



Neighborhood Economic Development Advocacy Project

73 Spring Street, Suite 506, New York, NY 10012
Tel: (212) 680-5100 Fax: (212) 680-5104
www.nedap.org

TESTIMONY OF JOSH ZINNER, CO-DIRECTOR OF THE NEIGHBORHOOD ECONOMIC DEVELOPMENT ADVOCACY PROJECT (NEDAP)

HEARING ON “EVALUATING THE GOVERNOR’S PROGRAM BILL TO ADDRESS MORTGAGE FORECLOSURES AND SUBPRIME LENDING IN NEW YORK STATE”

NEW YORK STATE SENATE BANKS COMMITTEE

May 12, 2008

Thank you Senator Farley and other members of the Committee for holding today’s hearing and for inviting me to testify. New York desperately needs strong and comprehensive legislation to prevent foreclosures and curb abusive lending practices. If the Governor’s program bill is strengthened in several key respects, it would go a long way toward protecting New York borrowers and communities, and restoring confidence in the mortgage markets.

I am Co-Director of the Neighborhood Economic Development Advocacy Project, known as NEDAP. NEDAP is a non-profit resource and advocacy center that works with community groups in New York City and State to promote economic justice and to eliminate discriminatory economic practices that harm communities and perpetuate inequality and poverty.

NEDAP has been at the forefront of fighting abusive lending in New York City and State since the mid-1990s, using a variety of strategies, including policy advocacy, community education and outreach, coalition-building, and research and documentation. My experience with this issue began with my prior job, where I served for a decade as the Director of the Foreclosure Prevention Project at South Brooklyn Legal Services, where we represented hundreds of lower income homeowners facing foreclosure as a result of abusive lending practices.

Unfortunately, abusive subprime lending is not a new phenomenon in New York State. Particularly since the mid-1990s, when the expanded securitization of subprime mortgages provided easy liquidity to the subprime market, subprime lenders targeted low and moderate income homeowners and communities, particularly communities of color, with an array of abusive mortgage products.

A common characteristic of many of these loans has been a lack of affordability at their inception. Loan flipping—or repeated refinancing of loans with little benefit to the borrower – has been rampant, as have hidden fees, prepayment penalties that lock borrowers into loans, and widespread misrepresentation by brokers and lenders about the true terms of a loan. Borrowers have been routinely steered to higher cost subprime loan products – often on the basis of race-- when they otherwise should have qualified for a lower cost loan.

Unscrupulous speculators also have relied on lax underwriting standards in the industry to induce first-time, working poor homeowners into purchasing intentionally over-appraised properties in poor condition – a practice known as property flipping. Many of the first-time homebuyers targeted in these schemes have ended up with unaffordable mortgages, and lost their only shot at

homeownership. Collusion between the speculators, appraisers and lenders was central to the success of these schemes.

The dramatic increase in the last several years of risky mortgage products—such as 2/28 adjustable rate mortgages (ARMs), Payment Option ARMs, No Income No Asset, and piggyback mortgages – has only exacerbated the situation. These products, based on highly dubious underwriting standards, have been highly profitable for the industry and devastating to borrowers. Although the initial rates on 2/28 ARMs are often referred to as “teaser” rates, in reality many of the ARMs were high-cost and unaffordable at their inception. The ARMs are underwritten at the initial rates, so that those borrowers who are able to make the initial payments can no longer afford their mortgages when the rates re-set and the payments significantly increase after two years.

Lenders have used these abusive subprime loans to strip hundreds of millions of dollars in equity from New York homeowners. Many seniors and families who had owned their homes for generations lost all of their equity and were displaced. Foreclosures have continued to increase throughout the state, and have devastated many and low and moderate income communities.

In 2005, there were nearly 7,000 foreclosure filings in New York City. By 2007, that number had doubled, to nearly 14,000, an unprecedented number. In the first quarter of 2008, there have been more than 14,000 foreclosure filings statewide. Almost a third of these filings have been in Brooklyn and Queens alone, and nearly a fourth of these filings have been on Long Island.

According to a report released by the Pew Charitable Trusts, one out of every 32 New York State homeowners is projected to face foreclosure in the next two years. As a result, the combined state and local tax base could lose \$65 billion, with individuals seeing their property values decrease by an average of \$18,000.

