages was originated last year.<sup>7</sup> At its high point in 2006, nonprime lending constituted a third (33.6%) of all mortgage production. By the fourth quarter of 2008, it had fallen to 2.8%.<sup>8</sup> These loans are not being originated in large part due to the collapse of the secondary market for these mortgages, which was driving demand and facilitating production. So far, 2009 has seen no reversal of this investor retreat.

On the consumer demand side as well, every major indicator is down. Between 2006 and 2008, existing home sales dropped 24 percent,<sup>9</sup> while new home sales and new construction starts plummeted by 54 and 58 percent, respectively.<sup>10</sup> In February, mortgage applications for the purchase of homes hit their lowest levels since April 1998.<sup>11</sup>

## II. RISKY LOANS, NOT RISKY BORROWERS, LIE AT THE HEART OF THE MORTGAGE MELTDOWN.

In October of last year, CRL provided lengthy testimony to the Senate Banking Committee that describes the origins of this crisis in detail.<sup>12</sup> In this testimony, we focus on the question of whether the core problem in the subprime market was risky borrowers or risky loans. Specifically, many in the mortgage industry blame the borrowers themselves, saying that lower-income borrowers were not ready for homeownership or not able to afford it.<sup>13</sup> Yet our empirical research shows that the leading cause of the problem was the characteristics of the market and mortgage products sold, rather than the characteristics of the borrowers who received those products.

More specifically, research has shown that the risk of foreclosure was an inherent feature of the defective subprime loan products that produced this crisis. Loan originators—particularly mortgage brokers—frequently specialized in steering customers to higher rate loans than those for which they qualified. They also aggressively sold loans with risky features and encouraged borrowers to take out so-called “no doc” loans even when those borrowers typically had easy access to their W-2 statements and offered them to the originators.<sup>14</sup> Market participants readily admit that they were motivated by the increased fees offered by Wall Street in return for riskier loans. After filing for bankruptcy, the CEO of one mortgage lender explained the incentive structure to the *New York Times*: “The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,” he said. “What would you do?”<sup>15</sup>

These risky, expensive loans were then aggressively marketed to homebuyers and refinance candidates, often irrespective of borrower qualifications. In fact, in late 2007, the *Wall Street Journal* reported on a study that found 61% of subprime loans originated in 2006 “went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms.”<sup>16</sup> Even applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate subprime loans for—at most—half to eight tenths of a percent above the initial rate

<sup>6</sup>National Mortgage News (March 9, 2009).

<sup>7</sup>Inside B&C Lending (February 27, 2009).

<sup>8</sup>Id.

<sup>9</sup>National Association of Realtors, <http://www.realtor.org/research/research/ehsdata>.

<sup>10</sup>US Census Bureau, [http://www.census.gov/const/quarterly\\_sales.pdf](http://www.census.gov/const/quarterly_sales.pdf) and [http://www.census.gov/const/www/quarterly\\_starts\\_completions.pdf](http://www.census.gov/const/www/quarterly_starts_completions.pdf).

<sup>11</sup>Based on the Mortgage Bankers Association’s Weekly Mortgage Applications Survey for the week ending February 27, 2009. The four-week moving average for the seasonally adjusted Purchase Index reached its lowest level since April 1998. See [www.mortgagebankers.org/NewsandMedia/PressCenter/67976.htm](http://www.mortgagebankers.org/NewsandMedia/PressCenter/67976.htm).

<sup>12</sup>Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008) [hereinafter “Stein Testimony”], available at <http://www.responsiblelending.org/mortgagelending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf>.

<sup>13</sup>Favorite industry targets to blame for the crisis are the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac (the GSEs). For a complete discussion of why CRA and the GSEs did not cause the crisis, see Stein testimony, pp. 25-33.

<sup>14</sup>See, e.g., Glenn R. Simpson and James R. Hagerty, *Countrywide Loss Focuses Attention on Underwriting*, Wall Street Journal (Apr. 30, 2008).

<sup>15</sup>Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages*, New York Times (January 26, 2007).

<sup>16</sup>Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

on the risky ARM loans they were given.<sup>17</sup> Perhaps even more troubling, originators particularly targeted minority communities for abusive and equity-stripping subprime loans, according to complaints and affidavits from former loan officers alleging that this pattern was not random but was intentional and racially discriminatory.<sup>18</sup>

In 2006, the Center for Responsible Lending published, “Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners.”<sup>19</sup> In this report, we projected that 1 in 5 recent subprime loans would end in foreclosure—a projection that turns out to have actually underestimated the scope of the crisis, although it was derided at the time as pessimistic and overblown. Our research showed that common subprime loan terms such as adjustable rate mortgages with steep built-in payment increases and lengthy and expensive prepayment penalties presented an elevated risk of foreclosure *even after accounting for differences in borrowers’ credit scores*. It also showed how the risk entailed in these loans had been obscured by rapid increases in home prices that had enabled many borrowers to refinance or sell as needed. The latent risk in subprime lending has been confirmed by other researchers from the public and private sectors.<sup>20</sup>

A complementary 2008 study that we undertook with academic researchers from the University of North Carolina at Chapel Hill, “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,” supports the conclusion that risk was inherent in the loans themselves.<sup>21</sup> The study compared the performance of loans made through a loan program targeted to low- and moderate-income income families and comprised primarily of lower-cost 30-year fixed-rate loans to the performance of subprime loans, most of which were broker-originated and had nontraditional terms, such as adjustable rates and prepayment penalties.

