INTRODUCTION

On January 31, 2007, the Senate Banking, Finance & Insurance Committee held an informational hearing on nontraditional mortgage products. At the time of that hearing, some had begun expressing fear about future weakness in the subprime market, but many believed that the subprime sector remained strong, and that appropriate underwriting was in place to protect both lenders and borrowers.

In the eight weeks since that January hearing, the subprime mortgage market has been shaken to its core. Over twenty subprime lenders have shut their doors and ceased making new loans. The share prices of those lenders whose stock is still trading have fallen precipitously. The index used to gauge investor confidence in subprime mortgage-backed securities has fallen to record lows. Early payment defaults and foreclosure rates have risen to levels unseen in years. Newspaper articles about foreclosures and subprime real estate weakness are published every day, and the news seems worse from one day to the next.

On March 26, 2007, the Senate Banking, Finance & Insurance Committee will reconvene for a second discussion about the mortgage market. During the hearing, the Committee will hear from a panel of experts about the likely impacts of the recent problems experienced in the subprime market.

The key topic to be discussed by panelists: What short-, medium-, and long-range impacts can California expect to see as a result of the recent subprime market failures?

THE PAST EIGHT WEEKS: A REVIEW

Why Are Subprime Lenders Laying Off Workers and Shutting Their Doors?

The media is increasingly filled with stories of once-vaunted subprime lenders laying off large numbers of employees, shutting down their lending operations, and watching their share prices plummet, before being removed from active trading. Yet, the underlying the reasons for these failures are often lost in the sensational headlines. Many of these failures began up to 24 months ago as lenders loosened their underwriting standards and approved ever-increasing numbers of subprime loans with multiple layers of risk (e.g., no money down, stated income loans with the potential to negatively amortize). Lenders may have thought they were making sound loans or may have thought that their ability to sell these loans protected them from payment default. However, as we have seen over the past eight weeks, many of these lenders guessed wrong.

Here’s a brief explanation of what happened:

In today’s mortgage market, lenders very rarely retain and service the loans they make to borrowers. More commonly, a borrower obtains a mortgage loan from a lender known as an originator. The originator typically funds the loan with a line of credit from a Wall Street investment bank or a commercial bank. Once the loan funds, the originator sells the loan to a bank (usually the one from which it obtained its line of credit, but not always). The purchasing bank packages that loan with others into mortgage-backed securities it sells to investors.

Typically, the banks which extend lines of credit to originators require the originators to maintain a net worth or debt ratio at a certain level. These capital levels are intended to protect the banks, if the originator's financial condition worsens. The banks that extend lines of credit also require originators to buy back loans which fall into early payment default (i.e., loans which fail within the first few months after funding). Early payment default buy-backs are intended to protect both the bank that provides the line of credit and the investors to whom the bank sells its mortgage-backed securities.

In recent months, increasing numbers of subprime borrowers have experienced early payment defaults on their loans. The investment banks that provided the originators with lines of credit have required the originators to repurchase the bad loans, which has lowered the amount of capital these originators have on hand to satisfy their net worth and debt ratio requirements. Most of the recent problems experienced by originators such as New Century, Ameriquest, Accredited Home Loans, Fremont General, and others have been due to these originators lacking sufficient cash to buy back all of the bad loans they had previously sold to commercial banks and Wall Street investment houses. The cycle worsens for the lenders when the banks, now wary of the loose underwriting standards that caused the early payment defaults, see the lenders failing to meet their capital requirements and become reluctant to extend more lines of credit to the lenders. Squeezed from both sides by required buybacks and shrinking credit lines, over two dozen lenders have run out of cash and shut their doors in the last few months. Lenders that have been able to find the cash to make required buybacks are renegotiating the repurchased loans, then reselling them at a significant discount, taking significant losses in the process.

When lenders run out of cash to buy back the early payment defaulted loans from the investment banks, the banks end up stuck with the bad loans, which eats into their profits and share prices. The profits and share prices of the major investment banks, including Morgan Stanley, Merrill Lynch, Deutsche Bank, Lehman Brothers, Bear Stearns, Credit Suisse, Goldman Sachs, Barclays, and UBS, are also complicated by the fact that all of these companies are involved in multiple aspects of mortgage lending. All but Barclays offer multiple origination channels, and all but Deutsche Bank have servicing capabilities. Three of the firms, including Morgan Stanley, Merrill Lynch, and Deutsche Bank, own subprime lenders. Given their large size and diversity, no one expects the current subprime mortgage weakness to result in the failure of any large investment banks; however, their share prices have taken a hit as investors express concern about their subprime exposure.

