“Damaged credit? You can still purchase a home with low monthly rates.”

“Get Cash from the Equity in Your Home -- up to 125% of Your Home's Value”

“Eliminate your credit card debt now. No credit check”

“100% financing (No Money Down) Rates start at 2%”

“We have 100's of loan types! Rates as low as .25%”

“Non-FICO & No Doc Home Loans, Instant Approval - No Credit Check”

We have all seen and heard the ads. Mortgages that seemed so hard to obtain as recently as ten years ago are now readily available, apparently to anyone who calls one of the ubiquitous toll-free numbers touted in the advertisements. Many of us have relatives, friends, or coworkers that have purchased expensive homes on a modest salary or cashed out equity in their homes for luxurious purchases they previously thought unaffordable.

Yet, increasingly, the media is reporting on payment shock among borrowers whose low monthly payments rose steeply after their introductory loan periods expired. Newspaper articles and TV news stories are profiling borrowers who responded to ads offering low rates, and who are now in payment default, unable to afford their higher monthly payments, and unable to sell their homes in a stagnant housing market.

This informational hearing focuses on the types of loans and lending practices that have become the norm in today’s mortgage lending environment. For purposes of this hearing, we call any loan that allows a borrower to defer principal or interest during an initial introductory period a “nontraditional” loan. This definition is intentionally broad, in order to allow the Committee to discuss the broadest possible range of loan products available in today’s highly competitive mortgage market. We have also chosen to include prime loans, as well as nonprime loans, in furtherance of a broad, balanced discussion.

The timeliness of this hearing is unquestioned. Nontraditional loans have grown to comprise over one-third of all new loans made nationwide, and as many as half of all new loans made in California during 2006. Five federal regulatory agencies recently issued guidance on nontraditional mortgage product risks, in response to the increased marketing of nontraditional mortgage products to a wider variety of borrowers and the increased amount of credit risk layering associated with the marketing and underwriting of these products.

This hearing is intended to focus on nontraditional loans and lending practices, and on the recently-issued guidance. During the hearing, we will examine the types of nontraditional residential mortgage products currently available to homebuyers, as well as the sales features and

underwriting practices that often accompany these products. We will hear from lenders who have sold billions of dollars in nontraditional loans about their lending experiences and from housing counselors who see borrowers every day that have overcommitted themselves into mortgage loans they can no longer afford. After examining lender and borrower experiences with nontraditional mortgage products, we will hear from a varied group of regulators, lenders, brokers, and consumer groups about nontraditional mortgage product risk guidelines that were recently issued by five federal banking regulators. One of the key questions that will be debated before the Committee is whether that guidance should be applied by the state to its own licensees, and if so, how.

The remainder of this background paper offers information intended to provide the context for testimony to be given during the hearing. The paper includes sections on the following topics: a definition of key lending terms and underwriting practices; the evolution of mortgage lending practices; federal interagency guidance on nontraditional mortgage product risks; and responses to the federal guidance by state regulators and federal government-sponsored enterprises; the regulation of mortgage lenders and brokers in California; the composition of the mortgage market (i.e., the percentage of the market held by different types of products); the synergies between borrowers seeking loans and investors who trade in mortgage-backed securities; and the issue of rising delinquencies in the subprime market.

MORTGAGE LENDING PRODUCTS AND PRACTICES

The following terms will be used throughout the remainder of this paper:

Nontraditional loans are those that allow borrowers to defer repayment of principal, and in some cases, interest. These loans are also known as "alternative" or "exotic" mortgages. Borrowers who obtain these loans are given the opportunity to make relatively low payments during an initial low interest rate period in exchange for agreeing to make much higher payments during a later amortization period. Nontraditional loans are sold in the prime, alt-A, and subprime markets. Subprime borrowers generally pay interest rates at least 3% higher than prime borrowers, and sometimes much higher.

Nonprime borrowers: Any borrower who does not qualify for prime interest rates, usually because their credit score (e.g. FICO score) falls below a threshold level. Although lenders do use factors other than FICO scores to determine whether a borrower can qualify for a prime loan, FICO scores remain the single most important factor in determining whether a borrower falls into the prime pool (generally, FICO scores of 660-680 and above) or the nonprime pool (generally, FICO scores below 660). The nonprime pool of borrowers includes both Alt-A and subprime borrowers.

The Alt-A market lies somewhere between prime and subprime and is populated by borrowers who might have good credit, but who don't necessarily fit traditional lending standards. Examples include people with very short credit histories, self-employed individuals whose income might not appear neatly on a W-2, and people who receive large amounts of their income through tips or bonuses, among others. Because of their better credit as compared to subprime borrowers, Alt-A borrowers are often considered appropriate recipients of reduced

documentation loans and piggyback loans (see definitions below and statistics later in this paper).

Initial teaser rates: Low introductory rates intended to increase the affordability of a loan in its early years. It is not uncommon for loan interest to increase by 6 percentage points or more from an initial teaser rate to a fully-indexed rate, although many loans have interest rate caps that prevent the interest rate from jumping more than a few percentage points each time the loan resets to a higher rate.