In this study, the authors found a cumulative default rate for recent borrowers with subprime loans to be more than three times that of comparable borrowers with lower-rate loans. Furthermore, the authors were able to identify the particular features of subprime loans that led to a greater default risk. Specifically, they found that adjustable interest rates, prepayment penalties, and broker originations were all associated with higher loan defaults. In fact, when risky features were layered into the same loan, the resulting risk of default for a subprime borrower was four to five times higher than for a comparable borrower with the lower-rate fixed-rate mortgage from a retail lender.

CRL also conducted a more targeted study to focus on the cost differences between loans originated by independent mortgage brokers and those originated by retail lenders. In “Steered Wrong: Brokers, Borrowers and Subprime Loans,” CRL analyzed 1.7 million mortgages made between 2004 and 2006.<sup>22</sup> After matching brokered to retail-originated loans along multiple dimensions, including borrower credit scores, product type, and levels of debt and income verification, we observed consistent and significant price disparities between loans obtained through a broker and those obtained directly from a lender.

Specifically, for subprime borrowers, broker-originated loans were consistently far more expensive than retail-originated loans, with additional interest payments ranging from \$17,000 to \$43,000 per \$100,000 borrowed over the scheduled life of the loan. Even in the first four years of a mortgage, a typical subprime borrower who

<sup>17</sup> Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

<sup>18</sup> Julie Bykowitz, “City can proceed with Wells Fargo lawsuit”, Baltimore Sun (July 3, 2009) (available at <http://www.baltimoresun.com/news/maryland/baltimore-city/bal-md-foreclosure03jul03,0,5953843.story>).

<sup>19</sup> Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, “Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners” (Center for Responsible Lending, December 2006) available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf>.

<sup>20</sup> See e.g., Yuliya Demyanyk, “Ten Myth About Subprime Mortgages”, Economic Commentary, Federal Reserve Bank of Cleveland (May 2009) (available at <http://www.clevelandfed.org/research/commentary/2009/0509.pdf>); Karen Weaver, “The Sub-Prime Mortgage Crisis: A Synopsis” Deutsch Bank (2008) (available at [http://www.globalsecuritisation.com/08\\_GBP/GBP\\_GSSF08\\_022\\_031\\_DB\\_US\\_SubPrm.pdf](http://www.globalsecuritisation.com/08_GBP/GBP_GSSF08_022_031_DB_US_SubPrm.pdf)) (concluding that subprime mortgages “could only perform in an environment of continued easy credit and rising home prices”).

<sup>21</sup> Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models” Center for Community Capital, University of North Carolina at Chapel Hill (September 13, 2008) (available at [http://www.ccc.unc.edu/abstracts/091308\\_Risky.php](http://www.ccc.unc.edu/abstracts/091308_Risky.php)).

<sup>22</sup> Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers and Subprime Loans* (April 8, 2008), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrongbrokers-borrowers-and-subprime-loans.pdf>.

has gone through a broker pays \$5,222 more than a borrower with similar credit-worthiness who received their loan directly from a lender.

This finding was not surprising given what we know about broker compensation. Mortgage brokers typically receive two primary types of revenue: an origination fee and a yield spread premium (YSP). The origination fee is paid directly by the borrower and is generally calculated as a percentage of the loan amount. The YSP is an extra payment that brokers receive from lenders for delivering a mortgage with a higher interest rate than that for which the borrower qualifies. In the subprime market, lenders usually will pay the maximum YSP only if a loan contains a prepayment penalty. The penalty ensures that the lender will recoup their YSP payment either through excess interest collected over time or from the penalty fee, should a borrower refinance to avoid those interest costs. Ironically, while most subprime borrowers believed their mortgage broker was looking for the best-priced loan for them, the YSP serves as a powerful financial incentive for brokers to steer borrowers into unnecessarily expensive loans.

### III. PREVENTING RISKY LENDING IN THE FUTURE.

#### A. Create the Consumer Financial Protection Agency

In light of our research, we believe there are important additional steps Congress should take to prevent reckless lending that could once again fundamentally disrupt our economy. Most importantly, we urge you to support H.R. 3126, which would establish the Consumer Financial Protection Agency.