Lenders are increasingly under pressure from more than just the mortgage banks. Compounding the difficulty for some lenders is the appearance of class action suits over alleged deceptive sales tactics and the unwillingness of some insurers to pay off on mortgage reinsurance policies. Although neither lender suits nor insurer resistance to claims have reached the same level as early payment default buybacks, both have been in the news. The Washington Post recently reported on a class action lawsuit being brought against Chevy Chase Bank under the federal Truth in Lending Act for deceptive sales practices involving its adjustable rate mortgages. American Banker reported that National City Corporation, another subprime lender in financial trouble, is threatening to sue an unnamed insurer over its unwillingness to cover "a meaningful

number of claims" on a portfolio of second mortgages. At issue is whether fraud was involved in the initial issuance of the loans.

Among the large California lenders who have announced significant layoffs and/or ceased making new loans: New Century Financial Corporation, Accredited Home Lenders, Fremont General, ACC Capital (parent of Ameriquest and Argent Mortgage Companies), ResMae, and Ownit Mortgage Solutions. A few of these lenders also have regulatory compliance problems. Fremont is under a cease and desist order jointly issued by the Federal Deposit Insurance Corporation and the Department of Financial Institutions for taking too many risks, including making loans likely to end in foreclosure. New Century is under investigation by the Securities and Exchange Commission for its accounting practices and has received a grand jury subpoena for documents.

Not surprisingly, many of the remaining lenders have announced tighter underwriting standards. Lenders are demanding higher credit scores and more money down and are more closely scrutinizing – or discontinuing – limited documentation loans and piggyback mortgages.

What's happening to the borrowers?

According to the Federal Reserve Board, the percentage of loans at least 30 days overdue rose to 2.11% during the fourth quarter of 2006, up from 1.72% during the prior quarter. According to a recent report by the Mortgage Bankers Association (the same report that caused the Dow Jones industrial average to drop 243 points on March 13th), the percentage of foreclosures initiated during the fourth quarter of 2006 was the highest the trade group has seen since it started measuring these in 1972. The Mortgage Bankers Association also reported that 4.5% of all subprime mortgages nationwide were in the process of being foreclosed at the end of the fourth quarter, up from 3.3% a year earlier. Meanwhile, 13.3% of all subprime borrowers were behind on their payments, the highest level since 2002. That 13.3% was up from 12.6% at the end of the third quarter and compared to a fourth quarter delinquency rate among prime loans of 2.6% (up from 2.4% at the end of the third quarter).

The Alt-A market is also showing signs of weakness. A study released in early March by UBS-AG show that the default rate for Alt-A mortgages has doubled in the past 14 months, up to 2.4% of all Alt-A loans outstanding (though still low compared to the 10.5% delinquency rate reported by UBS-AG for subprime loans it examined). The UBS-AG study found that problems are greatest among Alt-A borrowers who took out interest-only ARMs; put little, if any money down; and who fail to document their income or assets. Glenn Costello, a managing director of Fitch Ratings, expects the foreclosure rate for Alt-A loans to be one-tenth to one-fifth of the rate for subprime borrowers.

On March 19, First American CoreLogic released a research report that predicted the volume of foreclosures likely to result from the subprime mortgage shakeout. Looking at 26 million mortgages, including over eight million adjustable rate mortgages (ARMs) originated between 2004 and 2006, the analysis forecasts that 1.1 million loans originated between 2004 and 2006 will be foreclosed on over the next six to seven years, representing 13% of the ARMs originated through purchase or refinance from 2004 through 2006. First American expects the greatest

foreclosure impacts to be felt by the holders of subprime mortgages with teaser-rates, interest-only, or negative amortization features. However, the analysis concludes that while those involved with the riskiest loans are likely to suffer, the losses will translate to less than one percent of total U.S. mortgage lending projected over the six to seven year prediction horizon of the report. First American does not believe that subprime foreclosures will significantly impact the economy or the mortgage lending industry.

As noted in the background paper prepared for this Committee's January 31st informational hearing, the Center for Responsible Lending (CRL) issued a report in December 2006 that studied the same question as First American CoreLogic, but reached a different conclusion. CRL analyzed the performance of more than six million subprime mortgages from the period 1999 through 2004 and noted that foreclosures were highest in areas with the lowest housing price appreciation. They used that relationship, together with a proprietary housing forecast from MoodysEconomy.com, to predict that 19% of subprime mortgages originated nationwide during 2005 and 2006 would end in foreclosure.

Increased foreclosures have prompted some consumer advocates to argue in favor of foreclosure assistance and loan suitability standards, and some industry advocates to argue in favor of market forces and voluntary lender forbearance. As noted below, Fannie Mae, Freddie Mac, and the five federal banking regulators have responded to recent subprime market troubles, as well.