Interest-only loans: Loans in which a borrower may defer payment of principal during an initial interest-only period. The interest-only period typically lasts between three and ten years. During this time, interest payments may be fixed or variable, depending on the loan. After the initial interest-only period ends, borrowers must begin to pay principal, and the principal is amortized over the remainder of the loan (For example, if a borrower obtained a 30-year interest-only loan and paid no principal during the first five years of the loan, the full amount of the principal would be amortized over the remaining 25 years of the loan).

Negative amortization: A loan whose amount due increases, rather than decreases, over time.

Payment-option: Also known as option loans, these loans typically give the borrower a choice of four different amounts to pay each month. The four options: 1) a payment that covers none of the principal and only part of the interest due, allowing the loan to negatively amortize; 2) an interest-only payment; 3) a principal and interest payment based on a 30-year amortizing loan; and 4) a principal and interest payment based on a 15-year amortizing loan.

Typically, a negatively amortizing loan will recast when the interest due reaches 120% or 125% of the original loan amount, depending on the terms of the loan (some loans recast at 110% of the original loan amount). When the loan recasts, the borrower is required to begin paying principal and interest that are amortized over the remaining years of the loan. (For example, if an individual chooses to make minimum payments for five years, and the loan recasts at the end of the five-year period, further payments would be amortized over the remaining 25 years of the loan, requiring the borrower to pay back all of the accrued principal, plus all of the deferred interest over 25 years).

Borrowers whose loans negatively amortize may or may not know by how much their debt is increasing each month. Lenders are currently under no requirements to inform borrowers of the extent of their negative amortization. Many payment-option loans also have built-in recasting periods (typically every five years) that kick in, even if the home has not negatively amortized to a certain trigger level.

As noted above in the description of interest-only loans, an individual with a payment-option mortgage who chooses to make interest-only payments will eventually be required to make payments that begin to pay down the principal. Payment-option adjustable rate mortgages (ARMs) in which a borrower selects to pay interest-only behave much the same as regular (non payment-option) interest-only loans.

Most payment-option mortgages are adjustable, although some lenders have introduced payment-option fixed rate mortgages.

Piggyback: Also known as simultaneous second-lien loans or wrap-arounds, piggybacks are second mortgages, either open or closed lines of credit, that are taken out at the same time as a primary mortgage. They allow a buyer to purchase a home with little or no money down, and to avoid paying mortgage insurance. Piggy backs are commonly designed to wrap around a primary mortgage that covers 80% of the home's cost. The piggy backs in this case cover 10% to 20% of the remaining cost of the home. The down payment accounts for any amount not covered by the first lien and the piggy back.

Silent seconds: Piggyback loans whose existence is not involved in underwriting the primary loan (e.g., when the loan-to-value ratio used by a lender to qualify a borrower for the first lien includes only the first mortgage).

2/28s: Also known as hybrid ARMs, these are loans in which the borrower owes a low, fixed rate for the first two years. These loans reset after the 24th month into adjustable rate mortgages that typically readjust every six months. Evidence suggests that 2/28s are the most popular form of subprime loan in today's market. Similar hybrid ARMs that provide different amounts of time before the fixed period resets include 3/27s, 5/25s, and 7/23s.

40- and 50-year mortgages: These mortgages are not nontraditional according to the definition provided above (i.e., they do not allow borrowers to defer payment of principal or interest), but they do allow borrowers to spread their principal payments over a time period longer than 30 years. Like nontraditional mortgages, 40- and 50-year mortgages allow borrowers to "buy more house" than they would be able to with a 30-year fixed rate mortgage, because the lengthier amortization period lowers their monthly payments to a more affordable level.

Reduced-documentation loans: A class of loans commonly referred to as "stated-income," "state asset," "no-doc," or "low-doc" loans. These loans generally allow borrowers to verbally state the income and assets they will have at their disposal to pay off their mortgages, rather than requiring them to submit copies of their W-2s and/or provide copies of past income tax returns. These loans come in several different types, a few of which are listed immediately below. Reduced-documentation loans often carry higher interest rates than those with full documentation.

NINA: Short for no income, no assets. A type of stated-income loan in which the borrower is not required to provide documentation regarding his or her income or assets.

NINJA: Short for no income, no job or assets. In a loan of this type, a borrower is not required to provide documentation of their income or assets, and the individual's employer is not called to verify their employment.

No ratio: A loan in which the underwriter does not look at a borrower's income, but does look at a borrower's assets. Called a no ratio loan, because there is no debt-to-income ratio reviewed during underwriting.