As demonstrated above, the subprime market itself delivered loans with significant inherent risks over and above borrowers' exogenous risk profiles through the very terms of the mortgages being offered. Although financial regulatory agencies were aware of this risk, regulatory action was discouraged by the concern that any regulatory agency taking action against these types of loans would place their regulated institutions at a competitive disadvantage. In addition, the ability of lenders to choose their regulator has resulted in a system where lenders may exert deep influence over their regulator's judgment.<sup>23</sup>

The Consumer Financial Protection Act would gather in one place the consumer protection authorities currently scattered across several different agencies, and would create a federal agency whose single mission is to protect our families and our economy from consumer abuse. The Agency would restore meaningful consumer choice by averting the race to the bottom that has crowded better products out of the market.<sup>24</sup>

H.R. 3126 is appropriately balanced to enhance safety and soundness and allow appropriate freedom and flexibility for innovation. The bill also incorporates the elements that are essential to an effective consumer protection agency. These include the following:

- The bill provides the Agency with essential rule-making authority to prevent abusive, unfair, deceptive and harmful acts and practices and to ensure fair and equal access to products and services that promote financial stability and asset-building on a market-wide basis.
- The bill provides the Agency with strong enforcement tools, along with concurrent authority for the States to enforce the rules against violators in their jurisdictions. We urge that the bill also ensure that individuals harmed by violations of the Agency's rules have redress.
- The bill reforms the preemption of State laws to ensure that States are not hamstrung in their efforts to react to local conditions as they arise and preserves the ability of states to act to prevent future abuses.
- The bill gives the Consumer Financial Protection Agency supervisory authority to ensure that financial institutions comply with the rules it puts in place and to give the Agency access to the real-world, real-time information that will best enable it to make evidence-based decisions efficiently.

In other areas of the economy, from automobiles and toys to food and pharmaceuticals, America's consumer markets have been distinguished by standards of fairness, safety and transparency. Financial products should not be the exception—particularly since we have demonstrated that it is the subprime mortgage products

<sup>23</sup> See e.g., Silla Brush, "Audit: OTS knew bank data was skewed", The Hill (May 21, 2009) (available at <http://thehill.com/business--lobby/audit-ots-knew-bank-data-skewed-2009-05-21.html>).

<sup>24</sup> See Center for Responsible Lending, Neglect and Inaction: An Analysis of Federal Banking Regulators' Failure to Enforce Consumer Protections (July 13, 2009) available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/neglect-and-inaction-7-10-09-final.pdf>.

themselves that raised the risk of foreclosure. A strong, independent consumer protection agency will keep markets free of abusive financial products and conflicts of interest. Dedicated a single agency to this mission will restore consumer confidence, stabilize the markets and put us back on the road to economic growth.

*B. Prohibit predatory lending, particularly unsustainable loans, yield spread premiums and prepayment penalties.*

It is also imperative to pass legislation that would require sensible and sound underwriting practices and prevent abusive loan practices that contributed to reckless and unaffordable home mortgages. For this reason, we urge the passage of H.R. 1728. While there are some ways in which this bill should be strengthened, it represents a critical step forward in requiring mortgage originators to consider the consumer's ability to repay the loan and to refinance mortgages only when the homeowner receives a net tangible benefit from the transaction.

Another crucial advantage of H.R. 1728 is its establishment of certain bright line standards that will result in safer loans and in more certainty for originators of those loans. The bill's safe harbor construct would grant preferred treatment to loans made without risky features such as prepayment penalties, excessive points and fees, inadequate underwriting, and negative amortization. It would also ban yield spread premiums—which, as we explained earlier, were key drivers of the crisis—and it would permit states to continue to set higher standards if necessary to protect their own residents.

Similarly, we strongly support the Federal Reserve Board's recently released proposal to ban yield spread premiums for all loan originators. While the Board's rule is not yet written tightly enough, it represents an important step forward in the recognition that disclosure alone is not enough to protect consumers and that certain practices themselves give rise to unfairness and unnecessary risk.

Many industry interests object to any rules governing lending, threatening that they won't make loans if the rules are too strong from their perspective. Yet it is the absence of substantive and effective regulation that has managed to lock down the flow of credit beyond anyone's wildest dreams. For years, mortgage bankers told Congress that their subprime and exotic mortgages were not dangerous and regulators not only turned a blind eye, but aggressively preempted state laws that sought to rein in some of the worst subprime lending.<sup>25</sup> Then, after the mortgages started to go bad, lenders advised that the damage would be easily contained.<sup>26</sup> As the global economy lies battered today with credit markets flagging, any new request to operate without basic rules of the road is more than indefensible; it's appalling.

#### IV. AVOIDING ADDITIONAL UNNECESSARY FORECLOSURES STEMMING FROM THE CURRENT CRISIS.

Finally, we urge this Committee to take further action to help save the homes of the millions of families facing impending foreclosure.

*A. Ensure that Current Anti-Foreclosure Efforts are as Strong as Possible.*

It is very important for all of us to monitor and evaluate the Treasury's Home Affordable Modification Program (HAMP) and HUD's Hope for Homeowners (H4H) program.

The HAMP program has the potential to modify millions of mortgages. However, it has gotten off to a slow start, hampered by a severe problem with servicer capacity, by a piece-by-piece rollout of complementary programs addressing second liens and short sales, and by lagging compliance and appeals procedures. Many servicers who are participating in this voluntary program are apparently not following all of

<sup>25</sup> Id.

