Sub-Prime Mortgage Task Force
Final Report
November 9, 2007

Submitted by:

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INTRODUCTION

In April 2007, Governor M. Jodi Rell convened a Task Force of housing, banking and mortgage lending and consumer experts to examine and make recommendations regarding the issue of sub-prime lending in Connecticut.

The Governor charged the Task Force with completing a definitive analysis of the sub-prime lending market in Connecticut, including the number of families currently holding sub-prime mortgages, the number in foreclosure, the opportunities for refinancing, and the assistance or guidance available to or needed by affected homeowners.

Governor Rell requested that Howard F. Pitkin, Commissioner of the Department of Banking and Gary E. King, President – Executive Director of the Connecticut Housing Finance Authority co-chair the Task Force. The Task Force's research, findings and recommendations are detailed within this report.

EXECUTIVE SUMMARY

The Task Force makes the following findings and recommendations, which are specified in more detail in the body of this report.

Major Findings:

- Sub-prime mortgage lending increased dramatically nationally and in Connecticut from 2001 through 2006, with underwriting standards noticeably relaxing during this period.

- Significant defaults of sub-prime loans, largely those originated in 2005 and 2006, have caused financial turmoil in the sub-prime lending industry and the tightening of credit standards for sub-prime borrowers.

- A large number of borrowers took out adjustable rate mortgages with a low initial interest rate that reset to a much higher interest rate in two years. These borrowers anticipated refinancing prior to their monthly payments increasing. However, refinancing is now often not available due to the tightening of credit standards. As a result many borrowers are now exposed to significant payment increases and possible default.

- It is estimated there are about 71,000 active sub-prime mortgages in Connecticut, with outstanding loan balances totaling more than $15 billion. Over 8% of these mortgages are now seriously delinquent.

- There is a concentration of sub-prime mortgages in communities with a higher than average number of low and moderate income households, minority households and affordable single-family housing.

- About 21,000 adjustable rate sub-prime mortgages will reset to a higher interest rate between October of 2007 and 2009.

- The single best opportunity for distressed sub-prime borrowers to obtain relief is to work directly with their mortgage loan servicer to modify the terms of their mortgage.

- The State's housing counseling infrastructure currently does not have the capacity to meet the need for counseling services that will be required to assist distressed borrowers.

Major Recommendations:

- Implement a public awareness campaign urging lenders and borrowers to work together to avoid foreclosure and maintain homeownership.

- Add capacity to the State's housing counseling infrastructure to support borrowers in this process.

- Sponsor a mortgage refinance program to assist borrowers who used a sub-prime mortgage to purchase their first home as well as mortgage programs that can serve as a reasonable substitute for the credit once available through the sub-prime mortgage market.

- Initiate regulatory, policy and consumer education and protection measures to help prevent a recurrence of the problems resulting from sub-prime lending practices of recent years.

TASK FORCE PROTOCOL

The Task Force initially met on May 3, 2007 and separated into three committees:

- Research, Analysis & Data
- Program & Product Development
- Policy, Regulation & Consumer Education

The Committee on Research Analysis and Data acquired and reviewed data and information pertaining to sub-prime lending in Connecticut. The Committees shared their results with the Task Force's other working Committees to provide an appropriate foundation for recommendations.

The Committee on Policy Regulation and Consumer Education examined how existing laws, policies and consumer education initiatives could be adapted to address the sub-prime lending problem in Connecticut.

The Committee on Program and Product Development focused measures to best assist sub-prime borrowers facing distress, default and foreclosure.

In convening and charging the Task Force, Governor Rell noted that U.S. Senator Christopher J. Dodd (D-CT) was examining the issue of sub-prime lending on the federal level as Chairman of the Senate Banking, Housing and Urban Affairs Committee. The Governor expects the work of her Task Force to complement federal efforts devoted to this issue.

The Task Force convened a public hearing on July 10, 2007. A copy of the transcript is available upon request from either the Department of Banking or the Connecticut Housing Finance Authority, and is available in electronic format with a copy of this report at www.chfa.org

The Task Force met on September 24, 2007 to conclude its work and review the proposed findings and recommendations.

RESEARCH, ANALYSIS AND DATA: A SUMMARY OF THE SUB-PRIME MARKET

Changes in the Mortgage Marketplace:

The American home mortgage marketplace has changed dramatically over the last thirty years. Traditionally, mortgage lending was undertaken by local depository institutions, such as savings and loan associations, savings banks, commercial banks and, to a lesser degree, credit unions. These institutions took deposits in their market areas and loaned funds to borrowers in the same areas in order to purchase and refinance homes. Credit decisions were often made based on a direct knowledge of local economic conditions and borrowers. Typically, the same institution would also then service the loan through maturity. Mortgage default and foreclosure matters were dealt with by a local institution with a stake in the local economy and knowledge of local conditions and borrowers. These lenders were able to manage defaults with some flexibility, balancing the financial needs of the credit institution and the borrower.

Additionally, most loans in the past were fixed rate loans with a fixed term and required a significant downpayment. Credit standards for borrowers were typically stringent by today's standards. Credit was limited to borrowers who could afford to save for their downpayment, had good credit and a proven ability to repay the loan, as well as a solid employment history. This system served the nation well; however, in order to increase homeownership, the mortgage marketplace evolved in ways that are difficult for even the informed to understand.

More specifically, innovations in mortgage capital markets over the last thirty years based on the applications of technology and product standardization opened local markets to capital raised nationally and internationally through a variety of government-backed, government-sponsored and private institutions. These institutions purchase loans from local originating lenders, pool these loans and sell shares in the pools to a wide variety of investors. Frequently, these mortgage pools and their underlying security agreements have terms and conditions which dictate levels of flexibility in managing the assets consistent with the yield expectations of various investors. Often, but not always, the local originating institution will also sell servicing of the loan to others, who are usually large institutions geographically removed from the origination market. These large institutions rely upon the economy of scale enabled by technology to efficiently and profitably service large numbers of mortgage loans.

As a result of these changes, the mortgage market infrastructure is now one in which origination, credit risk tolerance, loan servicing, delinquency and foreclosure processes and risk management decision-making are institutionally distinct. Typically, these elements of lending and loan servicing are also dispersed far and wide geographically to institutions that operate to protect their own interest according to specific and often rigid operating rules associated with large scale standardization. This is particularly true in the sub-prime mortgage market.