EVOLUTION OF MORTGAGE LENDING PRACTICES

California's mortgage market, like the US mortgage market, has undergone significant changes over the past several decades. Prior to 1980, the mortgage market was dominated by savings and loan associations, who originated conventional mortgage loans; mortgage bankers, who originated government mortgage loans, and mortgage brokers, who handled everything else. Changes enacted by the Depository Institutions Deregulation and Monetary Act of 1980 reduced the lending advantage that savings and loans had enjoyed, and allowed the mortgage market to shift toward federal banks and federal government sponsored enterprises (GSEs), the latter of which played a key role in the development of mortgage-backed securities. The Alternative Mortgage Transaction Parity Act of 1982 authorized state-chartered lending institutions to offer alternative mortgage products, including those with variable interest rates and balloon payments, and is credited with increasing parity among state-and federally-chartered mortgage banks. The Tax Reform Act of 1986 stimulated mortgage demand by retaining the federal income tax deduction for mortgage interest and eliminating similar deductions for consumer debt like car loans and educational loans. These legislative changes, together with the increased popularity of mortgage-backed securities, encouraged and facilitated product innovation and expanded credit availability during the 1980s. (Note: A separate section of this background paper covers the topic of mortgage-backed securities).

Prior to the mid-1990s, most lenders required potential homeowners to put 20% down on their new home loans. People with damaged credit, employees with non-wage income, and young people with few savings for down payments were largely shut out of the housing market. As the millennium approached, however, the mortgage lending market changed dramatically, and credit became much more widely available.

The increasing popularity of the Internet and advances in computing technology made it easier and cheaper to process and package new loans. Electronic databases made it easier for lenders to assess the risk of lending to borrowers with damaged credit, and the secondary market helped lenders package riskier loans with less risky ones to mitigate their exposure. Strong interest from investors in the US and abroad gave lenders a great incentive to lend, because they were able to rapidly resell their loans on the secondary market, making a profit in the process.

These changes had dramatic consequences for home ownership. According to a recent study by the Federal Reserve Bank of Chicago, subprime lending has put as many as two million families into homes over the past decade, helping push the U.S. homeownership rate to 69% in 2005, up from 65% in 1995. Although subprime lending alone did not cause this change, it is believed to have accounted for close to half of the four-percentage point rise in home ownership and is believed to have had almost as much of an impact on rising home ownership as demographic changes, low interest rates, and government programs combined. Former Federal Reserve Chairman Alan Greenspan has referred to subprime lending as "the democratization of credit."

Changes over the past decade not only helped subprime homebuyers enter the market, but also first-time homebuyers. In 2006, 45% of first-time homebuyers purchased their homes with no money down, up from 43% a year earlier, and up from nearly zero percent ten years before.

At about the same time that credit became more readily available, housing prices were increasing, and doing so dramatically in certain areas. Homebuyers seeking to purchase increasingly expensive homes were gravitating toward mortgages with low introductory interest rates and other features that put previously unaffordable homes within their grasp. Nontraditional mortgages became the norm. Nationwide, nontraditional loans comprised over one-third of all loans made during the first nine months of 2006, up from about 2% in 2000.

Although they have only recently grown to comprise a significant portion of the mortgage market, nontraditional mortgage loans have been available for many years. They were initially offered to higher-income borrowers, those with promising long-term earnings potential, such as young lawyers and doctors just finishing law and medical school, and to borrowers with uneven income streams, such as stock brokers or salespeople who receive large commission checks one or more times a year. As noted above, however, nontraditional loans have increasingly been used to help home buyers, especially those considered subprime borrowers, obtain credit.

In efforts to qualify new borrowers for homes they would otherwise be unable to afford and to allow existing homeowners to refinance, even as interest rates were rising, lenders began lending to ever-riskier borrowers on ever more favorable terms. These findings are not simply anecdotal; they are supported by several federal studies and examinations. For example:

In mid-2005, all five federal banking regulators (the Office of the Comptroller of the Currency, or OCC; Federal Reserve Board, or FRB; Federal Deposit Insurance Corporation, or FDIC; Office of Thrift Supervision, or OTS; and National Credit Union Administration, or NCUA) reviewed data from six of the most sophisticated residential mortgage lenders in the country, looking for trends and current practices. The six lenders chosen represented half of the projected 2005 nontraditional mortgage product originations, as well as half of all mortgage originations. The agencies' review found indications of loosening in underwriting standards, some instances of borrowers not being qualified based on fully amortizing payments, an increase in piggyback loans, and an increase in the use of credit scores in lieu of income and asset verification. The layering of these activities on top of subprime nontraditional mortgages added additional layers of credit risk. The survey also found concentrations of nontraditional products in areas experiencing the most rapid home price appreciation.

In January 2006, the Federal Reserve Board issued a report in which it found that a sizeable number of borrowers with ARMs did not fully understand the terms of their loans, particularly the percent by which their interest rates could change, whether there was a cap on interest rate increases, and the index to which their rates are tied. These findings were particularly true for lower-income borrowers and those with less education.