<sup>26</sup> For example, in September 2006, Robert Broeksmit of the Mortgage Bankers Association told Congress, "Our simple message is that the mortgage market works and the data demonstrate that fact," and "I strongly believe that the market's success in making these 'nontraditional' products available is a positive development, not cause for alarm." Statement of Robert D. Broeksmit, CMB Chairman, Residential Board of Governors, Mortgage Bankers Association, Before a Joint Hearing of the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy, U.S. Senate Committee on Banking, Housing and Urban Affairs, Calculated Risk: Assessing Non-Traditional Mortgage Products, available at [http://banking.senate.gov/public\\_files/broeksmit.pdf](http://banking.senate.gov/public_files/broeksmit.pdf). In May 2007, John Robbins of the Mortgage Bankers Association said, "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy. And we're not the only ones who think so." John M. Robbins, CMB, Chairman of the Mortgage Bankers Association at the National Press Club's Newsmakers Lunch—Washington, D.C., available at [http://www.mortgagebankers.org/files/News/InternalResource/54451\\_NewsRelease.doc](http://www.mortgagebankers.org/files/News/InternalResource/54451_NewsRelease.doc).



the program's directives. Most importantly, experience shows that they are not consistently following the requirement that loans be evaluated for HAMP eligibility before foreclosure proceedings are commenced.

To improve HAMP, servicers should be barred from proceeding with any portion of a foreclosure action prior to considering the consumer for a modification. In other words, they should not be permitted to institute an action, and if an action has already been instituted, they should not be permitted to move forward at all. Right now, reports indicate that many servicers are operating as if the only thing prohibited before consideration for a modification is the final foreclosure sale—and, even worse, many foreclosure sales are still going forward while the HAMP review is in process.

In addition, the net present value model must be far more transparent to consumers, consumers who are turned down must be told the specific reason for their denial through a formal declination letter, and the program needs to roll out a clear process for appeal of a decision above and beyond the servicer's own internal procedures.

One way to help with the various concerns just listed is to create a mediation program that would require servicers to sit down face-to-face with borrowers to evaluate them for loan modification eligibility. Similar programs are at work in several jurisdictions across the country, and they can be very helpful to ensure that homeowners get a fair hearing and that all decisions are made in a fair and transparent way.<sup>27</sup>

It is also crucial that the loan-level data that will be available to the Treasury Department by early August be released to the public, both in report form and in the maximum possible raw disaggregated form so that independent researchers and other interested parties can analyze the data themselves. In addition, the Treasury Department should publish benchmarks against which program performance will be evaluated.

Considering the difficulties that HAMP is encountering as it tries to scale up, it would be prudent to institute a deferment program along the lines of the Home Retention and Economic Stabilization Act introduced early this session by Representative Matsui and Senator Menendez (H.R. 527 and S. 241). This legislation permits homeowners making less than a certain income who are stuck in dangerous home loans, such as subprime or payment option ARM mortgages, to avoid foreclosure for up to nine months as long as they make a market-based mortgage payment and remain responsible during their deferment period. This deferment period would end if the homeowner was offered a HAMP or other sustainable modification.

As for the H4H program, so far, that program has failed to even begin to fulfill its promise. We supported recent legislative changes that offer some possibility for improving this program in a way that would jump start its use; however, the continued resistance of servicers and lenders to principal reduction and the need to extinguish all junior liens will likely continue to hamper this program's potential going forward. We do not believe the potential of this program will be able to be realized until Congress also lifts the ban on judicial modifications of primary residence mortgages (see section IV(B) below). We also must fix the perverse tax consequences that could befall homeowners using either one of these programs.<sup>28</sup>

#### *B. Lift the Ban on Judicial Modifications of Mortgages on Primary Residences*

We strongly believe that no voluntary program will be effective until there is a mandatory backstop available to homeowners. For that reason, we are pleased to see that Congress is beginning to revisit the need to permit judges to modify mortgages on principal residences.

This solution, which carries zero cost to the U.S. taxpayer, has been estimated to potentially help more than a million families stuck in bad loans to keep their homes.<sup>29</sup> It would also help maintain property values for families who live near homes at risk of foreclosure. And it would complement the various programs that rely on voluntary loan modifications or servicer agreement to refinance for less than the full outstanding loan balance.

Judicial modification of loans is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., but is denied to families whose most important asset is the home they

<sup>27</sup> Andrew Jakabovics and Alon Cohen, "It's Time we Talked: Mandatory Mediation in the Foreclosure Process," Center for American Progress (June 2009) (available at: [http://www.americanprogress.org/issues/2009/06/pdf/foreclosure\\_mediation.pdf](http://www.americanprogress.org/issues/2009/06/pdf/foreclosure_mediation.pdf)).

<sup>28</sup> For more information on tax consequences of principal reduction, see Stein Testimony, p. 10.

<sup>29</sup> Mark Zandi, "Homeownership Vesting Plan", Moody's Economy.com (December 2008) (available at [http://www.dismal.com/mark-zandi/documents/Homeownership\\_Vesting\\_Plan.pdf](http://www.dismal.com/mark-zandi/documents/Homeownership_Vesting_Plan.pdf)).

live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are not permitted to modify in chapter 13 payment plans.