Sub-prime Mortgage Lending:

Sub-prime mortgages are loans made to borrowers who do not qualify for a prime mortgage loan due to income, credit, or mortgage terms and conditions. According to the Federal Reserve there are about 7.5 million first lien sub-prime mortgages in the United States, representing about 14% of all first lien mortgages. [1]

The risk factors associated with sub-prime mortgage borrowers are low credit scores, high debt-to-income ratios, high loan-to-value ratios, and often undocumented sources of income. More than one of these risk factors is usually associated with such a loan. The mortgage products offered to sub-prime borrowers include fixed-rate mortgages, adjustable rate mortgages (ARMs), interest only mortgages and hybrid products that incorporate various fixed and adjustable rate product features.

Sub-prime mortgages have been an element in the mortgage market for many years. However, this higher-risk lending increased in recent years as innovations in the technology of mortgage origination and securitization and the development of asset-backed securities markets allowed investors to better quantify and spread risk on a global basis. [1]

Developments in the mortgage capital markets allowed mortgages to be aggregated into large pools of mortgages of different levels of risk. Shares of these pools are priced according to risk and sold to investors with different levels of risk tolerance and expectations of financial return with the highest risk shares receiving the highest return.

Levels of sub-prime lending increased significantly from 2001 through 2006. Low mortgage interest rates combined with the introduction of “innovative” or “exotic” mortgage products allowed for qualification of more and more borrowers. Additional mortgage brokers and originating firms entered the market. Importantly, as the marketplace absorbed increased mortgage capital and origination capacity, credit underwriting standards relaxed in 2006 to maintain a supply of qualified borrowers.[3] By 2005 and 2006, credit underwriting standards had been loosened significantly. As a result of this high capacity and loose credit many more sub-prime borrowers were defaulting on their loans sooner, highlighting the very weak credit of many sub-prime borrowers. [4]

These early defaults have had a significant impact on mortgage banking firms, who borrow money to originate loans which in turn are sold to investors at a profit. Contracts with investors typically call for loans which default early in their payment history to be repurchased from the investor by the mortgage banking firm. The level of early defaults on recent sub-prime mortgage lending forced many mortgage banking firms into financial distress and bankruptcy either from the financial impact of the re-purchases of early defaults or restriction or loss of credit lines essential to maintaining business operations.[5]

By late 2006, the performance of loans originated during 2005 and 2006 caused originators and investors to tighten credit standards in order to improve loan quality. By the spring of 2007 mortgage investors substantially lost confidence in the sub-prime mortgage market and seriously

curtailed investing. This meant that far less, if any, funds were available for mortgage lending on terms and conditions that were widely available only months earlier. [6]

Many sub-prime borrowers have so-called “hybrid” adjustable rate mortgages which carry a very low initial interest rate typically for 2 years (some for 3, 5, 7 or 10 years). The low teaser rate then adjusts or “resets” to a much higher, usually floating, index rate thereafter. Often these mortgages were underwritten maximizing the borrower’s ability to pay at the lower initial rate. This means that the significantly increased payment at the full “reset” interest rate would be beyond the ability of the borrower to pay, substantially increasing the likelihood of default.

During a time of relatively stable low interest rates and appreciating home prices, many sub-prime borrowers with 2/28 year or 3/27 year “hybrid” adjustable rate mortgages would refinance to a new hybrid adjustable rate mortgage prior to the reset of their initial mortgage. Many sub-prime borrowers with these adjustable rate mortgages were told, led to believe, or assumed that they would be able to refinance their current mortgage at a similarly low initial period interest rate prior to reset or into another type of product. Until 2006, this scenario was true for many sub-prime borrowers.

However, the tightening of credit standards, lack of real property value appreciation and the unavailability of funding on terms and conditions available when these adjustable rate mortgages were originated has had a particularly serious impact on those needing relief from mortgage rate increases scheduled at the end of their two or three year initial period. Many sub-prime borrowers with adjustable rate mortgages are now, or will soon be, in homes that they cannot afford to pay for and probably cannot sell at a price sufficient to pay off current mortgage balances.

These factors have combined to cause significant increases in defaults and foreclosure. In turn foreclosure is expected to have ramifications beyond the loss of a home for the single homeowners. Record foreclosures may depress property values, create neighborhood instability and blight as well as place increased demand on the supply of affordable rental property.

The sub-prime crisis has been the subject of much attention in Congress, as well as by Federal and state banking regulators and supervisors. The Senate Banking and House Financial Services Committees have held major hearings on sub-prime lending. Under Senator Dodd's leadership, the Senate Banking Committee, industry representatives and low income housing advocates, agreed on a statement of principles. The statement calls for mortgage industry and sub-prime borrowers to work together on loan modifications that will allow sub-prime borrowers to remain in their homes. The goal of these principles is to preserve homeownership as well as limit overall losses to mortgage investors. (See Appendix A for this Statement of Principles)

The Federal Reserve system and other lending regulators, including the Office of the Comptroller of the Currency, The Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Association have issued an important joint statement of regulatory guidance. This guidance states that work out arrangements between the borrower and lender based on safe and sound standards are generally in the best interest of the borrower and the financial institution. In addition, these regulators have encouraged their regulated

residential mortgage servicers to work with borrowers who are unable to make mortgage payments and refer borrowers to housing counseling agencies. (See Appendix B for this Federal Financial Regulatory Agencies Final Statement on Sub-prime Mortgage Lending*)*

The State Department of Banking has urged its regulated banks to exercise forbearance prudently and will give credit for compliance with the Community Reinvestment Act for doing so.

Bond rating agencies have noted the increased use of mortgage loss mitigation techniques including loan modifications. Such agencies have indicated that loss mitigation measures can often be in the best interest of investor value and return and that investor imposed restrictions on loan modifications are generally "not beneficial" to investors. [7]

During the Senate and House committee hearings lead officials from Fannie Mae and the Freddie Mac pledged to move into the marketplace with "tens of billions of dollars" through mortgage products that would offer some opportunity for sub-prime borrowers to refinance their mortgages. However, overseers and regulators of these institutions have expressed reluctance to make changes to their current programming in order to accommodate significant discrete initiatives in this area. Implementation has been slow.[8]

More recently, the Federal Housing Administration (FHA) has made a positive contribution by announcing a new mortgage insurance initiative, "FHA Secure". FHA secure is designed to help sub-prime borrowers with payment problems arising from rate increases to obtain a new FHA-insured mortgage. This program is not suitable for all sub-prime borrowers but can offer an alternative to default for certain qualified borrowers.

Sub-prime Lending: The Connecticut Market

Governor Rell charged the Task Force to undertake a definitive analysis of sub-prime mortgage lending in Connecticut.

