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“A Call to Action on the Subprime Mortgage Crisis: Putting Common Sense Ahead of Ideology”

Remarks by Senator Charles E. Schumer on the State of the Economy
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I'm honored to be here today with my friend and an outstanding former Treasury Secretary, Larry Summers. And I want to thank the hard working, talented staff and leadership of the Brookings Institution for holding this and so many other important discussions on the state of our economy and our nation. In particular, I want to thank our moderator, Doug Elmendorf; and so many of the scholars in residence at the Institute.

Larry has done a great job laying out some of the serious problems facing our economy and the steps we need to take to stave off the dreaded R-word – Recession.

I want to talk a little more in depth about the subprime mortgage crisis. The subprime crisis has become a symbol of the Bush Administration's serious mishandling of so many economic and domestic policy priorities. The administration's ham-handed efforts in the wake of Hurricane Katrina became a metaphor for its inability to manage the government. And unfortunately, the housing mess, which has hit homeowners and neighborhoods with too many foreclosures, credit markets with mountains of debt, and the economy with weak job and economic growth, is further evidence that this administration is ideologically handcuffed, and cannot step up to the plate to solve major problems.

As our country teeters on the edge of recession for the first time since 1990, the Bush administration is just whistling into the wind. They seem to be unable to get the government moving quickly, decisively, and competently to address a serious economic crisis. It is this irresponsible inaction, attributable to their ideological opposition to government action, that has exacerbated the steep economic challenges we are now facing.

And our housing problems have rippled through the economy. The fact is that economic contagions are difficult to contain – it's not like a bottle of water, it's much more like a pond

where ripples start and can spread quickly. The initial ripple from the spike in subprime foreclosures moves outward to cause additional and larger ripples that are bigger and cover more of the pond. The subprime ripple leads to another ripple of lower housing prices and a credit crunch for banks and financial markets. Another ripple driven by consumer anxiety causes lower consumer spending, which makes up nearly two-thirds of our economic growth, and leads to an even larger ripple that may end up causing a recession.

Because of the administration's unwillingness to act, we are teetering on the brink of recession. This outcome could have been avoided. There is no doubt that an economic slowdown could have still occurred, but the administration's inaction could spell the difference between an economic slowdown and a full-blown recession.

FOUR MYTHS SURROUNDING THE SUBPRIME CRISIS:

I want to focus for a few minutes on the four myths surrounding the administration's limited response to this crisis and then I want to spend some time talking about the seven steps we need to take to get a handle on this crisis and hopefully avert a recession, or at least prevent a prolonged or debilitating recession.

1. The Myth of Vastly Expanded Home Ownership from Subprime Lending

The first myth is that most of this subprime lending led to millions of brand-new, first-time homeowners in America. The fact is that only a small percentage of subprime borrowers were first time homeowners. According to the chief national bank examiner for the Office of Comptroller of the Currency, only 11 percent of subprime loans went to first-time buyers last year. The vast majority were refinancings that caused borrowers to owe more on their homes under the guise that they were saving money. Too many of these borrowers were talked into refinancing their homes to gain additional cash for things like medical bills. Other subprime borrowers were homeowners that simply moved to another house; and too large a percentage went to investors and speculators. And the truth is, after this subprime crisis blows over, there will be a net loss of homeownership in this country.

2. The Myth of the Unqualified Borrower

The second myth is that subprime borrowers couldn't have qualified for better loans, and thus that the subprime market is the only place they could have gotten a mortgage. A corollary follows that these people can't be helped by the government or refinancings. But in truth, many of these people were PRIME borrowers. I had been talking about this myth for months, but policymakers ignored it, which is a major reason they wouldn't act to solve this problem.

Finally, to its credit, the *Wall Street Journal* did a study confirming what I, and others like Martin Eakes at the Center for Responsible Lending had been saying for so long – a majority of subprime borrowers would have qualified for a conventional prime-rate loans. Based on the Journal's analysis of borrowers' credit scores, 55 percent of subprime borrowers had credit scores worthy of a prime, conventional mortgage in 2005. By the end of last year that percentage rose to over 61 percent according to their study. While some will have damaged their

credit in the interim, it's clear that many subprime borrowers have the financial foundation for sustainable homeownership, but may have been tricked into unaffordable loans by unscrupulous brokers.