Proposals to lift this ban have set strict limits on how it must be done. Such proposals would require that interest rates be set at commercially reasonable, market rates; that the loan term not exceed 40 years; and that the principal balance not be reduced below the value of the property. And if the servicer agrees to a sustainable modification, the borrower will not qualify for bankruptcy relief because they will fail the eligibility means test. As Lewis Ranieri, founder of Hyperion Equity Funds and generally considered “the father of the securitized mortgage market,”<sup>30</sup> has recently noted, such relief is the only way to break through the problem posed by second mortgages.<sup>31</sup>

#### CONCLUSION

As we survey the broken mortgage market, it is important to remember that the benefits of homeownership have not changed. Long-term homeownership remains one of the best and most reliable ways that families can build a better economic future, and all of us have a strong national interest in ensuring that the mortgage market works to build our economy, not tear it down. In an effective home lending market, lenders and borrowers will enter transactions with the same fundamental measure of success—that is, a commitment to a mortgage that represents a solid investment both short-term and long-term. We urge Congress to take the actions we have outlined to ensure that opportunities for sustainable homeownership remain open and meaningful.

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#### PREPARED STATEMENT OF JOSEPH R. MASON

Thank you Congresswoman Maloney, Senator Schumer, and Committee Members for inviting me to testify today.

Recent history is rife with examples of subprime servicer problems and failures, resplendent with detail on best—and worst—practices. The industry has been through profitable highs and predatory lows, over time reacting to increased competition with greater efficiency and, where sensible, increased concentration reflective of scale economies in processing and knowledge.

Servicing is nothing if not a service industry, motivating borrowers to pay the loans under the servicer’s own management even when the borrower cannot afford to pay others.

But intensively customer service-based enterprises such as servicing are hard to evaluate quantitatively, so that proving a servicer’s value is difficult even in the best business environment. Unfortunately, today’s is not the best business environment, so proving servicer value has now become crucial to not only servicer survival, but the survival of the market as a whole.

There are seven key reasons why servicers are facing difficulties with today’s borrowers:

1. Modification is Expensive. Modified and defaulted loans can cost thousands of dollars per loan per year to service, compared to roughly fifty dollars for performing loans.

2. Arrearages are a Drag on Profits. Servicers have to pay investors as if the loan was current until the servicer resolves the delinquency, whether through modification or foreclosure.

3. Mortgage Servicing Rights Values Decline. When loans default, servicing fees end, so the values of the loan servicing contracts decline.

4. Increased Fees are only a Partial Fix. It is difficult to convince investors to accept a doubling of servicing fees, and even that will not cover typical increased costs. Servicers are reluctant to impose fees directly on borrowers, however, as those fees have been viewed as per se predatory in the past.

5. When Servicers are Threatened, Employees (and Expertise) Flee. Reduced servicing staff, particularly with respect to the most talented employees that have other options, will have a demonstrably adverse affect on servicing quality.

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<sup>30</sup>Lewis Ranieri to deliver Dunlop Lecture on Oct. 1, Harvard University Gazette, Sept. 25, 2008, available at <http://www.news.harvard.edu/gazette/2008/09.25/06-dunlop.html>.

<sup>31</sup>Lewis S. Ranieri, “Revolution in Mortgage Finance,” the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, available at [http://www.jchs.harvard.edu/events/dunlop\\_lecture\\_ranieri\\_2008.mov](http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov) (last visited Oct. 13, 2008). Ranieri is “chairman, CEO, and president of Ranieri & Co. Inc. and chairman of American Financial Realty Trust, Capital Lease Funding Inc., Computer Associates International Inc., Franklin Bank Corp., and Root Markets Inc. He has served on the National Association of Home Builders Mortgage Roundtable since 1989. . . .” *Harvard University Gazette*, Sept. 25, 2008.

6. Servicer Bankruptcy Creates Perverse Dynamics. While most securitization documents stipulate a transfer of servicing if pool performance has deteriorated or if the servicer has violated certain covenants, which are expected to generally precede bankruptcy, the problem is that the paucity of performance data makes it difficult for the trustee or the investors to detect servicer difficulties prior to bankruptcy to make the change.

7. Default Management is More Art than Science. While modifications can be a useful loss mitigation technique when appropriate policies and procedures are in place, servicers that are unwilling or unable to report the volume, type, and terms of modifications to securitized investors or regulators may be poorly placed to offer meaningful modifications.

The main drawback with current policy is therefore that the industry can use modification to game the system and investors are wary. There are four major reasons for investor concern.

1. Aggressive Reaging makes Delinquencies Look Better than they Really Are. Investors know that redefault rates on modified loans are high, so calling the modified loan “current” again immediately is disingenuous at best.

2. Aggressive Representations and Warranties also Skew Reported Performance. At their best, representations and warranties help *stabilize* pool performance. At their worst, representations and warranties inappropriately *subsidize* the deal. In practice, it is difficult to decompose the difference between stabilization and subsidization.

3. Reaging and Representations and Warranties are used to Keep Deals off their Trigger Points. Residual holders, nay, servicers, however, continue to push for lowering delinquency levels, no matter how artificially, in order to maintain positive residual and interest-only strip valuations that can keep them from insolvency. Aaa-class investors are therefore at the mercy of servicers who are withholding information on fundamental credit performance in lieu of modification.

4. Current Industry Reporting does not Capture even the Most Basic Manipulations. Servicers that utilize unlimited modifications or modifications without appropriate controls could end up necessitating *greater* credit enhancement to maintain credit ratings, whether because of servicer capabilities or the possibility for delaying step-down by skewing delinquencies.

