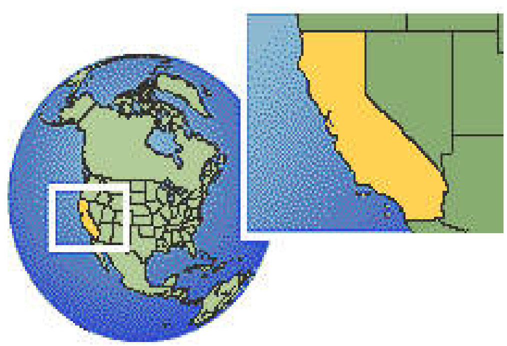
Assembly Banking and Finance Committee

Impact of Mortgage Turmoil on California Communities



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Informational Hearing Background
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INTRODUCTION

The last few months have been marked by a severe market correction in the subprime mortgage industry. In response to the extreme financial losses incurred by investors, the market for subprime mortgages has adjusted sharply. Investors are demanding that mortgage originators employ tighter underwriting standards, and some large lenders are pulling back from the use of brokers. Many people hope that the reassessment and resulting increase in the attention to loan quality should help prevent a recurrence of the recent subprime problems. However, this reasoning assumes that the markets will remain in their current conservative position for the long term.

Additionally, California is now facing the prospect of reduced revenues due to foreclosures and increase local government cost to mitigate foreclosure related issues. This crisis has also been labeled as a "turning back of the clock" on the recent gains of homeownership and asset building opportunities for many communities that have been left out of other wealth building opportunities. Several California communities rank in the top ten nationwide in the number of foreclosures and defaults. According to Realtytrac, Stockton, California leads the way with 1 out of every 27 homes in foreclosure.

It is estimated that the subprime lending crisis in the United States will result in almost 2 million foreclosures nationwide.[1] In California, lenders filed 72,571 "notices of default" on borrowers in the third quarter of 2007, eclipsing a record of 61,541 set in 1996, according to DataQuick Information Systems. Most of the loans that went into default last quarter were originated between July 2005 and August 2006. Actual losses of homes to foreclosure statewide totaled 24,209 during the third quarter, the highest number since DataQuick began

[1] *Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues and How We Got Here.* Report and Recommendations by the Majority Staff of the Congressional Joint Economic Committee. October 2007.

recording data in 1988, up 38.7 percent from last quarter and up six-fold year-over-year.

In the midst of this market correction, borrowers are facing increased pressures as adjustable rate mortgages (ARMS) reset to higher rates, home prices decline, and new borrowers are limited in options as the market engages in retrenchment.

The crisis is the result of a confluence of circumstances that has played into the unusually poor performance of subprime mortgages that were originated in 2006. Among the largest contributing factors were relaxed underwriting standards and subsequent deterioration in mortgage payment performance. In addition, many market participants have suggested that fraud, such as misrepresentations made by mortgage brokers, appraisers and the borrowers themselves, has also played a significant role and exacerbated the problem. Numerous sources have indicated that home values, borrowers' incomes as well as other information may have been overstated and the intended use of the home was often misstated (i.e., as a primary residence rather than an investment property).

Second, the mortgage lending system allowed incentives to push some people into loans that they should never have taken. For instance, some brokers received incentives if they placed a person in a subprime loan even though the person also qualified for a prime loan. Some brokers were also incentivized to sell as many loans as they could, since they receive their commissions regardless of whether or not a person defaulted on the loan a year or two later.

Third, the decline in home prices on a national basis has been a significant factor in the decline in subprime mortgage loan credit performance. People who now had homes at lower values, or had loans larger than the value of their homes, were frequently unable to refinance with other lenders.

Also, variety of mortgage companies that had issued subprime loans overextended themselves in the market causing many of their creditors to demand payments on lines of credit immediately. This meant that several of the largest non-bank lenders of subprime loans were forced to file bankruptcy and foreclose on loans. Stricter lending practices by remaining mortgage companies have also been a factor in the subprime mortgage crisis, since some of the homeowners were ineligible for any type of loans based on new criteria.

July 2007 marked the twelfth consecutive month of home price decline on a year-over-year basis.[2] This is the longest period of declining home prices on a national basis since 1969, and declining home prices have reduced borrowers' equity in their homes and constrained their refinancing opportunities. The borrowers most affected by the housing downturn have been those who because of the timing of their purchase did not realize benefit from the price appreciation that had occurred in prior years. Compounding the problem of declining home prices is that many borrowers took out ARMs with low introductory rates in the hopes that housing prices would continue to rise and afford the borrower enough equity to refinance at a fixed APR.

Fourth, the introduction of exotic products in the market-place including option-ARMS, low teaser rate loans, no-documentation, stated-income and other non-traditional products originally meant for sophisticated borrowers were used as tools to circumvent traditional underwriting standards. In addition, the increase in zero downpayment, 100% financed subprime loans increased home ownership opportunities, but at the same time increased the riskiness of those loans. People who were on a thin financial cushion were offered the opportunity to take out multi-hundred thousand dollar loans with no downpayment, sometimes with no income documentation.

Finally, the stunning lack of financial literacy was a major contributing factor to the subprime crisis. A recent Wall Street Journal article noted that in a survey, approximately one-third of homeowners had no idea what type of home loan they had. The typical borrower is often overwhelmed by the complicated process of purchasing a home. In many cases, had a borrower known the right questions to ask they could have avoided long-term financial collapse. Unlike some other states, California does not require that financial literacy concepts be taught in its school curriculum.

During the past two years, serious delinquencies among subprime ARMs have increased dramatically. The fraction of subprime ARMs past due ninety days or more or in foreclosure reached nearly 15

[2] *Statement of Michael Kanef,* Group Managing Director, Moody's Investors Service. Committee on Senate Banking, Housing and Urban Affairs. September 26, 2007

percent in July, roughly triple the low seen in mid-2005.[3] For so-called near-prime loans in alt-A securitized pools (those made to borrowers who typically have higher credit scores than subprime borrowers but still pose more risk than prime borrowers), the serious delinquency rate has also risen, to 3 percent from 1 percent only a year ago. These patterns contrast sharply with those in the prime-mortgage sector, in which less than 1 percent of loans are seriously delinquent.

Higher delinquencies have begun to show through to increased foreclosures. About 320,000 foreclosures were initiated in each of the first two quarters of this year (just more than half of them on subprime mortgages), up from an average of about 225,000 during the past six years. Foreclosure starts tend to be high in states with stressed economic conditions and rise where house prices have decelerated or fallen.

Adjustable-rate subprime mortgages originated in late 2005 and in 2006 have performed the worst, with some of them defaulting after only one or two payments (or even no payment at all). Relative to earlier vintages, more of these loans carried greater risks beyond weak borrower credit histories--including very high initial cumulative loan-to-value ratios and less documentation of borrower income. The originate-to-distribute model seems to have contributed to the loosening of underwriting standards in 2005 and 2006. When an originator sells a mortgage and its servicing rights, depending on the terms of the sale, much or all of the risks are passed on to the loan purchaser. Thus, originators who sell loans may have less incentive to undertake careful underwriting than if they kept the loans. Moreover, for some originators, fees tied to loan volume made loan sales a higher priority than loan quality. This misalignment of incentives, together with strong investor demand for securities with high yields, contributed to the weakening of underwriting standards.

The fragmented market structure of mortgage originators in the subprime-lending industry may also have contributed. Data collected under the Home Mortgage Disclosure Act show that independent mortgage companies--those that are not depository institutions or their subsidiaries or holding company affiliates--made nearly half of higher-priced first-lien mortgages in 2006 but only one-fourth of loans that were not higher-priced.

[3] Testimony of Federal Reserve Chairman Ben S. Bernanke. *Subprime mortgage lending and mitigating foreclosures* Before the Committee on Financial Services, U.S. House of Representatives September 20, 2007

In addition, the sharp deceleration in home prices since 2005, including outright declines in some markets, left many of these more-recent borrowers with little or no home equity. In this situation, some borrowers (particularly owner-investors) may have found that simply walking away from their properties was their best option. Moreover, low home equity has made refinancing--the typical way for many subprime borrowers to avoid large scheduled interest rate resets--difficult or impossible for many. Thus, with house prices still soft and many borrowers of recent-vintage subprime ARMs still facing their first interest rate resets, delinquencies and foreclosure initiations in this class of mortgages are likely to rise further. It is difficult to be precise about the number of foreclosure initiations expected in coming quarters, as it will depend on (among other factors) the evolution of house prices, which will vary widely across localities. Historically, about half of homeowners who get a foreclosure notice are ultimately displaced from their homes, but that ratio may turn out to be higher in coming quarters because the proportion of subprime borrowers, who have weaker financial conditions than prime borrowers, is higher.