3. The Myth that Borrowers Can Easily Obtain Perfect Knowledge of The Terms of Their Mortgage Loans

When market participants have full knowledge of transactions, the results are efficient. But we have known since shortly after Adam Smith that they do not function well when important information is lacking. We make a great mistake when we accept the myth that the borrowers in mortgage markets are fully informed. The truth is that almost no one reads his entire mortgage document's fine print, few hire special real estate lawyers to walk them through the home purchase, and frankly, many borrowers were tricked or duped into bad loans by unscrupulous brokers and lenders.

Some ideologues blame the borrowers, and while that might make them feel better, it does nothing to solve this problem. That ideology is straight out of the 1890's and the early 1900's.

4. The Myth that the Free Market Alone Will Fix Everything

This administration is wedded to the philosophy that government should take a hands-off approach to governing and to dealing with economic crises. This crisis has been no exception. The myth that left to their own devices, free market forces will correct the disruptions caused by the subprime crisis has caused us perhaps the most economic pain because it has allowed the subprime crisis to wreak havoc in other areas of the economy.

Throughout the course of this year, the administration and its financial market regulators have repeated time and time again that the subprime crisis would be contained and mitigated by the strength of the U.S. economy.

Then, in August of this year, we began to witness the beginnings of a severe credit crunch in the U.S. credit markets that forced financial institutions to limit the amount of loans that they offered to individuals and companies.

As the administration looked on, the credit crisis trickled into the Alt-A and prime mortgage markets, pushing up mortgage rates for borrowers with even the best credit.

The tightening of lending and lack of confidence in credit quality has led to shrinking investment and consumption, and a slowdown in economic growth.

And the fallout wasn't limited to the U.S. We may even see a downturn in the global economy, as Secretary Summers has warned.

Today, the crisis is fueling a housing downturn that will hit every American family where it hurts the most – their equity. And as a result, we are facing an economic downturn that we haven't seen in this country since the Great Depression.

Economists like Robert Shiller estimate that a 10 percent decline in housing prices could lead to an overall \$2.3 trillion economic loss at a time when this country can least afford it. \$2.3 trillion in economic losses!

Unfettered free market forces did not contain this problem within the subprime segment of the housing market. Far from it. And the laissez-faire philosophy that allowed this crisis to spread far and wide won't get us out of this mess, either. Just ask my friend, Frank Ruggiero.

Frank Ruggiero was not a new homeowner. Frank Ruggiero had a steady income and reasonable credit, he could have qualified for a prime loan. Frank Ruggiero did not have perfect knowledge of his loan. He trusted his broker to give him accurate information. The free market did not save Frank's home. His family lost the home thanks to the unaffordable subprime loan foisted on him by an unscrupulous broker.

Critique of Administration and Federal Reserve Proposals

First let me say that I believe that left to his own devices, Secretary Paulson, freed of this administration's ideological handcuffs, would have acted more forcefully and quickly in the face of this crisis.

The bottom line is that the administration's rate freeze plan might have been a good first step last spring, but now it is too little, too late, and too dependent on the voluntary goodwill of the private sector. The keystone of the plan is a five year rate freeze that may help some homeowners, but most estimates state that only 5 to 10% of homeowners are likely to be eligible for the freeze. Based on the Administration's own numbers, this means that as few as 90,000 borrowers may receive a rate freeze. When we're facing as many as 2.2 million foreclosures over the next two years, dealing with only 10% of the borrowers at risk is simply not good enough. Those who don't qualify will have to work their way through the financing maze. The message to homeowners – "You are on your own."

The plan doesn't help the borrowers that need it most:

It doesn't help borrowers who have had their rates reset and have missed a payment already. These are the borrowers most in need of assistance, and they are ignored completely by the Administration's plan.

It doesn't help homeowners like Mrs. Ada Diaz of on Staten Island who I met as I traveled New York talking about this issue. She was put into an unaffordable loan several years ago and has already been foreclosed on and is left to fend for herself by this administration. There are 230,000 Americans who have already lost their homes to foreclosure in 2007 alone. This plan does nothing for them.

It doesn't help homeowners who were duped into their loans outside of the plans arbitrary start and end dates. Only homeowners with short term ARMs originated between January 2005 and July 2007 are eligible. This means that if you were convinced by an unscrupulous broker or

lender into refinancing your home back in December 2004, or as late as August 2007, you're out of luck.