Although the subprime industry has touted itself as having provided expanded homeownership opportunities, it is abundantly clear that the explosion of irresponsible subprime lending has led to diminished homeownership opportunities. This is especially true since the bulk of unsustainable subprime loans have been in the refinance market, where already existing homeowners have been induced into loans that put their homes at risk.

Wall Street investment banks shoulder a huge responsibility for the subprime fiasco. Without the easy liquidity provided by the securitization process, mortgage lenders could not have continued to originate such a high volume of unaffordable and unsustainable loans. The securitization of subprime loans became so highly profitable, that investment banks aggressively marketed exotic and non-traditional products to the mortgage lenders, urging them to make a higher dollar volume of loans regardless of sustainability.

There was no incentive at any level of the process to make responsible and sustainable loans to borrowers—mortgage brokers got their fee up front regardless of affordability, lenders were guaranteed a secondary market for unaffordable loans, and the Wall Street underwriters of the securitization trusts made a killing bundling the loans and selling various creative slices of the trusts to investors. The investment banks that underwrote the trusts ignored ample evidence that the securities that they were heavily marketing to investors were built on shaky ground. Everyone profited, except the working poor and working class homeowners themselves, who were left holding the bag.

The current crisis has unfolded in large part due to a serious lack of regulation at the federal level. An increasing number of states have moved, or are moving, to fill the void by passing comprehensive legislation to curb lending abuses. Every time a state acts, the industry's mantra is that regulation of the market will dry up credit to lower income and minority homeowners. The making of unaffordable loans, however, helps no one. The reality is that rampant abusive lending practices, and not sound ones, have reduced investor confidence and shrunk credit availability. Strong state regulation will restore investor confidence, and with it, a robust secondary market.

Procedural changes in the foreclosure process are also needed to help prevent foreclosures. The industry claims that voluntary loss mitigation efforts preclude the need for legislation that would balance the foreclosure process. However, these efforts are clearly not working. A recent report from the State Foreclosure Working Group, comprised of state attorneys general and state banking regulators, found that seven out of ten borrowers are still not on track for any loss mitigation outcome, despite several highly touted voluntary industry initiatives. The Working Group specifically concluded that new approaches are needed to prevent unnecessary foreclosures.

A. The Governor's proposed bill contains two key new procedural approaches which could help to significantly reduce foreclosures in New York State.

Mandatory Settlement Conference

We strongly support the provision amending the CPLR to require mandatory settlement conferences in foreclosure actions.

For many years, the New York State courts have been a virtual foreclosure mill, with lenders putting in pro forma papers and proceeding to foreclosure unopposed. Under the current system, the vast majority of homeowners in foreclosure actions in New York State do not have any chance to go before a judge, or to be heard by the courts in any manner.

We believe, based years of experience working in the courts and from discussions with the courts, that the number of borrowers defaulting in foreclosure actions far exceeds 90%. Unlike the summons in a landlord-tenant actions, which calls on the tenant to come to court on a date certain, a foreclosure summons does not cite a court date. Instead, it advises the borrower to answer. Most borrowers, without the resources to hire counsel, have no idea how to answer in a Supreme Court proceeding. Once they fail to answer, they have defaulted, and they are not served with any subsequent court papers.

As a result, many of the foreclosure cases that could be sensibly resolved early instead proceed through the foreclosure process. As the cases proceed, fees accrue and they become more and more difficult to resolve. The provision in the Governor's program bill mandating an early settlement conference would change the dynamic of the foreclosure process by helping push the resolution of those cases where settlement is in the best interests of both parties.

Court supervision would increase the likelihood that servicers would agree to affordable loan modifications, where feasible. Generally, the securitization structure has given servicers a disincentive to work with borrowers and seek sustainable loan modifications. It costs servicers money to complete a loan modification (as cited in *Inside B & C Lending*), while servicers receive numerous fees for foreclosures. Servicers therefore resist modifications and push foreclosures, even though in most instances modification would be in the best interests of investors.

Given the magnitude of the foreclosure problem in New York State, the industry cannot credibly claim that it is a bad idea to bring the parties before the court in an attempt to mediate a rational resolution. This is a common sense provision that will help prevent foreclosures, and is something that the courts support. The provision should be amended to state specifically that the lender cannot apply for an Order of Reference until the settlement conference has been completed. This will hold down the attorneys fees charged to the borrower, thereby increasing the chances that a resolution can be achieved.