The increased portion of homes lost to foreclosure reflects the slow real estate market, as well as the number of homes bought during the height of the market with multiple-loan financing. In selling a home, all loans must be paid off, which is not the case in the formal foreclosure process, where second mortgages and lines of credit are most often written off.

Exotic mortgages with low "teaser" interest rates that increase significantly after several years, interest-only mortgages, and mortgages made with little or no income verification have helped drive the homeownership rate in the United States to a record seventy percent. These subprime loans are made possible in part by mortgage securitization, where pools of principal and interest payments for mortgages are bundled into securities and sold to investors, a process that diversifies the risk of lending to borrowers with less than optimal credit. Nontraditional credit and securitization have been useful tools to make credit available to those who might not otherwise qualify.

Unfortunately, many of the borrowers who took advantage of subprime loans have been unable to afford the mortgages they received. As interest rates have risen and property values decreased, foreclosures have occurred at alarming rates and delinquencies continue to climb. Many borrowers were duped into mortgages they could not repay, or simply made poor financial decisions. The consequences are grim. Millions may lose their homes. Even borrowers with good credit are having more difficulty finding lenders willing to grant them mortgages. Many mortgage lenders are going bankrupt. Credit standards are tightening. Investors are losing money on subprime mortgage bonds. Economists predict that the effect of these lending practices on the economy will be felt for years to come.

SUBPRIME LENDING

Traditionally, 15 and 30 year fully amortizing conventional loan products have decreased from 62% of total originations in 2003 to just 33% by the end of 2006, while the origination of loans to subprime borrower , and origination of interest only and option-ARM loans to prime or near-prime borrower, have increased.[4]

Subprime mortgages are mortgages granted to customers of poor solvency and which therefore present greater risk of default than those to "normal" customers. These mortgages are thus qualified when they are granted to persons with a problematic credit history or to those unable to provide all the necessary documents (proof of income sources, for example) or in those cases where the amount of the mortgage represents a very high percentage of the price of the home being financed (more than 85%) or the monthly payment represents more than 55% of available earnings, etc.

The majority of subprime loans are not originated by traditional banks regulated by the Office of Comptroller of Currency for Federal banks or the California Department of Financial Institutions for state chartered banks. Subprime lending originated by banks, last year, only amounted to 10% of total subprime originations. The vast majority of subprime originations are made by non-depository institutions and brokers. The various lending institutions and brokers operate under different regulatory and supervisory regimes with varying intensities of enforcement effort. That fragmentation makes monitoring brokers and lenders difficult for regulators and investors alike.

Twenty years ago, the subprime mortgage market barely existed. There were a few lenders and brokers who offered these loans, but for the most part, borrowers with credit problems simply could not get a mortgage. This left millions of Americans unable to purchase a home or forced them to sell if they got into financial straits.

[4] Testimony of Emory W. Rushton, Senior Deputy Comptroller, Office of Comptroller of Currency, Before United States Senate Committee on Banking, Housing, and Urban Affairs

Homeownership has hit record-high levels in recent years largely due to a sustained period of record-low interest rates. But many experts also feel that the expansion of subprime lending has contributed to the gains in homeownership.

The growth of the subprime market can be attributed to several factors, including federal deregulation of the mortgage rates, the expanding use of credit scores and technological advances. In addition, as prime mortgage lending became more competitive, banks and other traditional mortgage lenders sought higher profits in the subprime market.

As they are more risky, sub-prime mortgages usually carry a higher interest rate. Normally, customers often pay a differential of between 2% and 3% more than the rate on a standard or prime mortgage.

Subprime mortgages emerged on the financial landscape more than two decades ago, but did not begin to expand significantly until the mid-1990s. The expansion was fueled by innovations--including the development of credit scoring--that made it easier for lenders to assess and price risks. In addition, regulatory changes and the ongoing growth of the secondary mortgage market increased the ability of lenders, who once typically held mortgages on their books until the loans were repaid, to sell many mortgages to various intermediaries, or "securitizers." The securitizers in turn pooled large numbers of mortgages and sold the rights to the resulting cash flows to investors, often as components of structured securities. This "originate-to-distribute" model gave lenders (and, thus, mortgage borrowers) greater access to capital markets, lowered transaction costs, and allowed risk to be shared more widely. The resulting increase in the supply of mortgage credit likely contributed to the rise in the homeownership rate from 64 percent in 1994 to about 68 percent now--with minority households and households from lower-income census tracts recording some of the largest gains in percentage terms.

However, for all its considerable benefits, the broadening of access to mortgage credit that has occurred during the past decade also had important negative aspects. Not surprisingly, given their weaker credit histories and financial conditions, subprime borrowers default on their loans more frequently than prime borrowers. The consequences of default may be severe for homeowners, who face the possibility of foreclosure, the loss of accumulated home equity, and reduced access to credit. In addition, clusters of foreclosures can lead to declines in the values of nearby properties and do great damage to neighborhoods.

In 1994, the subprime mortgage lending was only $35 billion.[5] By 2003, the market had grown to $330 billion. Nationally, in 2003 the subprime market was 9 percent of the total mortgage market, but in California, subprime lending was 13.3% of the market.[6] That share may be growing. In 2004, the prime mortgage market was sluggish, but subprime lending more than doubled in California to $197 billion.

Between 2001 and 2006 ARMs as a share of total subprime loans increased from 73 percent to more than 91 percent. The share of no-documentation or low-documentation loans increased from 28 percent to more than 50 percent and the percentage of borrowers who took out interest only payment loans increased from zero to more than 22 percent. Furthermore, ARM loans account for 44 percent of new foreclosures in the second quarter of 2007.While consumer groups applaud the fact that more families have access to credit, they have consistently expressed concerns that the subprime industry is selling people higher-priced loans when they could qualify for prime loans.

Although there is no single source that tracks covered loan volume in California, anecdotal evidence indicates that it is a small percentage of the overall mortgage market.

Not surprisingly, foreclosure rates are higher for subprime borrowers. In mid-2004, 4.6 percent of subprime loans were in foreclosure compared to 0.5 percent for prime loans. Consumer groups worry that when interest rates rise, too many subprime borrowers will find themselves saddled with loans they cannot afford and the foreclosure rates will climb even higher.

In the drive to extend credit into new markets and increase profit margins, the lending community turned to the secondary market in order to mitigate credit risk and increase the levels of subprime lending. Suddenly, loans that had been held by a bank were being

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5 Subprime Mortgage Lending and the Capital Markets, FRBSF Economic Letter. Dec 28, 2001.

6 Assembly Banking and Finance Committee Informational Hearing, *Covered and Subprime Loans in California: Are Consumers Getting the Protection They Need?* Background Briefing Paper. 2005

sold to Wall Street in the form of securities guided by complex financial arrangements and agreements.

Most important to the growth of the subprime market, however was the creation of a secondary market for subprime loans. In the early 1990s, Wall Street's acceptance of mortgage-backed securities comprised of pools of subprime loans greatly increased. A few years ago, Fannie Mae and Freddie Mac began purchasing these loans as well. These market-based activities have provided lenders with the funds needed to make new mortgages, thus bringing additional capital into the subprime arena.

SECONDARY MARKET

In recent history, banks funded mortgage loans through their customer's deposits with mortgage credit dictated by the volume of bank deposits. Furthermore, banks kept loans on their books. Today, banks and other non-depository lenders have the option to sell their loan on the secondary market. Some lenders issue their own securities based of loans they originate or purchase.

Mortgage-backed securities (MBS) are securities sold to investors like stocks and bonds. MBS are created when originators or financial intermediaries pool large volumes of mortgage loans and sell securities backed by the monthly payments made by borrowers on the underlying mortgage loans. When a homeowner, whose loan is secured in an investment pool, makes his or her monthly payment, the payment combined with the payments of other loans goes into the pool and forms the basis of cash flows for investors. Investors choose their position in mortgage pool based on priority of payments from the pool in the event of a default. The pools typically have several investment grade tranches, ranging from AAA ratings down to subprime rated traunches that would absorb the most losses in the event of default but offer the most return. Bonds are also structured as tranches that collect only interest on the underlying mortgage obligation, or trauches that received payments from the principle payments on the mortgage.