In its most recent annual survey of credit underwriting practices at nationally chartered banks, released in October 2006, the OCC found that 26% of lenders had eased their lending standards in the past year, most often by increasing the use of nontraditional mortgage products. The 2006 survey was the first in the survey's 11-year history in which a net easing in credit underwriting was found.

GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

In response to the increased marketing of nontraditional mortgage products to a wider variety of borrowers and the increased amount of credit risk layering associated with the marketing and underwriting of these products, the five federal banking agencies developed guidance to address issues of risk management and appropriate consumer disclosure. While issuance of nontraditional loan products did not necessarily concern regulators, the risk-layering practices and reduced underwriting controls they noticed among their lenders, together with the increased utilization of these products by subprime borrowers, did concern them.

In December 2005, the agencies, including the OCC, FRB, FDIC, OTS, and NCUA, jointly issued proposed guidance for comment.

Financial institutions submitting comments to the federal regulators argued that: 1) nontraditional mortgage products had been offered successfully for many years, 2) the guidance was too prescriptive and would stifle innovation, 3) the guidance would prevent certain qualified borrowers from being approved for loans, 4) the guidance was an inappropriate mechanism for addressing the regulatory agencies' consumer protection concerns, and 5) the guidance would only apply to federally-regulated lenders; not all lenders; thus, federally-regulated financial lenders would be at a competitive disadvantage.

In contrast, many consumer advocates commenting on the guidance asserted that the guidance did not go far enough in regulating or restricting nontraditional mortgage products. They noted that nontraditional mortgage products: 1) contribute to speculation and unsustainable appreciation in the housing market, 2) could lead to severe problems if and when there is a severe downturn in the economy, and 3) are harmful to borrowers, because borrowers do not understand the risks associated with them.

After modifying the guidance in response to comments, the agencies issued final guidance in September 2006[1]. The guidance, which is attached in an appendix to this paper, is intended to apply to both prime and subprime loans, and to cover federally-regulated financial institutions, as well as their subsidiaries and affiliates. Although a complete review of the guidance is beyond the scope of this background paper, key components include the following:

1. Financial institutions' analyses of borrowers' repayment capacity should include an evaluation of ability to pay the fully indexed rate, not just the initial low introductory rate. Analyses of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification.

2. Institutions should avoid the use of loan terms and underwriting practices that will heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins.

[1] Because the interagency guidance was not published in the Federal Register until October 2006 (FR Vol. 71, No. 192, Wednesday, October 4, 2006, pp58609-58618), it is interchangeably referred to as the September 2006 or the October 2006 guidance.

3. Higher pricing of loans with elevated risks should not replace the need for sound underwriting.

4. Second mortgages with minimal or no owner equity should not have a payment structure that allows for delayed or negative amortization unless the risk is mitigated.

5. Institutions with high concentrations of non-traditional products should have good risk management practices in place and capital levels commensurate with the risk.

6. Institutions that offer nontraditional mortgage products should make the potential consumers of these products aware of all possible risks and should provide this information in a timely manner (e.g., clear and balanced product descriptions should be made when a consumer is shopping for a mortgage, not moments before he/she is about to ink the contract). Payment shock, negative amortization, prepayment penalties, and the cost of reduced documentation loans should be explained. Monthly statements on payment-option ARMs should explain the consequences of each payment option.

Since the federal guidance has been issued, six Senate Banking Committee members, led by Chairman Christopher Dodd, have urged federal regulators to expand the types of loans covered by the guidance to 2/28s and other hybrid ARMs. In contrast, nine banking trade groups, including the American Bankers Association, America's Community Bankers, American Financial Services Association, Coalition for Fair and Affordable Housing, Consumer Bankers Association, Consumer Mortgage Coalition, Financial Services Roundtable, Independent Community Bankers of America, and the Mortgage Bankers Association, have called on federal regulators *not* to extend the guidance to other types of loans.

<u>Application of the federal guidance to others</u>

In issuing the guidance, the federal regulators urged states to work quickly to apply similar guidance to state-regulated entities engaged in mortgage lending and brokering. In November 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued guidance substantially similar to the federal guidance, but deleted sections of the federal guidance that were inapplicable to non-depository institutions (i.e., sections dealing with capital reserve requirements). The CSBS/AARMR guidance, which is included in an appendix to this background paper, is intended to be adopted by states and used by state regulators who oversee state-licensed mortgage lenders and brokers. According to the CSBS web site, twenty-four states to date have announced plans to apply the CSBS/AARMR guidance to their state licensees.

In December 2006, the Office of Federal Housing Enterprise Oversight (OFHEO), the agency which oversees both Fannie Mae and Freddie Mac, directed both GSEs to immediately take action consistent with the practices referenced in the interagency guidance. Specifically, both GSEs were directed to:

1) Develop and implement written policies that specify acceptable product attributes, portfolio limits, sales and securitization practices, and risk management expectations;

2) Design and implement internal controls to ensure that mortgages purchased and guaranteed by Fannie Mae and Freddie Mac meet the underwriting and consumer protection standards of the guidance;

3) Design and implement enhanced performance measures and management reporting that provide early warning for increased risk;

4) Establish appropriate loan loss allowance levels that consider the credit quality of the portfolio and conditions that affect collectability; and,

5) Maintain capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolio.