60 Day Pre-Foreclosure Notice

The provision that would require lenders to send a notice to borrowers 60 days before filing a foreclosure action also makes clear sense as a matter of public policy. It would direct borrowers to a non-profit loan counselor early on in the process, and would give the parties a formal 60-day window to work on a resolution prior to the filing of a foreclosure action. Currently, the only notice sent out that advises borrowers about non-profit assistance is served at the time a foreclosure action is filed. By this time, attorneys fees have accrued, and it is more difficult for the borrower to enter into a loan modification with the servicer. The 60-day pre-foreclosure notice will help ensure that more borrowers receive non-profit assistance in negotiating with servicers prior to the initiation of a foreclosure action. This will help to prevent foreclosures, and will reduce the number of foreclosure actions that are filed, preserving court resources.

B. The Governor’s proposed bill contains vital provisions that would curb abusive lending practices in the subprime market. However, certain provisions of the bill should be strengthened to better protect New York homeowners and prevent abuses.

It has become quite obvious throughout the country that the subprime market cannot police itself, and that strong protections are needed to curb abusive lending practices. A number of states have recently passed comprehensive responsible lending laws. The laws in Colorado, Illinois, Minnesota, Maryland, and Ohio apply most of their protections to all home loans. The laws in North Carolina and Maine apply a threshold for coverage of subprime loans that is similar to the threshold in the Governor’s proposed bill. Both houses of the Connecticut legislature just passed a bill with similar thresholds as the program bill, and it is expected to be signed soon by Governor Rell.

Thresholds

The thresholds defining coverage in the proposed bill, 3% over the comparable treasury security for a first-lien loan, and 5% over the comparable treasury security for a second lien loan, follow the thresholds recently proposed by the Federal Reserve Board, after careful and exhaustive study, to regulate higher priced loans. They accurately capture at least part of the higher cost lending market where so many of the abuses occur.

The proposed bill falls short, however, by failing to include the definition of “non-traditional” mortgages in the threshold language. Non-traditional mortgages, such as Payment Option ARMs and Interest-Only Mortgages include some of the biggest payment shocks in the market. These products are highly confusing to borrowers, and have been widely misused by unscrupulous lenders and brokers to mislead lower income borrowers into loans that they can ill afford.

Many Payment Option ARMs would not fall under the 3% over treasury threshold, because the initial teaser rates are so low. It is critical that non-traditional loans be covered because there is so much abuse in that market, and because the non-traditional market is enormous--- for example,

beginning later this year, the dollar value of re-sets for Payment Option ARMs will dwarf the value of re-sets for subprime ARMs. In New York State alone in 2007, there were well over \$2 billion in originations of non-traditional loans. Leaving out coverage of non-traditional loans creates a gap in the law. If non-traditional loans are included in the threshold for coverage, they would have to be exempted from the prohibition on negative amortization, so as not to ban them entirely (since by nature, they negatively amortize).

Under the program bill, Home Equity Lines of Credit (“HELOCs”) are specifically exempted from all of the borrower protections involving subprime loans. As a result, unscrupulous lenders can structure higher cost refinance loans as HELOCs, and circumvent the protections of the law. Many lenders have been disguising “piggyback” second mortgages as HELOCs to avoid existing lending laws, and these piggyback loans would not be covered under the current proposal. Several states such as North Carolina have included language in their laws which exempt legitimate HELOCs from coverage, but ensure that de facto mortgages disguised as HELOCs are covered by the law. We highly recommend such an approach.

Limitations and Prohibited Practices

The Governor’s program bill contains strong limitations and prohibitions, including the provisions requiring all lenders to make affordable loans; and the prohibitions for subprime loans against loan flipping, yield spread premiums, and prepayment penalties.

The program bill does conspicuously lack any kind of prohibition against steering, which is the practice of inducing a borrower into a higher cost loan than she otherwise would qualify for. Steering has been one of the biggest abuses in the subprime market, particularly where borrowers are steered to higher cost loans due to their race. Numerous studies, including a prominent one by Freddie Mac, have showed that a significant percentage of subprime borrowers should have qualified for lower cost, prime loans. A study by Senator Schumer found a significant correlation between steering and race.