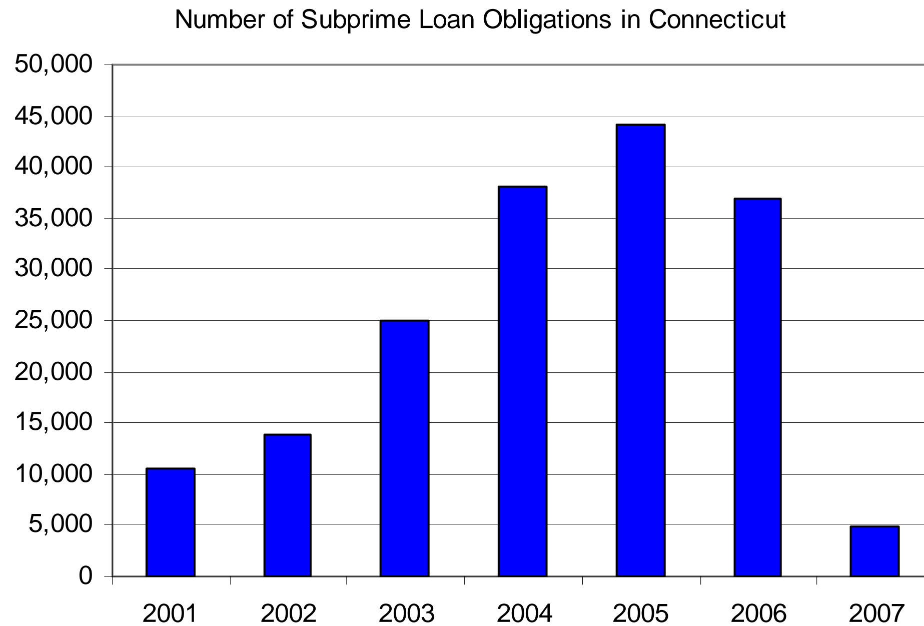
No single, current source of data provides the basis for defining the scope of sub-prime lending in Connecticut. For the Task Force to best complete its analysis of sub-prime lending in Connecticut, it considered two primary data sources, in addition to conducting an extensive review of secondary sources reporting on the sub-prime issue. The two primary data sources used in the sub-prime analysis were:

- The Mortgage Bankers Association National Delinquency Survey.
- Data purchased from First American Loan Performance.

Utilizing these two data sources, as well as other secondary reports, the Task Force compiled an analysis of sub-prime lending in Connecticut.

This analysis indicates that:

- The number of sub-prime loan originations steadily increased in Connecticut through 2006



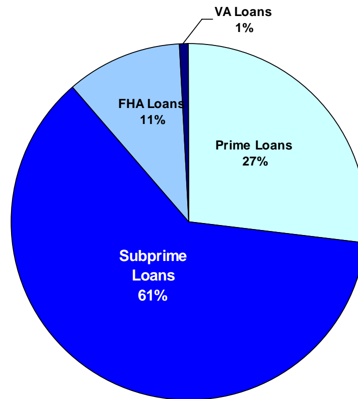
- There are about 71,000 active sub-prime mortgage loans in the state according to the data sources utilized. The Mortgage Bankers Association National Delinquency Survey indicates 66,860 sub-prime loans in Connecticut and is based on data from the 2nd Quarter 2007. The database acquired from First American Loan Performance documents just over 71,000 active sub-prime loans in Connecticut as of May 2007.
- Best estimates based on this data indicate that this total was about 13% of all active loans in Connecticut in mid-2007.

- Approximately 8.4% of active sub-prime loans in Connecticut are seriously delinquent as of June 2007, according to the Mortgage Bankers Association National Delinquency Survey.
- Connecticut has a lower percent of sub-prime loans than the national average and significantly less than several other states.
- Connecticut's delinquency rates are lower than the national average and significantly lower than some states with larger percentages of sub-prime loans.

	Number of Subprime Loans	All Loans	Subprime Loans as percent of All Loans	90+ Days Delinquent and In Foreclosure
U.S.	6,204,535	44,248,029	14.0%	9.3%
CT	**66,860**	**526,850**	12.7%	**8.4%**
ME	19,568	138,925	14.1%	11.2%
MA	92,624	800,719	11.6%	11.5%
NH	24,435	197,456	12.4%	8.0%
RI	20,826	137,492	15.1%	11.7%
VT	5,031	62,054	8.1%	9.1%
NJ	143,898	1,241,283	11.6%	8.9%
NY	291,546	2,003,013	14.6%	8.6%
PA	219,303	1,508,106	14.5%	9.7%
Illinois	228,997	1,667,730	13.7%	11.2%
Indiana	133,714	851,337	15.7%	13.8%
Michigan	220,745	1,499,090	14.7%	16.2%
Ohio	234,853	1,449,125	16.2%	16.5%
Wisconsin	66,916	596,644	11.2%	11.5%
California	824,736	5,576,654	14.8%	8.4%
Nevada	107,622	548,950	19.6%	**8.4%**
Florida	566,556	3,396,032	16.7%	8.5%

Source: Mortgage Bankers Association, National Delinquency Survey, June 2007

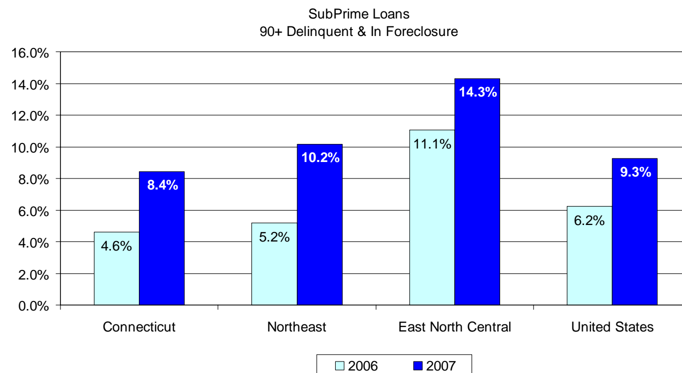
➢ Though sub-prime loans are about 13% of all loans they are about 61% of all seriously delinquent loans in Connecticut.



Source: Mortgage Bankers Association, National Delinquency Survey, June 2007

➢ Delinquency and foreclosure rates are rising throughout the country.
➢ To date, delinquency rates across the country seem to differ because of regional economic factors.
➢ Going forward, delinquencies will be affected by the growing number of adjustable rate mortgages reaching their initial reset dates.