The State Foreclosure Prevention Working Group’s *first* Report in February 2008 acknowledged that senior bondholders fear that some servicers, primarily those affiliated with the seller, may have incentives to implement unsustainable repayment plans to depress or defer the recognition of losses in the loan pool in order to allow the release of overcollateralization to the servicer.

Regulators can therefore do a great service to both the industry and borrowers in today’s financial climate by insisting that servicers report adequate information to assess not only the success of major modification initiatives, but also performance overall. The increased investor dependence on third-party servicing that has accompanied securitization necessitates substantial improvements to investor reporting in order to support appropriate administration and, where helpful, modification of consumer loans in both the private and public interest. Without information, even the most highly subsidized modification policies are bound to fail.

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PREPARED STATEMENT OF MICHAEL C. BURGESS, M.D.

Thank you Madam Chair, and I thank the witnesses for testifying here today.

I am looking forward to hearing more about the current home foreclosure situation and the effectiveness of the government workout plans to date.

Most people in my district share the opinion of CNBC’s Rick Santelli in his epic rant on the floor of the Chicago Mercantile Exchange back in February. They don’t want to support other adults who signed a contract to pay a mortgage that they ultimately could not afford and they don’t want the government to help people who are delinquent on their mortgages. Yet, foreclosures raise interest rates for everyone and hurt home equity and appraisal values. What do we say to those people who are still paying their monthly mortgage but are now living in a home that has lost \$50,000 or \$100,000 in equity? These homeowners have very little incentive to continue to make that payment, especially if they experience a significant life event like the loss of a job or major medical situation.

Home foreclosures seem to be rising despite the government’s best efforts to reverse the trend through programs like “Hope for Homeowners” and changes to Federal Housing Administration loan provisions. Perhaps the continued foreclosure trend can be attributed to the fact that foreclosure is often the best method to work out or “cram down” mortgages. As the front page of today’s *Washington Post* put

it, “banks and other lenders in many cases have more financial incentive to let borrowers lose their homes than to work out settlements.” According to the article, the Administration is seeking to influence lenders’ calculus in part by offering them incentives to modify home loans.

If banks need more financial incentives to help people in this economic environment, they are clearly not in a position to take on the risk of continuing to carry less than prime or high risk loans. The idea that we can pay off banks in order to save some delinquent homeowners is one that continues to anger not just Rick Santelli and the guys on the floor in Chicago, but people across this country who feel like they are the victims of their own responsible behaviors.

Banks and lenders are being rewarded and given incentives despite the fact that they were engaged in risky lending behaviors in order to appease political activist groups who pushed them into tough lending situations. [WSJ Article, “Housing Push for Hispanics Spawns Waves of Foreclosures”].

With that, I yield back the balance of my time.

#### HOUSING PUSH FOR HISPANICS SPAWNS WAVE OF FORECLOSURES

(By Susan Schmidt and Maurice Tamman, the *Wall Street Journal*, 5 January 2009)

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California Rep. Joe Baca has long pushed legislation he said would “open the doors to the American Dream” for first-time home buyers in his largely Hispanic district. For many of them, those doors have slammed shut, quickly and painfully.

Mortgage lenders flooded Mr. Baca’s San Bernardino, Calif., district with loans that often didn’t require down payments, solid credit ratings or documentation of employment. Now, many of the Hispanics who became homeowners find themselves mired in the national housing mess. Nearly 9,200 families in his district have lost their homes to foreclosure.

For years, immigrants to the U.S. have viewed buying a home as the ultimate benchmark of success. Between 2000 and 2007, as the Hispanic population increased, Hispanic homeownership grew even faster, increasing by 47%, to 6.1 million from 4.1 million, according to the U.S. Census Bureau. Over that same period, homeownership nationally grew by 8%. In 2005 alone, mortgages to Hispanics jumped by 29%, with expensive nonprime mortgages soaring 169%, according to the Federal Financial Institutions Examination Council.

An examination of that borrowing spree by the *Wall Street Journal* reveals that it wasn’t simply the mortgage market at work. It was fueled by a campaign by low-income housing groups, Hispanic lawmakers, a congressional Hispanic housing initiative, mortgage lenders and brokers, who all were pushing to increase homeownership among Latinos.

The network included Mr. Baca, chairman of the Congressional Hispanic Caucus, whose district is 58% Hispanic and ranks No. 5 among all congressional districts in percentage of home loans not tailored for prime borrowers. The caucus launched a housing initiative called Hogar—Spanish for home—to work with industry and community groups to increase mortgage lending to Latinos. Mortgage companies provided funding to that group, and to the National Association of Hispanic Real Estate Professionals, which fielded an army to make the loans.

In years past, minority borrowers seeking loans were often stopped cold by a practice called red-lining, in which lenders were reluctant to lend within particular geographical areas, often, it appeared, on the basis of race. But combined efforts to open the mortgage pipeline to Latinos proved successful.

“We saw what we refer to in the advocacy community as reverse red-lining,” says Aracely Panameno, director of Latino affairs for the Center for Responsible Lending, an advocacy group. “Lenders were seeking out those borrowers and charging them through the roof,” she says.

Ms. Panameno says that during the height of the housing boom she sought to present the Hispanic Caucus with data showing how many Latinos were being steered into risky and expensive subprime loans. Hogar declined her requests, she says.