At this time, the US mortgage market amounts to 10,000 billion dollars, of which sub-prime mortgages represent 13% of the total market and 9% of nominal gross domestic product (GDP) of the United

States.[7] Most of these sub-prime mortgage loans are granted by financial institutions that are not deposit-taking entities and therefore are subject to lower regulatory and supervision requirements compared with those for other banks and deposit institutions. Once the customer uses the loan to buy a house, the debt is noted in the balance sheet of the institution granting the loan. However, in order to boost their business, these institutions relieve themselves of these mortgages and sell them to commercial banks or investment banks. The new holders, in turn, package the mortgages in blocks and issue securitization bonds (CDO, or Collateralized Debt Obligations) using the sub-prime mortgages as security or collateral. That is to say, based on subprime mortgages, they create a new kind of asset that is more easily negotiable in the markets and it is this bond that carries the risk in the operation. To the extent that the holders of the mortgages keep paying off their debt every month, these funds are used to pay those who have bought these bonds.

The MBS market is the largest fixed income market in the United States. At the end of 2006, approximately $6.5 trillion of securitize mortgage-related debt was outstanding compared to $4.3 trillion of U.S. Treasury securities and $5.4 trillion of corporate debt.[8]

CDOs are a global phenomenon extending far beyond national boundaries or domestic capitol controls. JPMorgan estimate that $1.5 trillion in CDOs exist globally with $500 billion in structured finance CDOs meaning those made up of bonds back by subprime mortgages.[9]

Those buying CDOs are usually investment funds, insurance companies, liquid asset holders, traders, etc. who obtain higher yields from these assets than the market average although, naturally, running greater risk. This new product is broken down according to the credit risk assumed and a qualification or credit rating is assigned by the rating agencies.

The key elements to a typical securitization include the following:

- **Issuer** - A bankruptcy-remote special purpose entity (SPE) formed to facilitate a securitization and to issue securities to investors.

[7] "Sub-prime Mortgage Crisis in United States Centre of Attention." *La Caixa.*, The Spanish Economy Monthly Report. September 2007.
[8] Securities Industry and Financial Markets Association, *Research Quarterly*, February 2007, page 22.
[9] Anderson, Jenny and Heather Timmons. "Why a U.S. Subprime Mortgage Crisis Is Felt Around the World." *The New York Times*, August 31, 2007.

- **Lender** - An entity that underwrites and funds loans that are eventually sold to the SPE for inclusion in the securitization. Lenders are compensated by cash for the purchase of the loan and by fees. In some cases, the lender might contract with mortgage brokers. Lenders can be banks or non-banks.
- **Mortgage Broker** - Acts as a facilitator between a borrower and the lender. The mortgage broker receives fee income upon the loan's closing.
- **Servicer** - The entity responsible for collecting loan payments from borrowers and for remitting these payments to the issuer for distribution to the investors. The servicer is typically compensated with fees based on the volume of loans serviced. The servicer is generally obligated to maximize the payments from the borrowers to the issuer, and is responsible for handling delinquent loans and foreclosures.
- **Investors** - The purchasers of the various securities issued by a securitization. Investors provide funding for the loans and assume varying degrees of credit risk, based on the terms of the securities they purchase.
- **Rating Agency** - Assigns initial ratings to the various securities issued by the issuer and updates these ratings based on subsequent performance and perceived risk. Rating agency criteria influence the initial structure of the securities.
- **Trustee** - A third party appointed to represent the investors' interests in a securitization. The trustee ensures that the securitization operates as set forth in the securitization documents, which may include determinations about the servicer's compliance with established servicing criteria.
- **Securitization Documents** - The documents create the securitization and specify how it operates. One of the securitization documents is the Pooling and Servicing Agreement (PSA), which is a contract that defines how loans will be combined in a securitization, the administration and servicing of the loans, representations and warranties, and permissible loss mitigation strategies that the servicer can perform in event of loan default.
- **Underwriter** - Administers the issuance of the securities to investors.
- **Credit Enhancement Provider** - Securitization transactions may include credit enhancement (designed to decrease the credit risk of the structure) provided by an independent third party in the form of letters of credit or guarantees.

OBSTACLES TO LOAN MODIFICATIONS

The ability to offer workout options are predicated on the assumption that the borrower contacts his or her institution before becoming seriously delinquent on his or her loan or that the lender reaches out to contact borrowers who have missed a payment or who the lender believes are likely to run into trouble upon an interest rate reset. The ability to engage in workouts listed above also assumes that the institution which holds the loan is able to negotiate freely with the borrower to develop a workout option in the best interests of both. This latter assumption is valid when the originating lender retains the loan in its portfolio, but can be less accurate when the loan has been securitized, because the terms of the securitization governing documents may place restrictions on the servicer's flexibility to engage in loan modifications

When difficulty arises in making payments on a securitized loan, the borrower generally will not be dealing with the local banker with whom there might be an established relationship. Instead, the borrower will be dealing with a servicer. The servicer has responsibilities defined in the securitization documents that are substantially different than those of a lender. The servicer and the trustee are responsible for taking actions that are in the best interest of the investors who purchased portions of the securitization. Protecting the investors means determining the best alternative that would bring the maximum recovery on a defaulted loan on a present-value basis. If the servicer determines that a workout or modification of the loan achieves that goal, then there is an alignment of the investor/servicer/borrower relationship. However, if liquidation of the collateral (through a foreclosure or other means) results in the highest net present value of cash flows, the servicer may be bound by the terms of the securitization to pursue this approach to the benefit of the investor despite the resulting detriment to the borrower.

Even if a modification to the loan looks like the right approach, other factors might limit the servicer's options. Most securitizations are established as Real Estate Mortgage Investment Conduits (REMICs). The REMIC structure provides considerable tax benefits, (i.e., only the investors are subject to tax, not the conduit itself) but also includes provisions that could limit the flexibility of a servicer to modify a borrower's loan terms in a proactive manner. To qualify for tax-advantaged status, the pool of loans securitized in a REMIC must generally be treated as a static pool, which usually precludes modifying loans in the pool. An exception to this general prohibition allows for modifications when default is reasonably foreseeable. Once a determination is made that default is reasonably foreseeable, most securitization agreements provide significant flexibility for the servicer to modify terms of the loan. This allows for modification of terms when a loan has defaulted, but may prohibit changes to loans that are current.

The Internal Revenue Service (IRS) leaves it to servicers to determine what "reasonably foreseeable" means as it relates to default, which makes these determinations dependent upon the facts and circumstances of each mortgage. In many cases, servicers would likely need to seek legal determinations from outside counsel, especially with respect to whether a default was reasonably foreseeable, in order to modify loans in the pool. Some securitization documents indicate that once a loan is delinquent for a certain amount of time, for example, 60 days, modifications of the terms may be allowed, subject to REMIC laws. In some deals, the servicer must certify with a legal opinion that a modification of loan terms would not result in an adverse REMIC event. Therefore, while some flexibility is available, the specifics are often unclear. Further clarification regarding permissible modification activities under REMIC laws would improve the servicer's ability to work through problems with the borrower.

Aside from the restraints imposed on modifications by the REMIC structure, the personal service agreement (PSA) can also impose barriers to loan modification. The language in each PSA is different and each establishes the rules about how a particular securitization operates or what needs to be done to change those rules. Many PSAs contain more than 200 pages of dense legal verbiage. The PSA provides a blueprint as to how cash flows and losses are allocated and distributed to the various parties, and establishes the rules that the servicer must abide by in managing this critical function in the transaction. The PSA sets forth whether and how a servicer can modify the underlying loans in a securitization. The documents will also identify the other parties in the transaction who might have an important role in this decision.

If the PSAs terms and conditions regarding modifications prove to be overly restrictive, changing the PSA can be very difficult and may require extraordinary actions, such as obtaining the consent of two-thirds or all of the investors. In some deals, the PSA is quite explicit in allowing the servicer flexibility in modifying delinquent loans, while in other transactions the language is vague.