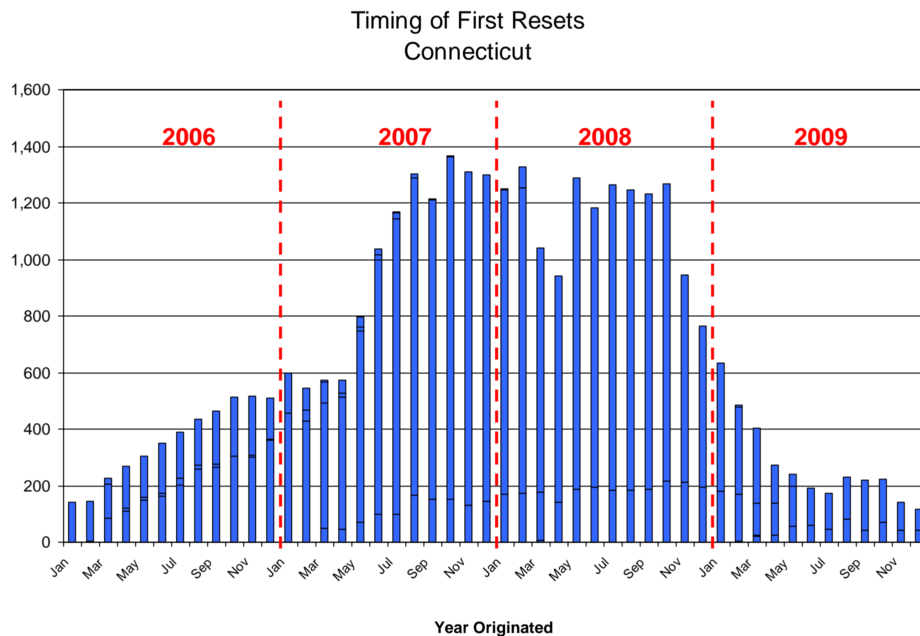
90+ Days Delinquent and in Foreclosure	Connecticut		Northeast		East North Central		United States	
	2Q 2006	2Q 2007	2Q 2006	2Q 2007	2Q 2006	2Q 2007	2Q 2006	2Q 2007
Prime Loans	0.39%	0.57%	0.43%	0.73%	1.31%	1.62%	0.75%	0.98%
Subprime Loans	4.61%	8.42%	5.19%	10.15%	11.06%	14.29%	6.24%	9.27%



Source: Mortgage Bankers Association, National Delinquency Survey, June 2007 and June 2006

- Estimating the number of sub-prime mortgage loans that will eventually be foreclosed is an uncertain and fluid question. Underlying conditions in the economy will have a substantial influence as will the extent to which current sub-prime borrowers can refinance or modify their loans.
  - Moody's Investor Services estimates cumulative financial losses due to default and foreclosure in riskier pools of loans originated in 2006 ranging as high as 16%.[8]
  - The National Center for Responsible Lending (NCRL) has provided an analysis of 2006 sub-prime originations in metro areas nationwide which indicates that overall about 20% of these originations will end in foreclosure and that this rate will vary considerably across the nation. The study's estimates for Connecticut metro areas range from 10 to 16% - generally less severe than in most other areas.[9]
  - The Mortgage Banker's Association anticipates lower foreclosure experience than projected in the NCRL study that will vary widely across the nation with local economic factors being the major determinant.[10]

- In the coming year, there will be record numbers of resets occurring in Connecticut.
  - Just over 21,000 adjustable-rate sub-prime loans in Connecticut will reach their initial reset date between October 2007 and December 2009.

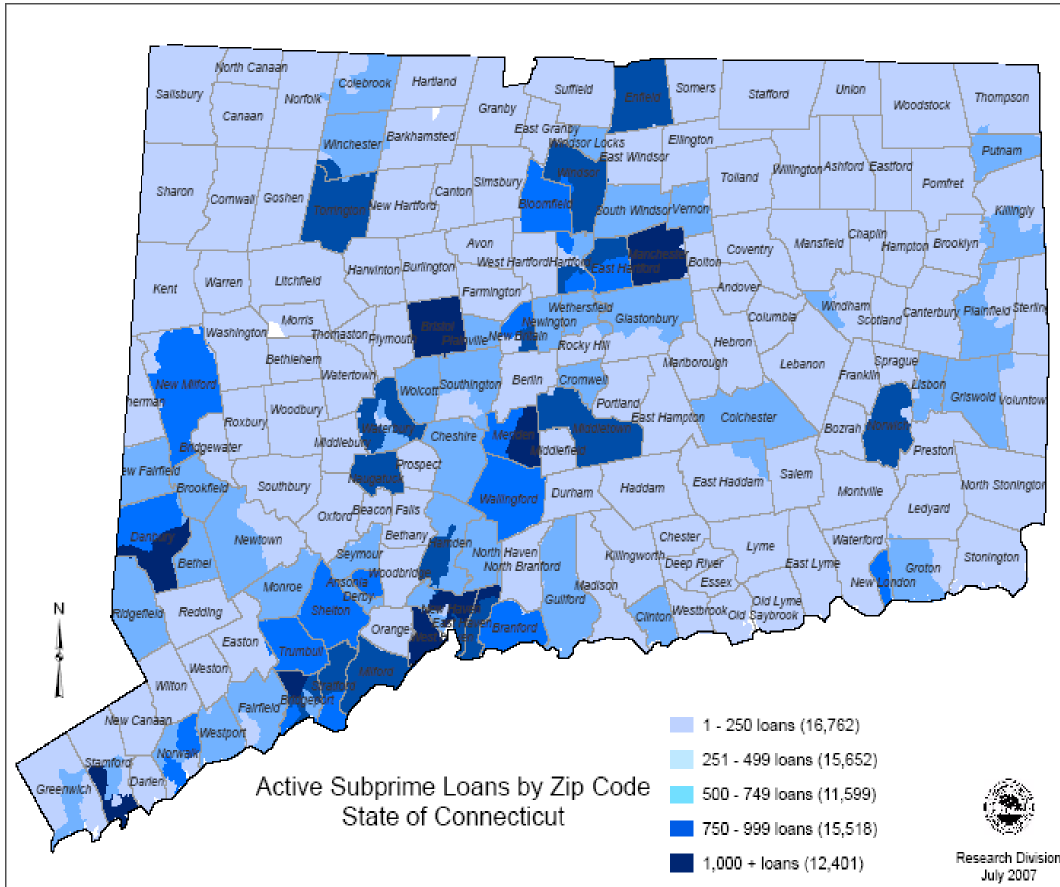


- There is a substantial concentration of sub-prime mortgages originated for purchase and refinancing in the state's major urban centers and "ring" communities.
- The following table ranks communities by the number of sub-prime mortgages.