Because Fannie Mae and Freddie Mac purchase and guarantee such a significant portion of the securitized mortgage market, many expect OFHEO's action to have the practical effect of applying the interagency federal guidance to a broader spectrum of lenders and brokers than those explicitly covered by the federal guidance. For example, *any* lender who wishes to sell a loan to Fannie Mae or Freddie Mac and *anyone* who brokers a loan with the potential to be sold to Fannie or Freddie will need to follow the federal guidance, because Fannie and Freddie will be unable to purchase any loans negotiated in a manner inconsistent with the guidance. This would be true, regardless of whether the hypothetical lender and broker in the examples immediately above were explicitly covered by the federal guidance.

MORTGAGE LENDING AND BROKERING IN CALIFORNIA

Although a comprehensive discussion of residential mortgage brokering and lending in California is beyond the scope of this background paper, a brief discussion of these topics is offered to provide context for the discussion of whether, and how, the interagency guidance and the CSBS/AARMR guidance can be applied to state-regulated residential mortgage lenders and brokers.

Three state departments regulate residential mortgage lending and brokering activities in California – the Department of Financial Institutions (DFI), Department of Corporations (DOC), and the Department of Real Estate (DRE). DFI regulates state-chartered banks and credit unions, both of whom are authorized to engage in residential mortgage lending under the Banking Law and the Credit Union Law, respectively. Banks and credit unions employ loan officers to market their loans and sometimes also use mortgage brokers operating under the Real Estate Law as a source of borrower referrals. Because virtually all of DFI's bank and credit union licensees are federally-insured by either the FDIC or NCUA, virtually all of DFI's bank and credit union licensees are already covered by the interagency federal guidance issued in September 2006. The only licensees not explicitly covered by the interagency guidance are California's 18 privately-insured, state-chartered credit unions. However, DFI has traditionally treated

privately-insured credit unions and NCUA-insured credit unions the same with respect to compliance with NCUA guidance.

DOC oversees two laws that authorize businesses to engage in residential mortgage lending and brokering - the California Finance Lenders Law (CFLL) and the California Residential Mortgage Lending Act (CRMLA). Most commonly, finance lenders and residential mortgage lenders (also known as mortgage bankers) have their own in-house loan officers who interact with borrowers and potential borrowers regarding available mortgage products. CFLL and CRMLA licensees can also receive business from mortgage brokers operating under the Real Estate Law Brokering activities *by* CFLL and CRMLA licensees are limited under both laws and are less common. CFLL licensees may broker loans only to other licensed finance lenders. Licensed residential mortgage lenders are authorized to broker loans to other licensed mortgage bankers, as well as to institutional lenders such as banks and credit unions. These relatively uncommon brokering situations can result when none of the loan products or loan terms offered by the first lender are acceptable to or appropriate for a given borrower, but loan products or loan terms offered by a second lender are acceptable. Under both the CFLL and CRMLA, the licensed business entity is responsible for ensuring compliance with the licensing law; individual employees are not required to be licensed.

DRE licenses real estate sales people (more commonly known as real estate agents) and real estate brokers, who supervise real estate sales people and are also allowed to make or arrange real estate loans and to sell or service mortgage notes. Most of the residential mortgages facilitated by real estate brokers operating under the Real Estate Law involve loans made by finance lenders, residential mortgage lenders, banks, credit unions, and thrifts, although a smaller number of loans facilitated by real estate brokers are privately funded directly (i.e., not through the secondary market) by individuals or groups of individuals. In contrast to the CFLL and CRMLA, the Real Estate Law requires individual licensing. The Real Estate Law does allow for the licensing of corporations (e.g., brokerage firms), but the licensed corporation must act through a designated broker or officer.

The ability of individuals and businesses in California to broker mortgages under five different laws and under the jurisdiction of three different regulators complicates application of the CSBS/AARMR guidance to mortgage lending and brokering operations in our state. One of the key purposes of this informational hearing is to explore the opportunities and challenges that exist in the application of the CSBS/AARMR guidance uniformly across all licensees.

THE COMPOSITION OF THE MORTGAGE MARKET

It is too early to know how the federal guidance (and potential state guidance that might follow) will impact the mortgage market and the market for mortgage-backed securities. However, the following snapshots of both markets may be helpful for identifying potential impacts to follow.

Precise figures on the ever-changing make-up of the mortgage market are hard to come by. To complicate matters, different organizations measure the market in different ways. For those reasons, statistics regarding the overall market are somewhat difficult to compare with one

another. The available statistics do, however, provide readers with a general sense for the distribution of different types of mortgages within the market as a whole.