Even if the servicer can arrange a modification of terms, the servicer may still be limited in the ability to take a proactive approach to modifying a loan. If a servicer foresees problems on the horizon for a group of borrowers that is currently paying as agreed, the servicer might not be able to modify the terms of the loan until the borrower enters into the “imminent default” category. For example, following Hurricane Katrina, some banks granted blanket payment moratoria for borrowers with homes in the Gulf Coast region, but many servicers were limited in their ability to grant similar blanket moratoria for mortgages that were securitized. Instead, these servicers had to make modifications on a case-by-case basis based on the facts and circumstances of each borrower. In situations like this, waiting for the borrower to fall behind in payments may not be the most prudent course of action for any of the parties involved. If solutions could be reached to forestall a problem, the result would be greater flexibility for servicers and possibly loss mitigation.

While the servicer has an important role in the decisions relating to the underlying borrower, there are other parties involved in the transaction whose views also carry significant weight. In most older deals (and some more recent), the servicer must obtain the consent and approval of the rating agency and bond insurer before considering loan modifications in amounts greater than 5 percent of the total transaction. Yet, excessive modifications might be viewed as a negative factor when ratings are reviewed by the ratings agencies.

Financial guarantors and other credit enhancement providers have become more involved in the structured finance market as well, often providing insurance on the deeply subordinated tranches of securitizations to facilitate the sale of these more risky positions. In this role, a guarantor steps in and absorbs losses should the underlying collateral begin to deteriorate. Therefore, the guarantor has a vested interest in the decisions made by the servicer in dealing with distressed borrowers. In some transactions, the servicer is required to gain the prior written consent of the credit enhancement provider for any modification, waiver, or amendment that would cause the aggregate number of outstanding mortgage loans which have been modified, waived or amended to exceed 5 percent of the original pool balance. Whether the credit enhancement provider, servicer, and borrower share the same interest will depend on the facts and circumstances of the specific situation. If their interests are not aligned, however, the credit enhancement provider’s demands will no doubt have a large effect on the ultimate outcome.

The accounting rules also play an important role in the decisions made by the various parties. Securitization is often used as a balance sheet management strategy, whereby assets sold into a securitization are removed from the seller's books, thus freeing up resources such as capital. Lenders must meet strict accounting requirements before they can remove assets from their books, to show that they no longer "control" these assets, and that the risks and rewards associated with the loans have been transferred to the investors.

Overall, the ability to securitize pools of such mortgages certainly helped to make mortgage loans available and has reduced the cost of credit for borrowers. However, the securitization structure also has introduced a number of new participants and complexities into the loan relationship, which reduces flexibility for addressing the problems of distressed borrowers.

OPTIONS FOR HOMEBUYERS FACING FORECLOSURE

- **Reinstatement-**This means bringing the mortgage current. This is rare, unless you get a tax refund, a bonus check, or some other windfall that could catch you up on owed mortgage payments.
- **Partial Reinstatement-**Pay off a portion of what is owed.
- **Forbearance-**Lender agrees to take less than the full payment.
- **Repayment Plan-** Outstanding debt is paid off over the course of several months or a year so a large payment can be broken down into smaller ones.
- **Loan Modification-**This changes the terms of loan—a later pay-off date or a change in the interest rate.
- **Refinance-**You may need decent credit to qualify, but this can get you a new loan with a better fee schedule or interest rate.

If a borrower can't afford to make payments at all, then they have three options for liquidation:

- **Short Sell-**A short sell is selling your house for less than the amount you owe. Lenders consider this a settlement and may forgive your remaining debt.

- **Deed in lieu of Foreclosure-**This is a voluntary transfer of your property to your lender.

- **Assumption-**This option lets someone else assume your mortgage for you.

RECENT ACTIONS

The national Hope Campaign provides free, twenty-four hour, bilingual counseling for people that are in fear of losing their homes. The number is 1-800-HOPE. In addition, the United States Department of Housing and Urban Development has a list of regional counseling services. Although picking up the phone will not put money in the bank, it can reduce the probability of a foreclosure. A 2004 study by Freddie Mac indicated that retention options could reduce the possibility of foreclosure by 60–80 percent, depending on the type of loan.

Countrywide Financial Corp., the largest U.S. home-mortgage lender by volume, said it will refinance or restructure up to $16 billion in loans by the end of next year for homeowners facing higher payments because of interest-rate resetting.

Countrywide also recently announced it's partnering with the Neighborhood Assistance Corporation of America (NACA), a community and advocacy group that that has often been at odds with Countrywide's lending policies. Borrowers wanting to rework loans through NACA are required to go through the organization's comprehensive approval process. They fill in an application on NACA's website. Then they must attend a home buyer's workshop of about four hours long held at any of the organization's 33 offices in 19 states. The workshop covers mundane, but misunderstood, aspects of mortgage borrowing, such as what a settlement statement means. After that, borrowers make an appointment for one-on-one counseling sessions of about 90 minutes to two hours. The counselors help prepare realistic budgets, looking at incomes and expenses including car payments and child-care costs.

Wells Fargo, of San Francisco, offered some 80,000 repayment plans and made 25,000 "workouts" - including loan modifications — aimed at helping borrowers keep their homes.

The Housing Finance Agencies of Maryland, Massachusetts, New York and Ohio have all started refinance programs to assist distressed borrowers with long term, fully underwritten prime mortgage products. These programs are not give-aways of state funds, but rather loan guarntee programs where the state steps in to gaurantee the payment of the loan. Each state has contributed one hudred million dollars or more to this effort.

In response to the subprime fallout, federal regulators (Office of Comptroller of Currency, Office of Thrift Supervision, Federal Reserve Board, Federal Deposit Insurance Corporation, and National Credit Union Administration) issued guidance on nontraditional mortgage product risks. The guidance applies to both prime and nonprime loans and covers federally-regulated financial institutions, their subsidiaries and affiliates, and federally-insured financial institutions.

Key components of the federal guidance 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.

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 nontraditional products should have good risk management practices in place and capital levels commensurate with the risk, and;

6. Institutions that offer nontraditional mortgage products should make the potential consumer of these products aware of all possible risks and should provide this information to potential borrowers in a clear, balanced, and timely manner. Payment shock, negative amortization, prepayment penalties, and the cost of reduced documentation loans should be explained.

Monthly statements on payment-option adjustable rate mortgages should explain the consequences of each payment option.

7. 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, CSBS and AARMR issued guidance substantially similar to the federal guidance, but deleted sections of the federal guidance that were inapplicable to nondepository institutions (i.e., sections dealing with capital reserve requirements).

8. Subsequent to the issuance of this guidance State Senator Mike Machado introduced SB 385, which was also co-authored by the Assembly Banking Chair, Assemblymember Ted Lieu, in order to clearly give state regulators the authority to enforce the guidance on their licensees. SB 385 was signed by the governor October 5, 2007.

On April 17, 2007 the federal regulators also issued guidnace to lenders concerning their efforst to work with troubled borrowers:

> "The federal financial institutions regulatory agencies encourage financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.
>
> Many residential borrowers may face significant payment increases when their adjustable rate mortgage (ARM) loans reset in the coming months. These borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The agencies have long encouraged borrowers who are unable to meet their contractual obligations to contact their lender or servicer to discuss possible payment alternatives at the earliest indication of such problems.
>
> The agencies encourage financial institutions to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes. However, there may be instances when workout arrangements are not

> economically feasible or appropriate. Financial institutions should follow prudent underwriting practices in determining whether to consider a workout arrangement. Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed- rate products to provide financially stressed borrowers with predictable payment requirements. Financial institutions may receive favorable Community Reinvestment Act (CRA) consideration for programs that transition low and moderate income borrowers from higher cost loans to lower cost loans, provided the loans are made in a safe and sound manner."

On May 2, 2007 United States Senator Chris Dodd held a Homeownership Preservation Summit that reached a series of principles with lenders and services on efforts to assist trouble borrowers. Those principles are:

1) Early contact and evaluation of borrowers prior to loan reset.

2) Modify loans to create long-term affordability.

3) Establish dedicated teams or resources in order to handle modifications in an efficient and timely manner.

4) For those who are eligible, low cost financing options should be offered.

5) Lenders should work with GSEs to make credit available to borrowers through new products and expanded programs that will help borrowers out of resetting subprime ARMS.

6) Maximize success, minimize damage.