Town	Number of Loans	Amount of Loans (x $1m)	Town	Number of Loans	Amount of Loans (x $1m)
Bridgeport	5,213	$973,907	Darien	986	$479,058
New Haven	3,998	$633,688	Milford	972	$227,776
Waterbury	3,333	$393,149	New Milford	969	$202,038
Stamford	2,599	$963,234	Naugatuck	953	$146,146
Hartford	2,573	$361,374	Norwich	953	$139,220
West Haven	1,946	$324,611	Torrington	950	$124,145
Norwalk	1,923	$636,425	Enfield	905	$124,890
Danbury	1,854	$423,527	Windsor	843	$134,336
Meriden	1,757	$240,158	Middletown	813	$121,289
New Britain	1,717	$219,963	Greenwich	776	$643,588
Easton	1,614	$360,909	Bloomfield	727	$107,252
East Hartford	1,504	$202,526	West Hartford	681	$132,830
Bristol	1,377	$194,069	Wallingford	668	$122,773
Manchester	1,126	$163,883	New London	631	$103,696
Hamden	1,064	$187,164	Shelton	610	$151,515

Source: Loan Performance, amount of loans X $1,000,000

➢ The following map shows where active sub-prime loans are located statewide.

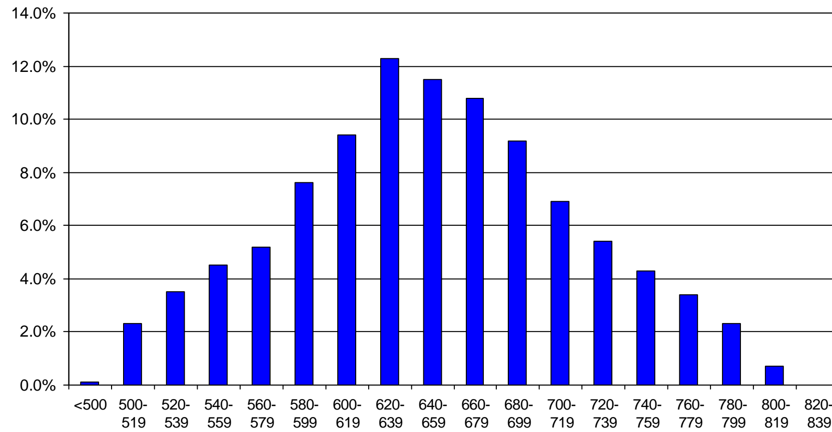


Source -- Loan Performance -- based on 71,932 mortgage loans

Prepared by: L. Zajac

➢ Connecticut's sub-prime borrowers have a wide range of FICO credit scores.

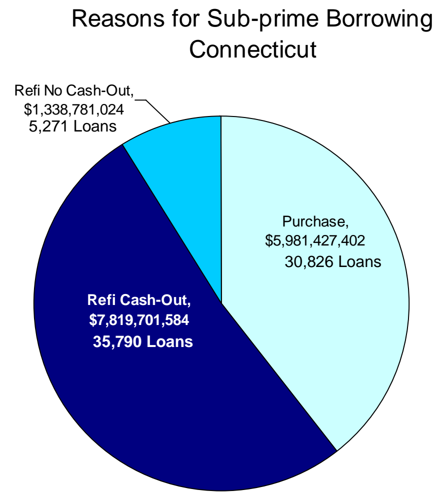
FICO Scores of Active Subprime Loans in Connecticut



Source: Loan Performance

A high FICO score suggests that a borrower may have the ability to secure alternative credit. Therefore a number of sub-prime borrowers in Connecticut, based on credit scores, may be able to refinance their sub-prime mortgages.

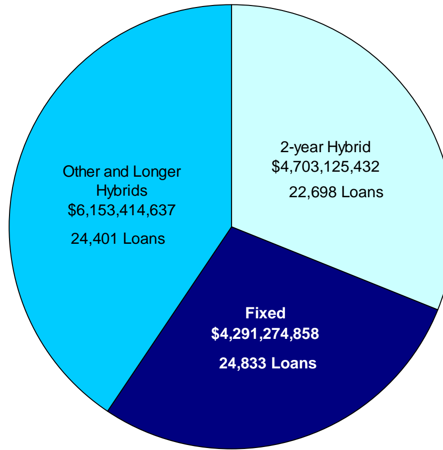
➢ Sub-prime borrowers generally obtain their loans for one of three purposes:



- "Cash-out" Refinancing: in this case, a current homeowner refinances a loan for a larger amount than their existing loan and uses the cash for another purpose, such as paying credit cards, making a large purchase or home-improvement.
- Rate and Term Refinancing: this term refers to a current homeowner refinancing for the same amount as the homeowner's existing loan in order to reduce payment or change maturity.
- Home Purchase Financing: this term refers to a homeowner borrowing to purchase either a new or existing home.

➢ There are three basic types of active sub-prime mortgages:

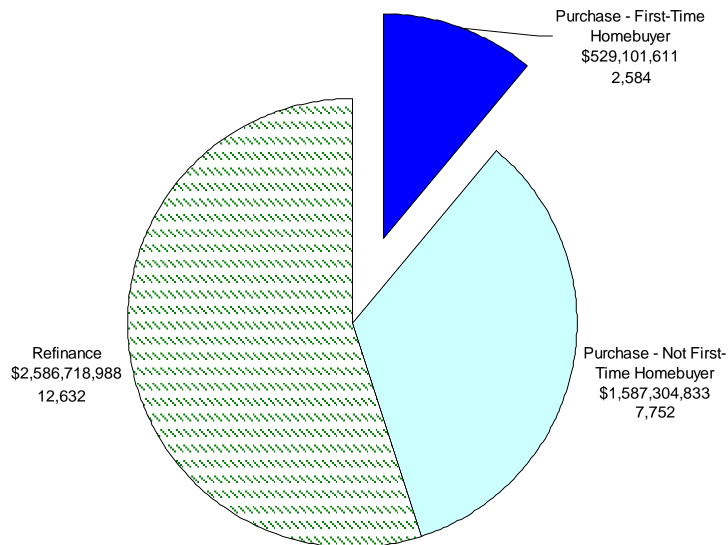
Types of Sub-prime Mortgage Loans
Connecticut



Source: First American Loan Performance

➢ The following chart shows how 2-28 adjustable rate loans were used in Connecticut.