The Responsible Lending Act (introduced by Assemblyman Towns and Senator Robach) contains language prohibiting steering, which could serve as a template. Several states, such as North Carolina, Ohio, and Minnesota, have passed laws prohibiting steering by requiring lenders to act in good faith and with fair dealing. Any comprehensive law addressing abuses in the subprime market should include a prohibition on steering.

The definition of “fully indexed rate”, for purposes of determining the affordability of a loan, should be strengthened. The definition in the program bill would require that lenders underwrite an ARM based on the amount of the monthly payment at the first re-set. Most ARMs, however, continue to adjust upward at regular intervals, and tend to adjust more frequently after the first re-set. Thus, a loan which was underwritten to the first adjustment could soon become unaffordable as the ARM subsequently re-set. Several states have used a definition of “fully indexed rate” which applies to subsequent rate adjustments. This definition would ensure that subprime ARMs are underwritten to be affordable, and will not lead to foreclosure within a reasonably short period of time.

Unscrupulous brokers have played a big part in the lending crisis, as they hold themselves out as acting in the interests of the borrower, but have no incentive to actually do so. In fact, the incentive has been in the opposite direction—it has been highly profitable for brokers to act against a borrower’s interest, as brokers have reaped fees by steering borrowers into higher cost loans.

The Governor's program bill contains a much-needed provision requiring brokers to act in a borrower's interest, and to act in good faith and with fair dealing. However, the provision should contain more specific language prohibiting broker steering. The provision should also require brokers to make a "reasonable inquiry" into a borrower's financial circumstances, so a broker cannot make an end run around his responsibilities by willfully closing his eyes to a borrower's existing circumstances.

The Governor's bill also contains a key provision prohibiting lenders and brokers from influencing or attempting to influence the result of an appraisal. This will help to reduce appraisal fraud, which has been central to property flipping schemes downstate and abusive refinancing schemes upstate--- and which has led many homeowners to owe far more on their mortgage than their property is actually worth.

Remedies

Although the existing provisions of Banking Law 6-1 relating to the higher cost threshold include statutory damages, the Governor's program bill does not provide for statutory damages for violations pertaining to non-conventional home loans. This is a definite shortcoming of the proposed bill. Actual damages can be difficult to prove, and statutory damages are critical to providing a deterrent against bad practices. We strongly recommend that statutory damages be added for non-conventional home loans.

The Governor's program bill provides for weaker assignee liability for non-conventional home loans than Banking Law 6-1 provides for the higher cost threshold. The existing provision in Banking Law 6-1 limits assignee liability to the amount of the underlying loan. The assignee liability provision in the program bill further limits assignee liability by adding a broad right to cure by the secondary market holder. If the assignee liability provision in the program bill is weakened any further, it would risk undermining the effectiveness of the law.

Assignee liability gives homeowners recourse against the current holder of their loan so they can effectively fight foreclosure. The securitization process has helped strip borrowers of the ability to raise defenses in foreclosure when there were illegalities in the origination. When borrowers raise defenses, the trusts typically claim that they have no responsibility for any abuses at origination--- and borrowers are left defenseless. The homeowner's only legal recourse is against the originator of the loan, which has no ability to stop the foreclosure. Many of the originators have gone bankrupt. Depriving homeowners of the right to defend against foreclosure is wrong as a matter of fairness and public policy.

Furthermore, weak assignee liability reinforces a lack of accountability by the secondary market. This lack of accountability has allowed Wall Street investment banks to purchase unsustainable and irresponsible loans without any concern for their viability or legality. This lack of accountability has created huge profits for Wall Street at the expense of homeowners, and ultimately, investors. This failure in the marketplace should be addressed by holding the secondary market liable for the loans that they purchase.

Servicer Licensing

The servicing industry has been largely unregulated on the state or federal level, and, as a result, many servicers have widely gouged borrowers, and have contributed to the rash of foreclosures through aggressive collection tactics. The section in the program bill which would require servicers

to be licensed with the Banking Department is a good first step toward reining in abusive servicers. We would recommend that the bill add a specific requirement that the Banking Superintendent promulgate regulations related to unfair and deceptive servicing practices.

Conclusion

Thank you for holding this hearing on such a critical topic. We urge the Legislature to act quickly and decisively to protect New York homeowners by passing a strong piece of legislation based closely on the Governor's program bill.