When the national housing market began unraveling, so did the fortunes of many of the new homeowners. National foreclosure statistics don’t break out data by ethnicity or race. But there is evidence that Hispanic borrowers have been hard hit. In part, that’s because of large Hispanic populations in areas where the housing bubble was pronounced, such as Southern California, Nevada and Florida.

In U.S. counties where Hispanics account for more than 25% of the population, banks have taken back 6.7 homes per 1,000 residents since Jan. 1, 2006, compared

with 4.6 per 1,000 residents in all counties, according to a Journal analysis of U.S. Census and RealtyTrac data.

Hispanic lawmakers and community groups have blamed subprime lenders, who specialize in making loans to customers with spotty credit histories. They complain that even solid borrowers were steered to those loans, which carry higher interest rates.

In a written statement, Mr. Baca blamed the foreclosure crisis among Hispanics on borrowers' lack of "financial literacy" and on "lenders and brokers eager to make a bigger profit." He declined to be interviewed for this story.

But a close look at the network of organizations pushing for increased mortgage lending reveals a more complicated picture. Subprime-industry executives were advisers to the Hogar housing initiative, and bankrolled more than \$2 million of its research. Lawmakers and advocacy groups pushed hard for the easy credit that fueled the subprime phenomenon among Latinos. Members of the Congressional Hispanic Caucus, who received donations from the lending industry and saw their constituents moving into new homes, pushed for eased lending standards, which led to problems.

Mortgage lenders appear to have regarded Latinos as a largely untapped demographic. Many were first or second-generation U.S. residents who didn't own homes. Many Hispanic families had multiple wage earners working multiple cash jobs, but had no savings or established credit history to allow them to qualify for traditional loans.

The Congressional Hispanic Caucus created Hogar in 2003 to work with industry and community groups to increase mortgage lending to Latinos. At that time, the national Latino homeownership rate was 47%, compared with 68% for the overall population. Hogar called the figure "alarming," and said a concerted effort was required to ensure that "by the end of the decade Latinos will share equally in the American Dream of homeownership."

Hogar's backers included many companies that ran into trouble in mortgage markets: Fannie Mae and Freddie Mac, both now under federal control; Countrywide Financial Corp., sold last year to Bank of America Corp.; Washington Mutual Inc., taken over by the government and sold to J.P. Morgan Chase & Co.; and New Century Financial Corp. and Ameriquest Mortgage Corp., both now defunct.

Hogar's ties to the subprime industry were substantial. A Washington Mutual vice president served as chairman of its advisory committee. Companies that donated \$150,000 a year got the right to place a research fellow who would conduct Hogar's studies, which were used by industry lobbyists. For donations of \$100,000 a year, Hogar offered to provide news releases from the Hispanic Caucus promoting a lender's commercial products for the Latino market, according to the group's literature.

Hogar worked with Freddie Mac on a two-year examination of Latino homeownership in 63 congressional districts. The study found Hispanic ownership on the rise thanks to "new flexible mortgage loan products" that the industry was adopting. It recommended further easing of down-payment and underwriting standards.

Representatives for Hogar declined repeated requests for comment.

The National Association of Hispanic Real Estate Professionals, one of Hogar's sponsors, advised the group, shared research data and built a large membership to market loans to Latinos. By 2005, its ranks had grown to 16,000 agents and mortgage brokers.

The association, called Nahrep, received funding from some of the same players that funded Hogar. Some 22 corporate sponsors, including Countrywide and Washington Mutual, together paid the association \$2 million a year to attend conferences and forums where lenders could pitch their loan products to loan brokers.

While home prices were rising, the lending risk seemed minimal, says Tim Sandos, Nahrep's president. "We would say, 'Is he breathing?' OK, we'll give him a mortgage," he recalls.

Nahrep's 2006 convention in Las Vegas was called "Place Your Bets on Home Ownership." Countrywide Chairman Angelo Mozilo spoke, as did former Housing and Urban Development Secretary Henry Cisneros, a force in Latino housing developments in the West.

Countrywide and other sponsors contracted with Nahrep to set up regional events where they could present loan products to loan brokers and their customers. Mr. Sandos says his organization doesn't get paid to promote particular lenders.

At the height of the subprime lending boom, in 2005, banking and finance companies gave at least \$2.3 million in campaign contributions to members of the Hispanic Caucus, according to data from the Center for Responsive Politics.

In October 2008, a charitable foundation set up by Mr. Baca received \$25,000 from AmeriDream Inc., a nonprofit housing company and Hogar sponsor. Mr. Baca has long backed AmeriDream's controversial seller-financed down-payment assist-

ance program. AmeriDream provided down-payment money to buyers, a cost that was covered by home builders in the form of donations to the nonprofit.

New housing legislation last fall outlawed the program. Mr. Baca is cosponsoring a bill that would allow AmeriDream and similar nonprofits to resume arranging seller-financed down-payment assistance to low-income Federal Housing Administration borrowers.

Such seller-financed loans comprise one-third of the loans backed by the FHA, and have defaulted at nearly triple the rate of other FHA-insured loans, according to agency spokesman William Glavin.