2/28 Adjustable Loans



Source: Loan Performance & Mortgage Bankers Association

Note that about 2,500 households are estimated to have used a 2/28 adjustable rate loan to purchase their first home.

RECOMMENDATIONS

Recommendations of the Committee on Program and Product Development:

1. Develop And Implement A Public Awareness Campaign To Encourage Sub-prime Borrowers And Their Loan Servicers To Work Together To Modify, Restructure Or Refinance Their Mortgages.

   Leaders in the mortgage lending sector, financial regulators and low income advocates see loan modifications for existing borrowers through their existing loan servicers as the "biggest and best" option with the most mutual benefit. Under Senator Dodd's leadership at the Senate Banking Committee, industry representatives and low income advocates agreed on a statement of principles that supports this approach. Recently, the Federal Reserve and other lending regulators have publicly urged this approach as the best way to support the housing and credit markets affected by the fallout from sub-prime lending.

   However, many sub-prime borrowers facing substantial payment increases and possible mortgage default are reluctant to contact their servicers in order to take advantage of options that may be available, as they fear foreclosure and home loss. Many servicers may be reluctant to reach out to borrowers prior to actual delinquency to discuss modification as this type of contact has not historically been considered appropriate absent actual default.

   Connecticut's public awareness campaign must urge these parties to work together for their own best interest. By encouraging borrowers to work with their servicers this campaign would be urging borrowers to avail themselves of the option most likely to keep them in their home. By encouraging servicers to work with borrowers to keep them in their homes this campaign will help minimize overall losses to servicers and investors as well as limit the collateral damage to neighborhoods and communities.

2. Convene A Meeting Of The Leading Mortgage Servicers In Connecticut To Encourage Their Support For And Cooperation In The Modification Of Sub-prime Mortgage Loans For Distressed Borrowers.

   The support and involvement of the state's mortgage loan servicers is critical to any effort to modify sub-prime mortgages facing distress, default and foreclosure. Within their responsibility to investors, servicing firms have discretion to use loan modification and loss mitigation techniques that are well accepted in the industry. National policymakers and industry leaders have identified this as the most viable option to provide the best assistance to the greatest number of distressed sub-prime borrowers. For many sub-prime borrowers facing an interest rate reset, loan modification may be the only alternative to default and foreclosure. The State of Connecticut should convene a conference of leading sub-prime loan servicers to encourage these firms to modify loans to provide relief to distressed sub-prime borrowers as well as to coordinate efforts to implement the balance of the Committee's recommendations.

3. Expand Housing Counseling In Order To Assist Borrowers In Working With Their Mortgage Loan Servicers.

   While many sub-prime borrowers may be willing to discuss their circumstances directly with their mortgage servicers, many will not be comfortable in doing so, and may unnecessarily delay important and timely discussions with their servicers. For many others, their financial and legal circumstances will make third party counseling appropriate.

   There are housing counseling agencies in Connecticut that do a good job at pre-purchase and loss mitigation counseling. However, the scale of the sub-prime crisis has begun to overwhelm the capacity in this system. Increased capacity will be needed to successfully assist more households in "workout" transactions or in navigating the foreclosure process.

   The Committee recommends that the State, private philanthropic and mortgage industry resources fund Connecticut's housing counseling network at a sufficient level to meet this challenge.

   Effort should also be made to offer re-location counseling to residents of sub-prime properties who may face dislocation as a result of the foreclosure process.

4. Develop And Implement A New State-Sponsored Refinance Mortgage Program.

   The Committee recommends that the Connecticut Housing Finance Authority (CHFA) initiate a mortgage refinancing program to assist qualified distressed subprime borrowers.

   In developing this refinancing program, CHFA should build on the experience and success of its existing first-time homebuyer mortgage programs.

   Eligible borrowers would be homeowners of low and moderate income with adjustable-rate mortgages that have reset and:

   - the original sub-prime loan was used for the purchase of their first home
   - the appraised value of the home supports the mortgage
   - borrower income supports mortgage repayment
   - credit history indicates a reasonable expectation of repayment
   - the credit underwriting process can be fully documented, and
   - the existing sub-prime lender has agreed to financial and other concessions to enable the borrower to be eligible for the program.

   CHFA should offer this new mortgage refinancing program, utilizing government backed mortgage insurance coverage through qualified current CHFA home mortgage program originators with an emphasis on those originators who also have mortgage loan servicing operations here in Connecticut.

CHFA's basic first-time homebuyer programs offer the best alternative to sub-prime lending for low and moderate income first-time homebuyers. Funding for this program should not be provided at the expense of these programs.

5. Provide Additional Home Mortgage Financing Programs Through CHFA To Help Meet The Current Demand For An Alternative To Sub-prime Mortgages.

   Many potential borrowers currently present a reasonable credit risk, but may not be able to obtain credit due to the recent tightening of credit underwriting standards. CHFA, with its lenders network and investment banking team, should initiate the development of loan products to meet this need. For example, without adversely affecting its existing first-time homebuyer program, CHFA should consider a program to purchase existing Connecticut mortgages out of larger portfolios at a deep discount. CHFA would then be would then be in a position, when default or serious distress arises, to modify the mortgage terms and conditions to enable homeowners to afford repayment and remain in their homes.

6. Maintain And Expand The Home Mortgage Lending Programs of CHFA To Assist Low And Moderate Income First-Time Homebuyers.

   Home mortgage financing programs offered through the Connecticut Housing Finance Authority are the best alternative in the marketplace for many sub-prime borrowers. Many borrowers who used sub-prime loans to purchase their first homes may have been able to qualify for a long-term fixed rate low down payment loan through the Connecticut Housing Finance Authority. These loans have helped over 100,000 low and moderate income Connecticut households attain homeownership. Many have purchased homes in the same communities most affected by the sub-prime mortgage crisis. Maintaining the availability of these programs is an important step in maintaining the availability of mortgage credit to such households on terms that are affordable and safe.

   Current federal law through the so-called "10-year Rule" seriously limits the ability of CHFA to recycle mortgage revenue bond proceeds into new long-term fixed rate mortgages. The Committee urges the repeal of this law in order to restore the maximum possible capacity of the Connecticut Housing Finance Authority to continue to meet the mortgage credit needs of low and moderate income first-time homebuyers.

7. Continue and Expand Research on Sub-prime Lending in Connecticut.

   The Research Data And Analysis Committee of the Task Force has provided valuable knowledge regarding sub-prime mortgage lending in Connecticut. This analysis should continue as the current sub-prime mortgage crisis evolves in Connecticut. The Committee's ongoing work should be shared with policymakers, industry and consumer groups on a regular basis. This knowledge will help to inform the development and management of the continuing efforts to mitigate the effects of sub-prime lending in Connecticut over the next two years.