Because the plan is voluntary, and each servicer can set his own eligibility criteria, many borrowers may get help, but many others could easily be excluded. Given the direct and indirect costs of this wave of foreclosures, this is a chance we cannot take. As I said before, we cannot rely on the same people who created this crisis to solve it.

The plan also suffers from a lack of transparency. Servicers don't need to report how many workouts they are doing, or what kinds of workouts they are doing. So we are supposed to rely on their good intentions and assurances, rather than any objective data to determine whether this plan is actually working.

Now you may hear the Administration and its allies claiming that this plan could help 1.2 million homeowners. But if you listen closely, what they are saying is that out of the estimated 1.8 million mortgages that will reset in 2008-2009, there are an initial 600,000 who are likely to default and have no hope of any government help. The remaining 1.2 million homeowners may be able to afford some kind of mortgage, somewhere, if someone chose to provide it.

With 3.5 million foreclosures predicted over the next three years according to the Center for Responsible Lending, this plan falls far short of what is needed to help American families. Independent experts have predicted that the plan may only help 145,000 households. Secretary Paulson has repeatedly stated that this plan isn't a silver bullet. I'd say that's an understatement.

Yesterday, another disappointing policy response came from the administration. The Federal Reserve offered its own revisions to regulations governing mortgage lenders in response to this crisis. While the announcement borrows some good provisions from a Senate bill I've introduced to hold mortgage brokers and lenders accountable, the Federal Reserve almost instinctively has avoided grabbing the bull by the horns and dealing in a forceful way with this serious problem.

This is a clear signal that Congress must act immediately to pass legislation that is now pending in the Senate Banking Committee that would regulate the Wild West of subprime lending, ban abusive lending practices, and prevent this crisis from happening again

SEVEN POLICY OPTIONS TO ADDRESS THE SUBPRIME CRISIS:

So how can we avert these serious losses and keep the economic train off of the recession tracks? Many in the administration continue to stand by and say "do nothing", or "let the market take care of itself." These ideological handcuffs are binding this administration and preventing it from dealing with this problem effectively. Ideologues from either side have always been poor at solving real, practical problems because they place ideology above pragmatism, and this case is no different. The American people want their government to help. Not haphazardly -- but with smart, targeted commonsense solutions to help the nation navigate this crisis.

As I mentioned, we know that a majority of the people who took out subprime loans over the past few years were at one time prime borrowers. This means that they have the capacity for homeownership, and we need to find a way to help them keep their homes and resolve this crisis. There are seven serious ideas that should be implemented by the administration, the regulators, and Congress, to help alleviate this crisis and ensure that it does not happen again.

First, to alleviate the current crisis, we must ensure that there is somebody on the ground to help out struggling borrowers. The days when borrowers could turn to their neighborhood bank officer are over. Many borrowers received their loans from mortgage brokers or other lenders who are long gone. They sold the loan into the secondary market and left town. Borrowers need somebody on their side to help them deal with their mortgage problems.

Housing counseling agencies are already working on the front lines of the foreclosure tsunami. Through their relationships within the community and with lending organizations, they are able to bring troubled borrowers and their lenders together to begin working out mortgage problems.

Too often borrowers are frightened by the prospect of delinquency or foreclosure and are afraid to contact their lenders. These counselors serve as a borrower's advocate, helping them navigate the complex loss mitigation process.

However, these agencies are being overwhelmed by the magnitude of the current crisis. Most are experiencing record requests for assistance and are desperately in need of additional funding to hire and train more counselors.

Senators Brown, Casey and I, with critical help from Senator Murray got \$180 million in the omnibus appropriations bill that passed last night, over the Administration's objections, for foreclosure prevention counselors, but more resources are needed.

We also must ensure that there is enough available money for borrowers to refinance. The credit crunch has restricted access to refinancings, a problem that must be corrected if we are going to be able to help people save their homes.

So, second, I propose that we provide additional flexibility to Fannie Mae and Freddie Mac to provide liquidity to the markets. These companies were created expressly for this purpose. They are not entirely private sector actors, and cannot behave that way. They have an obligation to get more involved in distressed markets, like the ones we are facing now, to provide liquidity and help troubled borrowers.