The overall market

Seven years ago (in 1999), only 5% of all loans were subprime, because lenders sought to avoid making loans to people less likely to repay. In the past two years, about 20% of all loans originated nationwide were subprime (Federal Reserve Board). The FDIC reports that 33% of all loans issued in 2005 were nonprime (subprime plus Alt-A), up from 11% in 2003. Inside Mortgage Finance documented a rise in the percentage of subprime loans from 10% of the total market in 1998 to 23% of the market in 2006. While the percentages reported by these three different sources are not identical (due most likely to whether subprime share of the market is measured by number of loans or by loan value), all three sources of information yield the same conclusion – namely, the subprime market has grown significantly in recent years.

In the first half of 2006, the FDIC reports that 46% of all loans (prime and nonprime) were adjustable rate mortgages. Sixty-three percent of the ARMs were either interest-only or payment-option mortgages. Thus, 29% of all loans made nationally during first half of 2006 were either interest-only or payment-option ARMs. The Mortgage Bankers Association provides a different look at the same market. According to that organization, 59% of all subprime loans issued in 2006 were ARMs. 18% of subprime loans issued in 2006 were interest only (First American Loan Performance).

In 2002, interest-only and payment-option ARMs represented 3% of total nonprime mortgages originations that were securitized. By the end of 2005, the interest-only share of credit to nonprime borrowers was 30%, and the payment-option share was slightly over 20%. The low- and no-documentation share of nonprime lending grew significantly during the same period, from 25% in 2001 to over 40% by the end of 2005. The securitized *subprime* market is heavily weighted toward hybrid ARMs (most often 2/28s). According to Fitch Ratings Service, hybrid ARMs comprised 81% of the subprime sector's securitized loans, up from 64% in 2002.

An August 2006 report from the Standard & Poor's Corporation offered a snapshot of the Alt-A market: Two-thirds of the collateral behind Q206 alt-A securitizations was underwritten with only a verbal verification of income and employment. Another 13% required no income documentation at all. Only 21% required more than one year of a borrower's income history to be documented. The higher creditworthiness of Alt-A borrowers also allows them to obtain piggyback loans covering all or part of their down payment. In Q206, 63% of securitized Alt-A loans were covered by piggybacks.

Piggyback loans

In 2005, 22% of people purchasing homes took out piggyback mortgages (Federal Reserve). Historically, only 5% to 10% of originations involved piggybacks. Market analysts believe that approximately 45% to 50% of loans eligible for mortgage insurance in 2005 involved piggybacks.

In the first quarter of 2006, 35% of subprime first liens had simultaneous second liens. By the third quarter, that number had fallen to 32%. Thirty one percent of prime loans in the first quarter of 2006 had simultaneous second liens, a number that fell to 29% by the third quarter of 2006. The percentage of second liens was highest among Alt-A loans (42% in Q106 and 44% in Q306).

Use of piggybacks is driven as much by underwriting standards as it is by short-term interest rates. When interest rates are low, piggybacks tend to be more popular. When the rates rise, private mortgage insurance becomes the less expensive option for borrowers. Interestingly, the factors affecting borrower choice between piggybacks and mortgage insurance are not expected to change in the near future, even after President Bush signed a law late last year allowing taxpayers to deduct mortgage insurance premiums on their federal income taxes.

The California market

There is wide agreement that subprime, nontraditional mortgages comprise a larger part of the market in states where home prices have been rising the fastest, including California. One unverified publication obtained by Committee staff suggested that 27% of all loans issued in California during 2006 have the potential to negatively amortize. The FDIC issued a chart in September 2006 suggesting that over 60% of all nonprime securitized loans issued in California were either interest-only or payment-option ARMs. A separate study performed by the FDIC in 2005 suggests that most of these were interest-only ARMs.

In 2005, the FDIC reviewed some of its largest institutions in areas experiencing high rates of home price appreciation. The FDIC found that of 21 of 30 institutions it reviewed offered nontraditional mortgage products. Of those institutions, all 21 offered interest-only mortgages; only two offered payment-option ARMs. The volume of interest-only loans was $24.4 billion, while the volume of payment-option ARMs was only $120 million.

SECURITIZATION OF MORTGAGES

Over two-thirds of all mortgages are securitized (i.e., bundled together and sold in groups on the secondary market). The loan bundles, commonly known as mortgage-backed securities (MBSs), collateralized debt obligations (CDOs), or collateralized loan obligations (CLOs), are widely seen as a way to spread credit risk to investors. Monthly payments on the mortgages are used to pay the interest on the mortgage-backed bonds.

Some CDOs are purchased by private firms, while others are purchased by Fannie Mae and Freddie Mac, the two GSEs. The importance of CDOs within the US economy is unquestioned. As of June 30, 2006, mortgage-backed securities accounted for the largest segment of the US bond market (23% of all outstanding bond market debt, compared to corporate bonds at 20% and Treasury debt at 16%).