8. Continue Program Development Efforts To Assist Borrowers And Communities.

   Over the next two years, Connecticut borrowers and communities will continue to be impacted by developments in the sub-prime mortgage market. Some borrowers and communities will be affected more seriously than others. The Connecticut Housing Finance Authority should work with members of the Task Force and others to develop programs that could mitigate the impact of sub-prime lending in areas experiencing significant impact, particularly areas with concentrations of low income and minority residents.

9. Enhance Borrower and Homebuyer Education Efforts.

   Well informed borrowers and homebuyers are best able to protect their interest in the mortgage application, approval and closing processes. Educated consumers are the most effective means of limiting abusive and misleading practices in the mortgage marketplace. State housing and banking agencies in cooperation with licensed mortgage lenders, real estate licensees, housing counseling agencies and consumer advocates should evaluate current borrower and homebuyer education efforts and recommend improvements.

Recommendations of the Committee on Policy Regulation and Consumer Education:

1. Increase Surety Bond Requirements For Mortgage Lenders And Brokers.

   Under Connecticut banking law, a mortgage licensee is required to have a surety bond in the amount of $40,000 to protect borrowers or prospective borrowers from a licensee's failure to perform its obligations.

   The Committee recommends the current surety bond requirement for brokers and lenders be increased from $40,000 to $60,000 to adjust for inflation and current market conditions. While 31 states have lower bonding requirements, $25,000 or less, the committee agreed an increase would be appropriate to afford additional consumer protection.

   Considerable discussion took place concerning the right to file a claim against a bond and the time within such a claim must be filed. To enhance the ability of the public and the Department of Banking to collect a claim made against the bond, the Committee recommends that consideration be given to using the type of surety bond currently used by the Department of Motor Vehicles (DMV). DMV has the authority to file a surety claim on behalf of the consumer. This type of bond could allow the borrower recourse to compensation and recovery of losses due to fraud or violation of lending laws by originators. Presently borrowers' recourse is limited to a civil suit for compensation and damages.

2. Increase Net Worth Requirements for Mortgage Lenders and Brokers.

   Currently, the Department of Banking requires mortgage brokers and lenders to maintain a tangible net worth of $25,000 and $250,000 respectively. The Committee recommends the broker requirement be increased from $25,000 to $50,000 but the lender requirement remain at $250,000. The Committee also recommends companies who are currently licensed be grandfathered over a 2-year phase in period. Subsequently, all licensees would need to meet the proposed new requirement.

3. Strengthen State Background Checks For Those Seeking Licenses And Registration As Mortgage Professionals.

   Since 1985, the Connecticut Department of Banking has performed background checks on individuals applying to be licensed in the mortgage industry. Unfortunately, because these checks only include Connecticut State Police records, an applicant's conviction in another state will not show in the report. This omission is particularly important in view of the fact that the mortgage business, in large part, is headquartered outside of Connecticut.

   The Committee recommends immediate expansion of background checks to include the use of Lexis Nexis Accurint system, on an interim basis. This will enable the Department of Banking to obtain national information on all applicants for licenses and originator registrations pending Connecticut's participation in the national mortgage licensing system.

4. Develop And Implement Training And Education Requirements For Mortgage Professionals.

   Despite being licensed by the Department of Banking, there are currently no requirements under Connecticut Law for training of lenders, brokers or originators. Accordingly, the following training requirements should be adopted for persons with supervisory authority who work with regulated entities and for mortgage loan originators:

   - Up to forty hours of pre-licensing training;
   - Up to eighteen hours of continuing education, every two years, prior to license or registration renewal;
   - A competency examination with a minimum passing score prior to obtaining a license or registration; and
   - Exemption for current licensees from the initial forty-hour training requirement, provided they pass the competency examination.

5. Issue Mortgage Underwriting Guidelines Through The State Department Of Banking.

   There is a need to revisit some basic underwriting standards and practices used in mortgage origination. Guidelines currently being used by non-bank mortgage licensees need to evolve to a safer standard in the interests of the public, the industry, and local and state economies.

   The following standards are recommended as underwriting guidelines:

   - Qualify borrowers at the fully indexed rate of interest and payment to eliminate future payment shock;
   - Include property taxes, homeowners insurance and condominium fees, if appropriate, in the debt-to-income ratio calculation;
   - Base the loan approval on the borrower's ability to repay the obligation, not the value of the collateral property; and
   - Use higher risk "stated income" loans only when there are mitigating factors to support the borrower's repayment capacity.

   It is the opinion of the Committee that guidelines be developed for underwriting instead of regulation or law because the standards change dynamically with the expansion and contraction of credit through economic cycles.

   The Conference of State Bank Supervisors (CSBS) has done considerable work in developing guidance for both sub-prime lending as well as examination guidelines for state banking departments. Further, in November 2006, the Department of Banking sent to all licensees the "Guidance on Non-traditional Mortgage Product Risks" developed by CSBS. In June 2007, the Interagency Guidance on Sub-prime Lending was issued which listed characteristics of sub-prime ARM products, elements of predatory lending and prudent underwriting guidelines. Nearly all of the underwriting issues discussed by the Committee are addressed in these guidelines. The Banking Department is in the process of adopting the Interagency Guidance on Sub-prime Mortgage lending. (See Appendix G for a copy of Guidance on Non-Traditional Mortgage Product Risks)

In addition, during July 2007, CSBS, The American Association of Residential Mortgage Regulators and The National Association of Consumer Credit Administrators adopted "Model Examination Guidelines" to be used during the supervisory examinations of non-bank lenders by each regulator. The Committee recommends these also be sent to the industry and used by the Department in its supervisory role. (See Appendix I for these "Model Examination Guidelines")

6. Limit The Use Of "Low Documentation" Or "No Documentation" Mortgage Loans.

   The Committee recommends limiting the use of low-documentation or no-documentation loans. Prudent underwriting of loans takes into consideration the capacity of the borrower to repay the obligation, the credit rating, and the value of the collateral. Sub-prime lending, in contrast, puts less emphasis on these elements than does conventional underwriting. Such relaxed underwriting, when coupled with a limited documentation or no documentation program, results in even greater risk. In the view of the Committee, it is irresponsible to layer this much risk, either for the borrower or the lender, inasmuch as layered risks increase the chances of delinquencies and foreclosures.