7) Systems should be developed so that parties can track progress and establish accountability.

IMPACTS OF FORECLOSURES

A recent report released by the Congressional Joint Economic Committee (CJEC) has highlighted some dismal impacts as a result of the foreclosure crisis:

- Approximately $71 billion in housing wealth directly destroyed through the process of foreclosure.

- More than $32 billion in housing wealth indirectly destroyed by the spillover effect of foreclosures which reduces value of neighboring properties.

- States and local governments will lose more than $917 million in property tax revenue as a result of the destruction of housing wealth caused by subprime foreclosures.

Additionally, CJEC has found that as a result of foreclosures, California could lose $110,921,021 in property tax revenue. They also estimate almost 200,000 foreclosures in California over the next five quarters. In another study regarding the typical cost of foreclosure to municipalities, the City of Chicago was used as an example.[10] In a review of the impact of foreclosure son Chicago it was found that the cost per property in some cases exceeded $30,000. Municipalities face increased expenditures due to foreclosures because they require direct expenditures for increased policing and fire suppression, demolition contracts, building inspections, legal fees and fees associated with managing the foreclosure process.

[10] Apgar, William & Mark Duda. "Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom" Homeownership Preservation Foundation. 2005

APPENDIX I

FORECLOSURE TIMELINE[11]:

Day 1
It's the first of the month, and the mortgage payment is due. The borrower misses the payment.

Day 16 to day 30
A late charge is assessed on payment.
The company that processes the borrower's payments (called the mortgage servicer) starts attempting to make contact to find out what happened.

Day 45 to day 60
The servicer sends a "demand" or "breach" letter to the borrower pointing out that terms of the mortgage have been violated.
The borrower is given 30 days to resolve the situation by paying the delinquent amount.

Day 90 to day 105
The servicer refers the loan to its foreclosure department and hires a local attorney or other firm to initiate foreclosure proceedings.
Depending on the state where the home is located, the servicer's representative may record a formal notice of foreclosure at the local courthouse, publish details of the debt in the local newspaper, attend hearings on the case and make appropriate court filings.

Day 150 to day 415
The house is sold at a foreclosure sale or auction. The wide time range is due to different state requirements. Borrowers in states with judicial foreclosures, or those in which lenders have to retake property titles via the court system, can get almost a year to straighten out their affairs before the sale. Those in nonjudicial states have as little as two months.

[11] Courtesy of Bankrate.com

<u>APPENDIX II</u>

<u>SUBPRIME CRISIS HISTORICAL TIMELINE</u>

<u>DECEMBER 2006</u>

• *December 28:* Ownit Mortgage Solutions files for bankruptcy.

<u>FEBRUARY 2007</u>

• *February 7:* The Senate Banking Committee holds the first hearing of the 110th Congress addressing legislative solutions to predatory lending in the subprime sector.

• *February 12:* ResMae Mortgage files for bankruptcy.

• *February 20:* Nova Star Financial reports a surprise loss.

<u>MARCH 2007</u>

• *March 2:* The Federal Reserve announces draft regulations to tighten lending standards. Lenders would be required to grant loans on a borrower's ability to pay the fully indexed interest rate that would apply after the low, initial fixed-rate period of two or three years. New regulations are met with skepticism in Congress.

• *March 2:* Fremont General stops making subprime loans and puts its subprime business up for sale.

• *March 8:* New Century Financial, the second largest subprime lender in 2006, stops making loans.

• *March 20:* People’s Choice files for bankruptcy.

• *March 22:* The Senate Banking Committee holds a hearing to investigate the sharp increase in defaults and foreclosures, questioning banking regulators, a Federal Reserve representative, industry executives and two homeowners. Both Democrats and Republicans criticize banking regulators for failing to respond more quickly to curb the growth in risky home loans to people with weak credit.

• *March 27:* At a Joint Economic Committee hearing, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, says housing market weakness "does not appear to have spilled over to a significant extent.” More Bernanke: “At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency.”

APRIL 2007

• *April 2:* New Century Financial files for bankruptcy.

• *April 6:* American Home Mortgage writes down the value of risky mortgages rated one step above subprime.

• *April 11:* The JEC, chaired by Senator Charles Schumer, releases a report analyzing the subprime mortgage foreclosure problem and its economic impact on the most vulnerable communities. The report, entitled “Sheltering Neighborhoods from the Subprime Foreclosure Storm,” argues that foreclosure prevention is cost-effective and presents policy suggestions for curbing future subprime foreclosures.

• *April 12:* Senator Schumer calls on Federal Government to intervene on behalf of homeowners in response to a National Association of Realtors report showing falling home prices due to rising foreclosures and a Los Angeles Times story in which the White House blamed homeowners for signing up for deceptive subprime mortgages.

• *April 12:* According to the Los Angeles Times, Tony Fratto, Spokesman for the White House, said “individuals need to Legend: In the Markets In Congress In the Administration JOINT ECONOMIC COMMITTEE Senator Charles E. Schumer, Chairman August 2007 make smart decisions in taking on debt, and there has to be some responsibility for making those decisions.” He also said that any federal action would be unwelcome and would encourage “risky behavior.”

• *April 18:* Senator Dodd hosts the Homeownership Preservation Summit, bringing together some of the largest subprime lenders, securitizers, and servicers, as well as consumer and civil rights groups, to discuss ideas and develop solutions to the subprime mortgage market crisis. Following the summit, Senator Dodd states, “I am not overly anxious to legislate… We think there may be enough laws on the books."

• *April 18*: Freddie Mac announces plans to refinance up to $20 billion of loans held by subprime borrowers who would be unable to afford their adjustable-rate mortgages at the reset rate.

• *April 24:* The National Association of Realtors announces that sales of existing homes fell 8.4% in March from February, the sharpest month-to-month drop in 18 years.

<u>MAY 2007</u>

• *May 3:* Senator Schumer introduces the first comprehensive plan to help homeowners avoid foreclosures. The plan includes a request for $300 million in federal funds for community non-profits to help homeowners refinance current mortgages through personalized financial counseling. Schumer calls on banks and lenders to also provide funding for nonprofit counselors. Senator Schumer, along with Senators Brown and Casey also introduce the "Borrower's Protection Act of 2007," which proposes federal regulation for mortgage brokers in order to avoid future defaults on subprime loans. The bill seeks to regulate mortgage brokers and originators under the Truth in Lending Act (TILA) by establishing on behalf of consumers a fiduciary duty and other standards of care. In addition, the bill outlines standards for brokers and originators to assess a borrower's ability to repay a mortgage and holds lenders accountable for brokers and appraisers.

• *May 4:* The House Financial Services Committee passes the "Expanding American Home Ownership Act". The bill would allow Fannie Mae and Freddie Mac to purchase and securitize larger mortgages (up to $625,500 or the region's median home price) in high-cost areas of the U.S. where the median price exceeds $417,000 (the current loan limit). The bill would also authorize zero down payment loans and direct the Department of Housing and Urban Development (HUD) to serve higher risk borrowers who would otherwise turn to predatory and high priced mortgage loan alternatives.

• *May 9*: The Federal Open Market Committee meets and leaves rates unchanged. The FOMC states in their minutes, "The correction of the housing sector was likely to continue to weigh heavily on economic activity through most of this year, somewhat longer than previously expected.” However, the FOMC continued to refer to the housing crisis as a “correction”.

• *May 17:* At the Federal Reserve Bank of Chicago’s Forty-Third Annual Conference on Bank Structure and Competition,
Chairman Bernanke reiterates his March statement by saying the Fed does not foresee a broader economic impact from the growing number of mortgage defaults.

• *May 25:* The National Association of Realtors reports that sales of existing homes fell by 2.6 percent in April to a seasonally adjusted annual rate of 5.99 million units, the slowest sales pace since June 2003. The number of unsold homes left on the market reached a record total of 4.2 million.

JUNE 2007

• *June 4:* Housing and Urban Development (HUD) Secretary Alfonso Jackson endorses counseling and financial education as the best way to tackle the subprime foreclosure boom in a speech at the National Press Club.

• *June 5:* At an International Monetary Conference in Cape Town South Africa, Chairman Bernanke endorses the basis of a proposal made by Schumer to increase federal funds for community non-profits engaged in helping families in unsuitable subprime loans avoid losing their homes to foreclosure.