According to the Mortgage Bankers Association, $1.2 trillion of privately-issued, residential mortgage-backed securities were issued in 2006. An additional $966 million worth of residential

mortgage-backed securities were issued by the GSEs. Nonprime loans comprised two-thirds of private CDOs in 2005, up from 46% in 2003.

Somewhat ironically, the worldwide nature of mortgage securitizations has meant that homeownership, the cornerstone of the American Dream, has been made possible in significant part by foreign investors. As much as one third of the $2 trillion in CDOs issued since 2002 has been purchased by foreigners.

Interestingly, the growth of nontraditional mortgages has changed the market for securities. As the nonprime market has grown, so has the popularity of private-label mortgage backed securities (i.e., those securitized by entities other than the GSEs). Total outstanding private-label CDOs represented 29% of all CDOs in 2005, more than double its share in 2003. At the same time, the share of CDOs held by the GSEs fell by 10 percentage points, from 53% to 43%. The shift is a dramatic reflection of investor choice. Investors left the guaranteed, GSE-backed mortgage market for higher interest rates in the potentially riskier, privately-backed mortgage securities market. As they did so, the amount of capital available to fund nontraditional mortgages grew, making more of these mortgages available to more borrowers.

Most asset-backed securities are priced in relation to the London Interbank offered rate, or Libor. High-quality debt issues are priced to yield Libor or a few hundredths of a percentage point above it. Traditionally, lower-quality debt has been priced one or two percentage points higher than Libor. Demand has been high for lower-quality debt securities, which typically offer higher yields than many other bonds. Demand for these securities has also encouraged several Wall Street investment firms, including Morgan Stanley, Merrill Lynch, and Bear Stearns, to purchase subprime lenders. Using sophisticated methods, these Wall Street firms have figured out how to profit on the difference between Libor and the price of high-yielding CDOs.

The downside to the lucrative profit potential offered by mortgage-backed securities occurs when loans fail to perform (i.e., become delinquent). When a lender sells a bundle of mortgages on the secondary market, the lender commonly agrees to buy back loans that fail to perform. If a large enough percentage of a lender's loans become non-performing, as has increasingly been the case, the lender will lack sufficient cash with which to buy back the loans, and will be forced to shut its doors. Ownit Mortgage Solutions of Agoura Hills, California, which had billed itself as one of the top 15 lenders to homebuyers with weak or no credit histories, shut its doors in December 2006, when it ran out of cash needed to buy back its nonperforming loans from investment banks and others who purchased the loans on the secondary market. Sebring Capital Partners out of Carrollton, Texas, another subprime lender that ran out of cash to buy back nonperforming loans, folded the same week.

The problem causing several subprimes to close or put themselves up for sale is not simply non-performing loans. Subprime lenders also face stiff price competition and an unfavorable yield curve.

Given recent trends in borrower delinquencies (see subsequent section) and closure of subprime lenders, the cost of insuring against default on mortgage-backed bonds is rising. The ABX Series Two index tracks investor confidence in securitized subprime loans. The index rises when

investors demand better returns to compensate them for the risk of holding risky mortgages. In mid-December, the index was trading 3.8 percentage points higher than Libor. Two weeks earlier, the ABX Series Two index was only 2.4 percentage points higher than Libor. Interestingly, though, prices on subprime bonds, which don't trade as actively as the ABX Series Two index, haven't moved much. Blended mortgage-backed securities, which are more highly rated, have also been stable.

In further support of the observation that the market is becoming bearish on parts of the mortgage lending market, significant signs of short interest have emerged. Short selling is the practice of borrowing shares, then selling them with the expectation of being able to buy them back at lower prices before the loan must be repaid. Short interest is a measure of how much short selling is occurring. Recently, the Wall Street Journal has noted that short interest is on the rise.

RISING DELINQUENCIES

According to the FDIC, one-to four-family mortgages, both fixed and adjustable rate, have historically had some of the lowest loss rates among the assets held by depository institutions. As of June 30, 2006, charge-off rates among FDIC-insured institutions were less than one tenth of one percent. This may, however, be one area in which past trends are unhelpful in predicting future loan performance.

As noted above, loans with initial teaser rates, interest-only loans, and payment-option loans all eventually reset their minimum required payments to much higher levels, with the timing and amounts of those higher payments determined by the terms of the loans. The combination of payment shock among nonprime borrowers who hold these nontraditional loans, a slowing housing market with limited housing price appreciation, and interest rates that continue to hover well above historic lows, is likely to make it more and more difficult for homeowners to refinance their way out of the fully indexed rates of their once-affordable mortgages. Homeowners unable to make their payments will either be forced to sell their homes – a potentially significant challenge in a stagnant housing market – or foreclose.

Recent statistics are showing increasing signs of delinquencies in the subprime market. About 12.5% of all subprime loans were delinquent in Q306, up from 11.7% in Q206. About 3.9% of homes purchased with these subprime loans were seized by lenders in Q306, up from 3.5% in Q206. These numbers translate into nearly one million households – in Q306, 223,000 households with subprime loans lost their homes to foreclosure, and about 725,000 had missed mortgage payments (Mortgage Bankers Association).