Fannie and Freddie say that this won't be a profitable business for them. I say "too bad". Even if involvement in subprime refinancings will impact the GSEs bottoms lines, they have a critical and urgent role to play in times of market crisis. Fannie and Freddie have a government guarantee and they, and their shareholders need to recognize that in troubled times, they are expected to step up to the plate.

I have introduced legislation that would temporarily raise the portfolio caps for these organizations by 10%, with 85% of the increase targeted towards refinancing subprime

borrowers. This kind of targeted help, although potentially more risky for the GSEs, is why they were created in the first place.

I have also introduced legislation that would raise the conforming loan limits for the GSEs. This proposal has the support of Secretary Paulson, as well as Chairman Bernanke. This conforming loan limit increase would allow the GSEs to buy so-called “jumbo” loans, and provide liquidity to this segment of the mortgage market, which has suffered tremendously during the credit crunch. This is especially important in high-cost areas like New York and California, where average homes are priced out of the GSEs portfolios because of the low loan limits currently in place. This proposal will help alleviate the liquidity crunch in the jumbo loan market.

Third, I will be introducing new legislation to provide additional liquidity to the markets. This legislation will temporarily allow states and localities to use single-family tax-exempt bonds—known as Mortgage Revenue Bonds or MRBs—to refinance subprime loans at risk of foreclosure. Currently, mortgage refinancing is not permitted under the MRB program. Fixing that is a good idea.

The Administration has proposed that we provide a temporary, three-year increase in the volume cap that limits state issuance of MRBs and other qualified private activity bonds. Treasury officials tell us they had \$5 billion a year in mind, but that doesn’t go nearly far enough, and it ignores one key fact: The reduced homeownership that is a result of the subprime crisis means we also need more money to go towards multifamily rental housing. The Administration’s insistence that all of the increase in the volume cap go towards single-family housing is not ideal for areas that have been hit hardest by the subprime crisis, like Buffalo, Albany, Cleveland and Detroit. As we address this crisis, we need to be thinking about affordable rental housing, or we will be addressing only half the problem.

So I will be soon introducing a bill that takes the Administration’s proposal and expands on it, by doubling the amount of increased bond cap they are proposing, making a portion of the increased cap permanent, and giving states and localities the flexibility to respond to a wide range of mounting housing needs. Demand for affordably priced, sustainable housing has gone through the roof in New York and all across the country, putting even greater pressure on state caps. We shouldn’t be asking jurisdictions to take on subprime mortgages when they can’t begin to meet their other housing needs with the resources available to them.

In short, it would be a big mistake to tie the hands of the states. I will insist that any increase in bonding authority allow some of the money to go towards rental housing, as well as foreclosure relief. These problems are two sides of the same coin, and must be addressed together.

My fourth proposal addresses the many subprime borrowers who won’t qualify for refinancing. These borrowers may have damaged credit, have lost some income or have loans that are greater than the value of their homes. Judicial loan modifications through bankruptcy could be a highly effective tool for helping families recover from this situation. However, today’s bankruptcy code prevents courts from modifying the terms of a primary mortgage loan. In fact, the law singles out the home mortgage loan as the one debt the courts are not permitted to modify.

To address the subprime crisis, Senator Durbin has proposed legislation that I have cosponsored to amend the bankruptcy code to make primary home loans eligible for the same remedies that are available on other, less important debts. This would allow borrowers to pay the fair market value for their home and to keep that home, rather than seeing the home sold to a third party for its liquidation value.

I recognize that there are some concerns surrounding the idea of changing the bankruptcy code, but given the magnitude of the crisis we are currently facing, and with estimates that this proposal could help over 600,000 borrowers, this is something that we should seriously pursue.

The House has recently passed a narrower, compromise version of this legislation that only allows current homeowners to take advantage of this new protection in the bankruptcy code, which is an approach that the Senate can and should consider early next year.

None of these approaches is a silver bullet, but taken together, they can provide a significant amount of relief to the 2.2 million American homeowners at risk of foreclosure over the next couple of years.

In addition to alleviating the effects of the subprime market collapse, we must also be sure to correct the problems in the mortgage markets that allowed this crisis to develop in the first place. My last three proposals deal with reforms to both the primary markets in order to protect individual homeowners and to the secondary mortgage markets to ensure the stability of the financial markets.