• *June 6:* ZipRealty Inc., a national real-estate brokerage firm, announces that the number of homes listed for sale in 18 major U.S. metropolitan areas at the end of May was up 5.1% from April. This is a striking deviation from the general trend as tracked by the Credit Suisse Group, which says on a national basis; inventories of listed homes have typically been little changed in May during the past two decades.

• *June 12:* RealtyTrac announces U.S. foreclosure filings surged 90 percent in May from May 2006. Foreclosure filings were up 19 percent from April. There were 176,137 notices of default, scheduled auctions and bank repossessions in May.
The median price for a U.S. home dropped 1.8 percent the first three months of 2007. According to Freddie Mac, typically, more than half of all home sales occur in the April to June period.

• *June 14:* Goldman Sachs reports flat profit from a year ago due to mortgage market problems.

• *June 22:* Bear Stearns pledges up to $3.2 billion to bail out one of its hedge funds because of bad bets on subprime mortgages.

• *June 26:* Senator Schumer convenes housing experts to examine how to protect homebuyers from subprime lending and other mortgage industry abuses in a Banking Subcommittee hearing. The hearing focuses on the mortgage origination process, abuses in mortgage lending industry, responsible solutions to protect consumers in home-buying process and the impact of these proposed solutions on the market as a whole. The hearing also examines the Borrower's Protection Act of 2007 (S. 1299), which seeks to address many of the abuses that have taken place in the mortgage process by creating new regulations and requirements for various mortgage originators.

<u>JULY 2007</u>

• *July 10:* Standard and Poor's and Moody's downgrade bonds backed by subprime mortgages. Fitch follows suit.

• *July 10:* The Senate Appropriations Committee approves $100 million of the requested $300 million for HUD Housing Counseling programs in the Transportation, Housing, and Urban Development, and Related Agencies FY08 Appropriations Bill. With these funds, non-profit agencies are able to provide individual counseling by working one-on one with borrowers stuck in unaffordable subprime loans.

• *July 18:* Bear Stearns announces its two hedge funds that invested heavily in the subprime market are essentially worthless, having lost over 90% of their value, equal to over $1.4 billion.

• *July 17*: The Federal Reserve announces a pilot program to monitor brokers, joining the Board of Governors of the Federal Reserve with the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, to conduct targeted consumer-protection compliance reviews of underwriting standards, oversight, and risk-management practices within non-depository lenders with significant subprime mortgage operations.

• *July 18:* Commerce Department announces housing starts are down 19.4 percent over the last 12 months. Also announced is a 7.5 percent plunge in permits to build new homes, the largest monthly decline since January 1995. Permits are 25.2 percent below their level a year ago, reflecting continued pessimism among builders over the near-term outlook for new homebuilding.

• *July 18 and 19:* Chairman Bernanke testifies in front of the House Financial Services Committee and the Senate Banking Committee in his Second Monetary Report to Congress in 2007.

• *July 19:* The Dow Jones industrials close above 14,000 for the first time.

• *July 18 and 19:* In two days of testimony in Congress, Chairman Bernanke said there will be "significant losses" due to subprime mortgages, but that such losses are "bumps" in "market innovations" (referring to hedge fund investments in subprime mortgages). Bernanke reiterated that problems in the subprime mortgage market have not spilled over into the greater system. Bernanke also said the problems "'likely will get worse before they get better." He forecasts that the economy is poised for moderate growth, but continuing problems in the housing market prompt the Fed to slightly reduce its growth expectations.

• *July 25:* The JEC examines the impact of the subprime lending crisis on Cleveland, Ohio, one of the hardest hit communities in the nation. The hearing reveals the individual faces of the subprime mortgage crisis. Local residents and city council members testify.

• *July 30:* IKB Deutsche Industriebank, a German bank, is bailed out because of bad bets on U.S. mortgage-backed securities.

• *July 31*: Home prices continue to fall, marking the 18th consecutive decline, beginning in December 2005, in the growth rate of housing prices, according to the monthly S&P/Case-Shiller's Home Prices Indices, which tracks housing prices in metropolitan areas and is considered a leading measure of U.S. single-family home prices. The 10-City Composite index showed an annual decline of 3.4% (it's biggest since 1991) and the 20-City Composite reported an annual decline of 2.8%.

<u>AUGUST 2007</u>

• *August 1*: Two hedge funds managed by Bear Stearns that invested heavily in subprime mortgages declare bankruptcy. Investors in the funds file suit against Bear Stearns, alleging that the investment bank mislead them about the extent of the funds' exposure.

• *August 6:* American Home Mortgage files for bankruptcy.
• *August 7:* The Federal Open Market Committee leaves the overnight federal funds rate at 5.25%, referring to tightening in the credit markets and ongoing housing market crisis as a "correction". Despite financial market turmoil, the FOMC forecasts that "the economy seems likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in the employment and incomes and a robust global economy."

• *August 7:* Senators Schumer and Dodd separately write to James B. Lockhart III, director of the Office of Federal Housing Enterprise Oversight (OFHEO), urging him to consider temporarily raising the limit on purchases of home loans by Fannie Mae and Freddie Mac in response to increasing concerns of a credit crunch spilling into the broader mortgage market.

• *August 7:* Senator Clinton introduces a plan to address mortgage lending abuses, including new regulations on brokers, strong state licensing standards, and federal registration for brokers. The plan also proposes a $1 billion fund to assist state programs that help at-risk borrowers avoid foreclosure.

• *August 8*: Senator Schumer writes to Federal regulators, urging them to devise an action plan to deal with the current liquidity crunch in the mortgage markets that threatens to spread across the economy as a whole. Schumer expresses his concerns that regulators are underestimating the spillover effects of the housing market crisis. "Nobody, including me, wants or expects the Federal regulators to step in and lend a hand to the private sector players who took risky gambles in the subprime market," says Schumer. "But when millions of Americans who have good credit now face the real possibility of not being able to purchase a home because of spillovers from the subprime market, we need the regulators to play a leadership role to preserve market liquidity and minimize the damage."

• *August 8:* Treasury Secretary Hank Paulson says, "Borrowers weren't quite as disciplined as they should be... Lenders clearly weren't as disciplined as they should be. We've seen some excesses. We've seen it in the subprime area, and that will be with us for a while."

• *August 9:* American International Group, one of the biggest U.S. mortgage lenders, warns that mortgage defaults are spreading beyond the subprime sector. With delinquencies becoming more common among borrowers in the category just above subprime.

• *August 9:* BNP Paribas, a French bank, suspends three of its funds because of exposure to U.S. mortgages.

• *August 9:* President Bush addressing the housing market crisis, saying, “The fundamentals of our economy are strong…I'm told there is enough liquidity in the system to enable markets to correct.” Bush also said, “The conditions for the marketplace working through these issues are good. My hope is that the market, if it functions normally, will be able to yield a soft landing.”

• *August 9 and 10:* European Central Bank and Federal Reserve intervene in markets by pumping billions of dollars of liquidity into the markets.

• *August 10:* John Edwards responds to President Bush’s comments, calling on the Administration to act to moderate the housing crisis. Edward’s a plan to protect homeowners and fight predatory lending includes strong national legislation to regulate mortgage abuses and prohibit predatory mortgage lending based on North Carolina’s state law and a Home Rescue Fund to work with local non-profits, government agencies and community financial institutions to help struggling homeowners renegotiate or refinance their mortgages.

• *August 10:* In regards to lifting the caps on Fannie Mae and Freddie Mac, President Bush said he would like to see Congress gets GSEs “reformed, get them streamlined, get them focused, and then I will consider other options”.

• *August 10:* The federal regulator for Fannie Mae denies the mortgage finance company's request to grow its investment portfolio, but did not close the door on the possibility of lifting the cap in the future.

• *August 13*: Aegis Mortgage files for bankruptcy.

• *August 15:* Rep Barney Frank announces plans to hold hearings in the House Financial Services Committee investigating credit rating agencies role in the subprime mortgage crisis.

• *August 16:* Countrywide Financial, the nation's largest mortgage lender, draws down $11.5 billion from its credit lines.

• *August 16:* All three major stock indexes were 10% lower than their July peaks – a marker indicating a correction of the stock market, due to tightening in the credit markets.

• *August 17:* The Federal Reserve cuts the discount rate by half a point. Stocks rally.