Delinquencies are also rising in the prime and alt-A markets. At the end of Q306, 2.33% of *all* mortgages were delinquent, the highest level since 2003 (Moody's Economy.com and Equifax). The Wall Street Journal found this increase particularly notable, because bad loans normally climb when the economy weakens and job losses rise. By contrast, the latest increase appears to be more closely tied to looser lending standards, borrowers tapping their equity, and slowing home price growth. Mark Zandi, chief economist at Moody's Economy.com said, "We're seeing

rises in delinquencies and loan losses that are unrelated to what's going on in the job market. It's very unusual."

New data in a research report by securities firm UBS shows that a high percentage of borrowers with delinquent, defaulted, and foreclosed loans have second mortgages, most of which are piggybacks taken out at the same time as their first loans in order to purchase a home. Of the $308.1 billion in mortgages originated in 2006, $103.5 billion, or 34%, were second mortgages. The UBS report did not include home equity mortgages taken out against homes that were already owned, making the numbers potentially more problematic.

A Fitch report issued in mid-December 2006 indicates that delinquencies on subprime loans increased by nearly 50% in 2006. Both Fitch and the Mortgage Bankers Association blamed the higher delinquency rates primarily on piggyback second loans, particularly those which allow consumers to purchase homes with no money down (i.e., with loan to value ratios of 100%).

Second mortgages can be risky, because the original lender may not know that a second mortgage exists. Lack of lender knowledge about second mortgages held elsewhere presents a problem for lenders trying to figure out how much money to set aside for potential losses. Today, most second mortgages are paired with primary mortgages of the interest-only ARM variety. In the Alt-A market, 58% of the $26.4 billion in interest-only ARMs originated in 2006 had second mortgages.

The implications of increased delinquencies go beyond the households who lose their homes. Higher loan losses could cause lenders to cut back on credit, shutting some borrowers out of the market and increasing costs for others. An increase in foreclosures could also exert downward pressure on housing prices, as lenders sell significant numbers of houses at a loss.

Future Delinquencies

At least one major group believes that recent delinquency rates are only the tip of the iceberg, and that the worst is yet to come.

In December 2006, the Center for Responsible Lending (CRL) report published a report that predicted significant increases in future foreclosure rates on subprime loans, both in California and across the nation. CRL analyzed the performance of more than six million subprime mortgages from the period 1999 through 2004 and found a statistically significant inverse relationship between foreclosures and home price appreciation (i.e., foreclosures were highest in areas with the lowest housing price appreciation). They then used this relationship, together with a proprietary housing forecast from Moody's Economy.com, to project foreclosure rates on subprime loans issued in 2005 and 2006.

Their findings were sobering: They predicted that 19% of subprime mortgages originated nationwide during 2005 and 2006 will end in foreclosure. One-third of families who received a subprime loan in 2005 or 2006 will eventually lose their home, when the cumulative effect of future refinancings and their failure rates are summed. (This latter finding was based upon the

observation that a borrower who repeatedly refinances one subprime loan with another faces a steadily increasing chance of foreclosure, reaching 36% by the fourth loan).

CRL's forecast for California's market was even more pessimistic than its national forecast. According to CRL, 21.4% of all subprime loans issued in California in 2005 and 2006 will foreclose at some point over the loans' lifetimes, and foreclosure rates in certain metropolitan statistical areas will be even greater. Foreclosure rates will be highest in Merced and Bakersfield, where rates of 25.0% and 24.2%, respectively, are predicted. Other California areas expected to have foreclosure rates above 20% included Vallejo-Fairfield, Fresno, Stockton, Santa Ana-Anaheim-Irvine, Riverside-San Bernardino-Ontario, Visalia-Porterville, Los Angeles-Long Beach-Glendale, Chico, Madera, Oakland-Fremont-Hayward, Sacramento-Arden Arcade-Roseville, Salinas, Santa Rosa-Petaluma, and San Diego-Carlsbad-San Marcos.

The CRL report has been criticized by some analysts for basing its predictions solely on expected slowdowns in home price appreciation. Michael Youngblood, a managing director of asset-backed securities at Friedman, Billings, Ramey & Co. Inc., also analyzed subprime mortgages originated from 2000 to 2005. He found that the highest default rates correlated with cities which had weak labor market conditions.

This finding was independently supported by lender FirstFed Financial Corporation, which indicated in late 2006 that it does not believe it will suffer from its exposure to option–ARMs and reduced documentation loans in California, unless and until unemployment rises in California. According to James Giraldin, First Federal Bank's president and chief operating officer, "Job losses are more of an indication that we're going to have a problem in our loan portfolio – and the unemployment picture looks good…We look at the job number constantly, and if we see slippage there, we'll start to be concerned." California's unemployment rate was 4.8% percent in December 2006, up 0.2 percentage points from the rate in November, and down 0.3 percentage points from one year ago.