In a news release, AmeriDream said the donation to Mr. Baca's foundation was intended to fund the purchase of gear for firefighters in his district. Local news reports say the foundation gave away \$36,000 in scholarships this year.

Internal Revenue Service records indicate that Mr. Baca's son, Joe Baca Jr., has an annual salary of \$51,800 as executive director of the Joe Baca Foundation, which is run out of the congressman's home. Joe Baca Jr. says he currently is taking only about half that listed salary.

Mr. Baca's office declined to comment on the AmeriDream contribution.

Mr. Baca remains opposed to strict lending rules. "We need to keep credit easily accessible to our minority communities," he said in a statement released by his office.

Mortgage lending to Hispanics took off between 2004 and 2007, powered by nonprime loans. The biggest jump occurred in 2005. The 169% increase in nonprime mortgages to Hispanics that year outpaced a 122% gain for blacks, and a 110% increase for whites, according to a Journal analysis of mortgage-industry and federal-housing data. Nonprime mortgages carry high interest rates and are tailored to borrowers with low credit scores or few assets.

Between 2004 and 2007, black borrowers were offered nonprime loans at a slightly higher rate than Hispanics, but the overall number of Hispanic borrowers was much larger. From 2004 to 2005, total nonprime home loans to Hispanics more than tripled to \$69 billion from \$19 billion, and peaked in 2006 at \$73 billion.

Mortgage brokers became a key portion of the lending pipeline. Phi Nguyng, a former broker, worked at two suburban Washington-area firms that employed hundreds of loan originators, most of them Latino. Countrywide and other subprime lenders sent account representatives to brokerage offices frequently, he says. Countrywide didn't respond to calls requesting comment.

Representatives of subprime lenders passed on "little tricks of the trade" to get borrowers qualified, he says, such as adding a borrower's name to a relative's bank account, an illegal maneuver. Mr. Nguyng says he's now volunteering time to help borrowers facing foreclosure negotiate with banks.

Many loans to Hispanic borrowers were based not on actual income histories but on a borrower's "stated income." These so-called no-doc loans yielded higher commissions and involved less paperwork.

Another problem was so-called NINA—no income, no assets—loans. They were originally intended for self-employed people of means. But Freddie Mac executives worried about abuse, according to documents obtained by Congress. The program "appears to target borrowers who would have trouble qualifying for a mortgage if their financial position were adequately disclosed," said a staff memo to Freddie Mac Chairman Richard Syron. "It appears they are disproportionately targeted toward Hispanics."

Freddie Mac says it tightened down-payment requirements in 2004 and stopped buying NINA loans altogether in 2007.

"It's very hard to get in front of a train loaded with highly profitable activities and stop it," says Ronald Rosenfeld, chairman of the Federal Housing Finance Board, a government agency that regulates home loan banks.

Regions of the country where the housing bubble grew biggest, such as California, Nevada and Florida, are heavily populated by Latinos, many of whom worked in the construction industry during the housing boom. When these markets began to weaken, bad loans depressed the value of neighboring properties, creating a downward spiral. Neighborhoods are now dotted with vacant homes.

By late 2008, one in every nine households in San Joaquin County, Calif., was in default or foreclosure—24,049 of them, according to Federal Reserve data. Banks have already taken back 55 of every 1,000 homes. In Riverside, Calif., 66,838 houses are owned by banks or were headed in that direction as of October. In Prince William County, Va., a Washington suburb, 11,685 homes, or one in 11, was in default or foreclosure.

Gerardo Cadima, a Bolivian immigrant who works as an electrician, bought a home in suburban Virginia for \$330,000, with no money down. "I said this is too good to be true," he recalls. "I'm 23 years old, with a family, buying my own house."

When work slowed last year, Mr. Cadima ran into trouble on his adjustable-rate mortgage. "The payments were increasing, and the price of the house was starting to drop," he says. "I started to think, is this really worth it?" He stopped making payments and his home was sold at auction for \$180,000.

In the wake of the housing slump, some participants in the Hispanic lending network are expressing second thoughts about the push. Mr. Sandos, head of Nahrep, says that some of his group's past members, lured by big commissions, steered borrowers into expensive loans that they couldn't afford.

Nahrep has filed complaints with state regulators against some of those brokers, he says. Their actions go against Nahrep's mission of building "sustainable" Latino home ownership.

These days, James Scruggs of Northern Virginia Legal Services is swamped with Latino borrowers facing foreclosure. "We see loan applications that are complete fabrications," he says. Typically, he says, everything was marketed to borrowers in Spanish, right up until the closing, which was conducted in English.

"We are not talking about people working for the World Bank or the IMF," he says. "We are talking about day laborers, janitors, people who work in restaurants, people who do babysitting."

Two such borrowers work in Mr. Scrugg's office. Sandra Cardoza, a \$28,000-a-year office manager, is now \$30,000 in arrears on loans totaling \$370,000. "Her loan documents say she makes more than me," says Mr. Scruggs.

Nahrep agents are networking on how to negotiate "short sales" to banks, where Hispanic homeowners sell their homes at a loss in order to escape onerous mortgages. The association has a new how-to guide: "The American Nightmare: Strategies for Preventing, Surviving and Overcoming Foreclosure."