• *August 22:* RealtyTrac Inc announces foreclosures were up 93% in July 2007 from July 2006. The national foreclosure rate in July was one filing for every 693 households. There were 179,599 filings reported last month, up from 92,845 a year ago.

• *August 22:* In letters to more than 40 major market players, and federal financial regulators including Chairman Bernanke and Secretary Paulson, Senator Schumer cautions that regulators' efforts to bring liquidity to tightened credit markets have so far overlooked the harrowing situation in the underlying mortgage market that stoked the credit crunch in the first place. Schumer urged banks, lenders, and loan servicers to direct resources to the non-profits on the frontlines of the mortgage crisis in the same vain as the Senate Appropriations Committee, which has set aside $100 million for nonprofits that work with homeowners to prevent foreclosure.

APPENDIX III

PENDING FEDERAL LEGISLATION

1. **H.R. 3838**-To temporarily increase the portfolio caps applicable to Freddie Mac and Fannie Mae, to provide the necessary financing to curb foreclosures by facilitating the refinancing of at-risk.
2. **H.R. 2061**-Predatory Mortgage Lending Practices Reduction Act- To protect home buyers from predatory lending practices.
3. **H.R. 3535**-Homebuyer's Protection Act of 2007- To amend the Truth in Lending Act to require escrow accounts for the payment of property taxes and insurance for all subprime loans, and to expand the coverage of the appraisal requirements under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, and for other purposes.
4. **H.R.3777**-Protecting Access to Safe Mortgages Act- To temporarily raise the portfolio caps applicable to Freddie Mac and Fannie Mae, to provide the necessary financing to curb foreclosures by facilitating the refinancing of at-risk subprime borrowers into safe, prime loans, to preserve liquidity in the mortgage lending markets, and for other purposes.
5. **S. 2036**-Protecting Access to Safe Mortgages Act - A bill to temporarily raise conforming loan limits in high cost areas and portfolio caps applicable to Freddie Mac and Fannie Mae, to provide the necessary financing to curb foreclosures by facilitating the refinancing of at-risk subprime borrowers into safe, prime loans, to preserve liquidity in the mortgage lending markets, and for other purposes.
6. **H.R. 3012**-Fair Mortgage Practices Act of 2007 - To amend the Truth in Lending Act to provide for the establishment of fair mortgage practices, generally, and for subprime mortgages in particular, to provide for a national system for licensing or registering residential mortgage loan originators, and for other purposes.
7. **H.R. 3133**-Financial Literacy for Homeowners Act - To authorize the Secretary of the Treasury to make grants to States, units of general local government, and nonprofit organizations for counseling and education programs for the prevention of predatory lending and to establish a toll-free telephone number for complaints regarding predatory lending, and for other purposes.

8. **S. 1222**-STOP FRAUD Act - A bill to stop mortgage transactions which operate to promote fraud, risk, abuse, and under-development, and for other purposes.
9. **H.R. 3666**-Foreclosure Prevention and Homeownership Protection Act - To establish a bipartisan commission to perform a comprehensive examination of the current foreclosure and mortgage lending crisis and to make recommendations for legislative and regulatory changes to address such problems.
10. **H.R. 3019**-Expand and Preserve Home Ownership Through Counseling Act - To establish an Office of Housing Counseling to carry out and coordinate the responsibilities of the Department of Housing and Urban Development regarding counseling on homeownership and rental housing issues, to make grants to entities for providing such counseling, to launch a national housing counseling advertising campaign, and for other purposes.
11. **H.R 1852**-Expanding American Homeownership Act of 2007 - To modernize and update the National Housing Act and enable the Federal Housing Administration to use risk-based pricing to more effectively reach underserved borrowers, and for other purposes.
12. **H.R. 1427**-Federal Housing Finance Reform Act of 2007 - To reform the regulation of certain housing-related Government-sponsored enterprises, and for other purposes.
13. **H.R. 3074**-Transportation, Housing and Urban Development, and Related Agencies Appropriations Act- Making appropriations for the Departments of Transportation, and Housing and Urban Development, and related agencies for the fiscal year ending September 30, 2008, and for other purposes.
14. **H.R. 3915-** To amend the Truth in Lending Act to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, to provide certain minimum standards for consumer mortgage loans, and for other purposes.

APPENDIX IV

GLOSSARY & COMMON MORTGAGE RELATED TERMS

- **7 / 23 and 5 / 25 Mortgages**
  Mortgages with a one time rate adjustment after seven years and five years respectively.
- **3 / 1, 5 / 1, 7 / 1 and 10 / 1 ARMs**
  Adjustable rate mortgages in which rate is fixed for three year, five year, seven year and 10-year periods, respectively, but may adjust annually after that.
- **Acceleration**
  The right of the mortgagee (lender) to demand the immediate repayment of the mortgage loan balance upon the default of the mortgagor (borrower), or by using the right vested in the Due on Sale Clause.
- **Adjustable Rate Mortgage (ARM)**
  A mortgage in which the interest rate is adjusted periodically based on a pre-selected index. Also sometimes known as a renegotiable rate mortgage, or variable rate mortgage.
- **Adjustment Date**
  The date that the interest rate changes on an adjustable rate mortgage (ARM).
- **Adjustment Interval**
  On an adjustable rate mortgage, the time between changes in the interest rate and/or monthly payment, typically one, three or five years depending on the index.
- **Adjustment Period**
  The period elapsing between adjustment dates for an adjustable rate mortgage (ARM).
- **Amortization**
  Loan payment divided into equal periodic payments calculated to pay off the debt at the end of a fixed period, including accrued interest on the outstanding balance.
- **Annual Percentage Rate (APR)**
  The measurement of the full cost of a loan including interest and loan fees expressed as a yearly percentage rate. Because all lenders apply the same rules in calculating the annual percentage rate, it provides consumers with a good basis for comparing the cost of different loans.
- **Balloon Mortgage**

A loan which is amortized for a longer period than the term of the loan. Usually this refers to a thirty year amortization and a five or seven year term. At the end of the term of the loan, the remaining outstanding principal on the loan is due. This final payment is known as a balloon payment.

- **Blanket Mortgage**
  A mortgage covering at least two pieces of real estate as security for the same mortgage.
- **Broker**
  An individual in the business of assisting in arranging funding or negotiating contracts for a client but who does not loan the money himself. Brokers usually charge a fee or receive a commission for their services.
- **Buy Down**
  When the lender and/or the home builder subsidized the mortgage by lowering the interest rate during the first few years of the loan. While the payments are initially low, they will increase when the subsidy expires.
- **Caps** (interest)
  Consumer safeguards which limit the amount of change to the interest rate for an adjustable rate mortgage.
- **Caps** (payment)
  Consumer safeguards which limit the amount of change to the monthly payments for an adjustable rate mortgage.
- **Change Frequency**
  The frequency (in months) of payment and/or interest rate changes in an adjustable rate mortgage (ARM).
- **COFI**
  An adjustable-rate mortgage with a rate that adjusts based on a cost-of-funds index, often the 11th District Cost of Funds.
- **Conventional Loan**
  A mortgage not insured by FHA or guaranteed by VA.
- **Conversion Clause**
  A provision in an ARM allowing the loan to be converted to a fixed-rate at some point during the term. Usually conversion is allowed at the end of the first adjustment period. The conversion feature may cost extra.
- **Debt-to-Income Ratio**
  The ratio, expressed as a percentage, which results when a borrower's monthly payment obligation on long term debts is divided by his or her gross monthly income. See housing expenses-to-income ratio.
- **Default**

Failure to meet legal obligations in a contract, specifically, failure to make the monthly payments on a mortgage.