7. Strengthen Mortgage Disclosure Requirements.

   The mortgage closing process is complex and involves numerous and lengthy legal forms, disclosures and agreements. Consumers in general seldom understand all of the forms being signed. Further, unsophisticated consumers, or those who use English as a second language, are at a distinct disadvantage in the mortgage loan closing process. The Committee acknowledges that the disclosure laws are generally under the purview of the federal government; however, the State could require plain language disclosures that would be "consumer friendly." The Committee recommends consideration of the following:

   - Simplify disclosures and put in language of borrower, if possible;
   - Disclose the highest potential payment over the life of the loan;
   - Disclose prepayment penalties and any other terms that will affect payments and payoff of any loan;
   - Require that sub-prime borrowers' taxes and insurance payments are escrowed as part of the loan agreement;

   It is anticipated and hoped the upcoming revisions to Federal Regulations implementing the Real Estate Settlement Practices Act (RESPA) will address these issues. The Department of Housing and Urban Development anticipates that these regulations will be promulgated in late 2007.

8. Enact A Connecticut Mortgage Fraud Statute.

There are basically two types of fraud in residential mortgage lending. *Fraud for housing* is the consumer who is committing the fraud in order to obtain the mortgage financing. In contrast, *fraud for profit* involves loan flipping schemes, equity skimming, or bait and switch tactics, strategies often perpetrated by the lender.

Although criminal fraud statutes exist and are generally applicable to fraud involving residential mortgages, the enactment of a mortgage fraud statute would serve as a loud warning and deterrent to potential perpetrators of mortgage fraud. Though other views were expressed, a majority of the Committee believes all parties to mortgage transactions, including consumers, should be covered by such a statute. Accordingly, the Committee recommends the enactment of a criminal mortgage fraud statute covering all perpetrators of mortgage fraud, who demonstrate criminal intent, including but not limited to lenders, brokers, attorneys, real estate agents and brokers, appraisers and borrowers.

9. Implement Foreclosure And Loss Mitigation Initiatives.

The Committee recommends additional emphasis be placed on financial education of sub-prime borrowers. Tools that educate borrowers and non-profit housing counselors on financial literacy such as CreditSmart®, a multi-lingual curriculum created by Freddie Mac, need broader exposure. CreditSmart® includes instruction on homeownership preservation, foreclosure prevention, planning for emergencies, property maintenance and avoiding financial traps.[11] The Committee concurs with other recommendations in this report and also recommends the following:

- Permit an option to cure default by partial payments or to bring loan current[12].
- Establish a major publicity campaign for the United Way 2-1-1 hotline. The Governor issued a press release on May 21, 2007, promoting the use of this resource. This number connects people with important community services including volunteer opportunities. 2-1-1 will help people find help, including housing assistance.
- The Department of Banking created a foreclosure hotline for impacted consumers. In August 2007, Governor Rell announced the establishment of a Mortgage Foreclosure Assistance Hotline. Connecticut Residents facing foreclosure on their homes should call 1-877-772-8313 (toll free) to receive advice and guidance concerning their mortgage problems.
- Provide increased state funding for housing counselors to work with borrowers facing ARM resets and foreclosures.
- Increase attorney participation in housing mortgage pro bono work by targeting retired and new attorneys

The Committee discussed other loss mitigation approaches aimed at ownership sustainability. One such program involves a third party, such as a housing development corporation that purchases the home of a defaulted sub-prime borrower either through a short or foreclosure sale. The corporation or other entity leases the property back to the former sub-prime borrower. The former sub-prime borrower would have a pre-established schedule to repurchase the property, enabling credit to be re-established. Terms of an agreement governing the transaction would be negotiated to the satisfaction of both parties. Purchases from the mortgagee would be made at a substantial discount to market value. If the homeowner cannot, or declines to take financial control and repurchase the home, the property is sold into the marketplace. The benefit of this program is property value preservation by avoiding vacancies for borrowers who cannot refinance into alternative mortgage programs. This type of program is designed to "save" a tier of homeowners that cannot otherwise obtain suitable financing but who may recover financial stability with counseling, time and changed circumstances.

ENDNOTES

[1] Speech of Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System at the Federal Reserve Bank of Chicago's 43rd Annual Conference of Bank Structure and Competition, Chicago Illinois, May 17, 2007.

[2] Ibid

[3] Testimony of Warren Kornfield, Managing Director Moody's Investor Service Before the Subcommittee on Securities, Insurance and Investment United State Senate, April 17, 2007.

[4] Moody's Investor Service, "Special Report – Early Defaults Rise in Mortgage Securitization", January 18, 2007; Moody's Investor Service, "Special Report – Challenging Times for the US Sub-prime Mortgage Market", March 7, 2007.

[5] For an illustrative example see "Behind Bravado: Certain Doom – A Connecticut Lender's Crash Foreshadowed The Sub-prime Implosion" by Kenneth R. Gosselin, Hartford Courant, Spetember 16, 2007.

[6] Testimony of Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, "Sub-prime Mortgage Lending and Mitigating Foreclosures" before the Committee on Financial Services, U.S. House of Representatives, September 20, 2007; Testimony of Harry Dinham, CMC, Past President – National Association of Mortgage Brokers on "Legislative and Regulatory Options for Minimizing and Mitigating Mortgage Foreclosures" before the Housing Financial Services Committee United State House of Representatives, September 20, 2007.

[7] Moody's Investors Service, "U.S. Sub-prime Mortgage Market Update; April 2007" April 20, 2007; Fitch Ratings, "U.S. Residential Mortgage Special Report: Changing Loss Mitigation Strategies for U.S. RMBS", June 4, 2007.

[8] Moody's Investor Service, "U.S. Sub-prime Mortgage Market Update: July 2007, July 24, 2007.

[9] "Losing Ground: Foreclosures in the Sub-prime Market and Their Cost To Homeowners", Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, Center for Responsible Lending, December 2006.

[10] "CRL Report Doesn't Show the True Picture of Sub-prime Role in Homeownership", Statement of Mortgage Bankers Association, fact sheet accompanying statement of John M. Robbins, CMB, Chairman of the Mortgage Bankers Association, March 27, 2007.

[11] Boerger, Patti. "CreditSmart© Now Features Homeownership Preservation Materials" FreddieMac, June 28, 2007

[12] The Committee had not ascertained the legal implications of this recommendation, but agreed that it would help reduce foreclosures. In lieu of this requirement, one option would be to obtain the servicer's commitment to delay foreclosure for 30-60 days until the mortgagor can obtain assistance from a non-profit housing counselor to mitigate the loss with a possible loan modification.