My fifth proposal is to enact major reforms to the rules that govern the mortgage lending industry, improving the regulation of mortgage brokers and non-bank lenders. In May, I introduced the first legislation to do that. Since that time, there have been a number of similar bills in the House and Senate, including Senator Dodd's recently introduced bill, which I have cosponsored. All of this legislation is based on the same basic principle, that the incentive structure in the mortgage industry has changed to favor quantity of originations, rather than quality, which has led to looser underwriting standards and inappropriate lending.

In order to correct this, legislation must impose new standards of care for mortgage originators, create a requirement that originators consider a borrower's ability to repay a loan, prohibit appraisal fraud, reduce or eliminate "liar loans", eliminate prepayment penalties and create effective remedies so that borrowers who do receive predatory or fraudulent loans have some recourse to restore their financial health. I plan on working with my colleagues in the Senate in the coming months to ensure that we enact strong legislation to protect borrowers in the future.

It is also important to make sure that borrowers understand the mortgage documents that they are signing so that they cannot be duped, as we saw happen too often over the last few years. My sixth proposal is to create an easy-to-read one-page disclosure form with all of the information that a borrower needs to make an informed decision on their mortgage. I also introduced legislation to require the banking regulators to create such a form. This information will give borrowers a clearer picture of the agreement that they're signing and allow them to more easily compare loans to ensure that they get the best deal.

Finally, my seventh proposal is to closely examine the role of that the rating agencies played in the explosive growth, and subsequent problems of the secondary mortgage market. One of the major factors of the subprime story has been how the risks associated with subprime mortgages and the related securities were so drastically underestimated by the credit rating agencies. One potential reason for this, which I think merits closer examination, is the potential conflicts of interest that result from the fact that most rating agencies are paid by the companies they rate rather than by the investors who use the ratings.

Until the 1970s, all of the credit rating agencies were funded by the investors. Investors care the most about the independence of the credit rating analysis, the integrity of the evaluation of credit quality, and the timely review of ratings. In the 70s, the payment structure switched, and today, the bulk of the rating agencies income now comes from fees charged to the issuers.

Given the ongoing problems in the secondary market, we must carefully examine the credit rating agencies and should consider the potential benefits of an investor-funded rating agency model. We should discuss whether we should promote the entry of serious, viable, investor-funded rating agencies to compete against the rating agencies that are purely paid by issuers, or to provide incentives for today's rating agencies to go back to their roots and have investors pay for the ratings. A more reliable rating system that provides accurate information about the value of securities will greatly reduce the fear and uncertainty that are creating the current credit crisis.

CONCLUSION:

The bottom line is that Americans are anxious. Homes are worth less than they were only a year ago, energy bills are higher, health care and college tuition costs are outpacing inflation and stagnant wages.

Instead of easing Americans' anxiety, many in Congress and in this administration have chosen to ignore that anxiety. The Administration continues to see the economy through rose-colored glasses, whether it be the subprime crisis, the credit crisis, the energy crisis, or the declining dollar, it blithely marches along without making any serious effort to solve these economic problems.

Last month, I said that taken together, the housing and credit crises, weak dollar and high oil prices are essentially the four horsemen of economic crisis. I still believe that is the case.

The 1890s and early 1900s taught us that autopilot does not work, but unfortunately it seems that the President missed that day in history class.

The number one problem in the markets is that they have very real sense that no one is in charge. The President has said nothing to reassure them and has in fact made them more anxious.

If the Administration chose to spend just \$200 million of the \$350 million we now spend DAILY in Iraq, we could help over 130,000 families in danger of losing their homes with counseling.

I think most families, folks from Main Street to Wall Street are wondering the same thing I'm wondering -- what world is President Bush living in to be so out of touch with the economic realities families and markets are facing?

I am hopeful that we can change directions in 2008 before even more families are swept up in this foreclosure tsunami and our economy is submerged in a recession. But we'll need all the help of the Bush administration, regulators, and Republicans in the Congress to make that happen.

And I'll be honest with you, those who are blocking efforts to help families and avert recession with these common sense measures I've gone over are not only ideologically handcuffed, but they are going to be handcuffed to this coming recession come November too.

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