- **Deferred Interest**
  When a mortgage is written with a monthly payment that is less than required to satisfy the note rate, the unpaid interest is deferred by adding it to the loan balance. See *negative amortization.*
- **Delinquency**
  Failure to make payments on time. This can lead to foreclosure.
- **Equity**
  The difference between the fair market value and current indebtedness also referred to as the owner's interest. The value an owner has in real estate over and above the obligation against the property.
- **Escrow**
  An account held by the lender into which the home buyer pays money for tax or insurance payments. Also earnest deposits held pending loan closing.
- **Federal Home Loan Mortgage Corporation**(FHLMC) also called "Freddie Mac"
  A government sponsored entity that purchases conventional mortgage from insured depository institutions and HUD-approved mortgage bankers.
- **Federal National Mortgage Association** (FNMA) also know as "Fannie Mae"
  A government sponsored entity that purchases and sells conventional residential mortgages as well as those insured by FHA or guaranteed by VA.
- **FHA Loan**
  A loan insured by the Federal Housing Administration open to all qualified home purchasers. While there are limits to the size of FHA loans, they are generous enough to handle moderately priced homes almost anywhere in the country.
- **First Mortgage**
  The primary lien against a property.
- **Fixed Installment**
  The monthly payment due on a mortgage loan including payment of both principal and interest.
- **Fixed Rate Mortgage**
  The mortgage interest rate will remain the same on these mortgages throughout the term of the mortgage for the original borrower.
- **Fully Amortized ARM**

An adjustable rate mortgage (ARM) with a monthly payment that is sufficient to amortize the remaining balance, at the interest accrual rate, over the amortization term.

- **Foreclosure**
  A legal process by which the lender or the seller forces a sale of a mortgaged property because the borrower has not met the terms of the mortgage. Also known as a repossession of property.
- **Government National Mortgage Association (GNMA)**
  Also known as "Ginnie Mae." Provides sources of funds for residential mortgages, insured or guaranteed by FHA or VA.
- **Graduated Payment Mortgage** (GPM)
  A type of flexible payment mortgage where the payments increase for a specified period of time and then level off. This type of mortgage has negative amortization built into it.
- **Growing Equity Mortgage (GEM)**
  A fixed rate mortgage that provides scheduled payment increases over an established period of time. The increased amount of the monthly payment is applied directly toward reducing the remaining balance of the mortgage.
- **Impound**
  The portion of a borrower's monthly payments held by the lender or servicer to pay for taxes, hazard insurance, mortgage insurance, lease payments, and other items as they become due. Also known as reserves.
- **Initial Interest Rate**
  This refers to the original interest rate of the mortgage at the time of closing. This rate changes for an adjustable rate mortgage (ARM). It's also known as "start rate" or "teaser."
- **Interest**
  The fee charged for borrowing money.
- **Interest Accrual Rate**
  The percentage rate at which interest accrues on the mortgage. In most cases, it is also the rate used to calculate the monthly payments.
- **Interest Rate Buydown Plan**
  An arrangement that allows the property seller to deposit money to an account. That money is then released each month to reduce the mortgagor's monthly payments during the early years of a mortgage.
- **Interest Rate Ceiling**
  For an adjustable rate mortgage (ARM), the maximum interest rate, as specified in the mortgage note.
- **Interest Rate Floor**

For an adjustable rate mortgage (ARM), the minimum interest rate, as specified in the mortgage note.

- **Investor**
  A money source for a lender.
- **Jumbo Loan**
  A loan which is larger than the limits set by the *Federal National Mortgage Association* and the *Federal Home Loan Mortgage Corporation.* Because jumbo loans cannot be funded by these two agencies, they usually carry a higher interest rate.
- **Lien**
  A claim upon a piece of property for the payment or satisfaction of a debt or obligation.
- **Lifetime Payment Cap**
  For an adjustable rate mortgage (ARM), a limit on the amount that payments can increase or decrease over the life of the mortgage.
- **Lifetime Rate Cap**
  For an adjustable rate mortgage (ARM), a limit on the amount that the interest rate can increase or decrease over the life of the loan.
- **Loan**
  A sum of borrowed money (principal) that is generally repaid with interest.
- **Margin**
  The amount a lender adds to the index on an adjustable rate mortgage to establish the adjusted interest rate.
- **Monthly Fixed Installment**
  The portion of the total monthly payment that is applied toward principal and interest. When a mortgage negatively amortizes, the monthly fixed installment does not include any amount for principal reduction and doesn't cover all of the interest. The loan balance therefore increases instead of decreasing.
- **Mortgage**
  A legal document that pledges a property to the lender as security for payment of a debt.
- **Mortgage Banker**
  A company that originates mortgages for resale in the secondary mortgage market.
- **Mortgage Broker**
  An individual or company that charges a service fee to bring borrowers and lenders together for the purpose of loan origination.
- **Negative Amortization**

When your monthly payments are not large enough to pay all the interest due on the loan. This unpaid interest is added to the unpaid balance of the loan. The home buyer ends up owing more than the original amount of the loan.

- **One Year Adjustable Rate Mortgage**
  Mortgage where the annual rate changes yearly. The rate is usually based on movements of a published index plus a specified margin, chosen by the lender.
- **Payment Change Date**
  The date when a new monthly payment amount takes effect on an adjustable rate mortgage (ARM) or a graduated-payment mortgage (GPM). Generally, the payment change date occurs in the month immediately after the adjustment date.
- **Periodic Payment Cap**
  A limit on the amount that payments can increase or decrease during any one adjustment period.
- **Periodic Rate Cap**
  A limit on the amount that the interest rate can increase or decrease during any one adjustment period, regardless of how high or low the index might be.
- **Points** (Loan Discount Points)
  Prepaid interest assessed at closing by the lender. Each point is equal to 1 percent of the loan amount (e.g., two points on a $100,000 mortgage would cost $2,000).
- **Preapproval**
  The process of determining how much money you will be eligible to borrow before you apply for a loan.
- **Primary Mortgage Market**
  Lenders, such as savings and loan associations, commercial banks, and mortgage companies, who make mortgage loans directly to borrowers. These lenders sometimes sell their mortgages to the secondary mortgage markets such as *FNMA* or *GNMA,* etc...
- **Principal**
  The amount borrowed or remaining unpaid. The part of the monthly payment that reduces the remaining balance of a mortgage.
- **Principal Balance**
  The outstanding balance of principal on a mortgage not including interest or any other charges.
- **Principal, Interest, Taxes, and Insurance (PITI)**
  The four components of a monthly mortgage payment. Principal refers to the part of the monthly payment that reduces the remaining balance of the mortgage. Interest is the fee charged

for borrowing money. Taxes and insurance refer to the monthly cost of property taxes and homeowners insurance, whether these amounts are paid into an escrow account each month or not.

- **Private Mortgage Insurance** (PMI)
  In the event that you do not have a 20 percent down payment, lenders will allow a smaller down payment - as low as 3 percent in some cases. With the smaller down payment loans, however, borrowers are usually required to carry private mortgage insurance. Private mortgage insurance will usually require an initial premium payment and may require an additional monthly fee depending on your loan's structure.
- **Refinance**
  Obtaining a new mortgage loan on a property already owned often to replace existing loans on the property.
- **Reverse Annuity Mortgage** (RAM)
  A form of mortgage in which the lender makes periodic payments to the borrower using the borrower's equity in the home as collateral for and repayment of the loan.
- **Second Mortgage**
  A mortgage made subsequent to another mortgage and subordinate to the first one.
- **Secondary Mortgage Market**
  The place where primary mortgage lenders sell the mortgages they make to obtain more funds to originate more new loans. It provides liquidity for the lenders.
- **Servicer**
  An organization that collects principal and interest payments from borrowers and manages borrower escrow accounts. The servicer often services mortgages that have been purchased by an investor in the secondary mortgage market.
- **Step Rate Mortgage**
  A mortgage that allows for the interest rate to increase according to a specified schedule (i.e., seven years), resulting in increased payments as well. At the end of the specified period, the rate and payments will remain constant for the remainder of the loan.
- **Third Party Origination**
  When a lender uses another party to completely or partially originate, process, underwrite, close, fund, or package the mortgages it plans to deliver to the secondary mortgage market.
- **Two Step Mortgage**
  A mortgage in which the borrower receives a-below-market interest rate for a specified number of years (most often seven

or 10), and then receives a new interest rate adjusted (within certain limits) to market conditions at that time. The lender sometimes has the option to call the loan due with 30 days notice at the end of seven or 10 years. Also called "Super Seven" or "Premier" mortgage.

- **Underwriting**
  The decision whether to make a loan to a potential home buyer based on credit, employment, assets, and other factors and the matching of this risk to an appropriate rate and term or loan amount.
- **Wraparound Mortgage**
  Results when an existing assumable loan is combined with a new loan, resulting in an interest rate somewhere between the old rate and the current market rate. The payments are made to a second lender or the previous homeowner, who then forwards the payments to the first lender after taking the additional amount off the top.