Announcements by Freddie Mac and Fannie Mae

On February 27, 2007, Freddie Mac announced that, as of September 1, 2007, it "would no longer purchase subprime mortgages that have a high likelihood of excessive payment shock and possible foreclosure." Freddie's announcement had three main components. First, the company will only buy subprime ARMs and the mortgage-related securities backed by these subprime loans that qualify borrowers at the fully-indexed and fully-amortizing rate (not the initial "teaser" rate). Second, Freddie will limit the use of low-documentation underwriting for these types of mortgages to help ensure that future borrowers have the income necessary to afford their homes. Specifically, Freddie will no longer purchase "no income, no asset" loans and will limit "stated income, stated asset" loans to borrowers whose incomes derive from hard-to –verify sources, such as the self-employed and those in the cash economy. Freddie will also apply a reasonableness standard to stated incomes. Third, Freddie will strongly recommend that mortgage lenders collect escrow accounts for borrowers' taxes and insurance payments. Freddie clarified that its statement targeted subprime hybrid ARMs (e.g., 2/28s and 3/27s), which currently comprise approximately 75% of the subprime market. Freddie also announced it planned on developing fixed-rate and hybrid ARM products that will provide lenders with more choices to offer subprime borrowers.

Freddie Mac does not purchase many subprime loans directly from lenders, but it does invest in securities backed by subprime loans. Freddie Mac holds about $180 million of these securities and says that about half of these would not meet its stronger underwriting criteria. Richard Syron, Freddie Mac's chairman and chief executive was quoted in a Washington Post interview about Freddie's February 27th statement, saying "What was appropriate in the past is not appropriate under the changed economic circumstances."

Hours after Freddie Mac announced its decision, Fannie Mae outlined its growth strategy for the subprime mortgage market. Daniel Mudd, Fannie's chief executive, said that Fannie Mae has a small but growing position in the subprime sector, and that he expects its subprime business to increase. However, Mr. Mudd said that he expects Fannie to shift its mix of subprime assets away from purchased securities and toward its own production. If its exposure to subprime loans increases, Mr. Mudd said that Fannie will be more concerned with multiple layers of risk than specific loan characteristics, such as products underwritten with little or no documentation of a borrower's financial position. According to an article in American Banker, only 2.2% of the mortgage assets Fannie Mae currently owns or guarantees fall into the subprime category.

Issuance of Interagency Statement on Subprime Lending

On March 2, 2007, only three days after Freddie Mac announced it would no longer purchase subprime hybrid ARMs that were not underwritten to the fully-indexed and fully-amortized rate, the five federal banking agencies (Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration) issued a long-awaited statement on subprime hybrid ARMs.

In their Proposed Statement on Subprime Mortgage Lending, which is included as an appendix to this background paper, the agencies responded to criticism that their September 2006 Guidance on Nontraditional Mortgage Product Risks had failed to cover subprime hybrid ARMs. In their Proposed Statement, the agencies discuss risk management practices, underwriting standards, consumer protection principles, and control systems that institutions should put into place around subprime hybrid ARMs.

The key components of the Proposed Statement include the following:

1. An institution's analysis of a borrower's repayment capacity should include a borrower's ability to repay the debt at its fully indexed rate, assuming a fully amortizing repayment schedule.

2. An institution's debt to income analysis should assess a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or PITI) as a percentage of gross monthly income. This assessment is particularly important, if the institution relies on reduced documentation or allows other forms of risk layering.

3. The higher a loan's risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and liabilities.

4. Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include approving loans based on the borrower's ability to repay the loan and providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select products and choose among payment options.

5. Consumers should be informed of payment shock, prepayment penalties, balloon payments, the cost of reduced documentation loans, and responsibility for taxes and insurance.

6. Institutions should develop control systems to monitor whether actual practices are consistent with their policies and procedures.

Although the Proposed Statement is a separate document from the September 2006 Nontraditional Mortgage Product Risks Guidance, it contains a statement that the 2006 Guidance "outlines prudent underwriting and consumer protection principles that institutions should also consider with regard to subprime mortgage lending." Furthermore, as was the case with the September 2006 guidance, the Proposed Statement "applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions." State-regulated mortgage lenders and brokers are not covered.

On the same day the Proposed Statement was released, the Conference of State Bank Supervisors (CSBS) announced plans to develop a parallel statement for use by state lending regulators, just as they developed guidance that paralleled the Nontraditional Mortgage Product Risk Guidance released in September 2006. Both the federal banking agencies and the CSBS made it clear that their statements are intended to be wholly separate documents from the September 2006 guidance, rather than a modification of, amendment to, or clarification of the earlier guidance.

Who's holding the mortgages?

The demand for subprime mortgage-backed securities has been strong. Fully 35% of all mortgage securities issued in 2006 were considered subprime, while only 21% of all mortgages made fell into that category. While it is relatively easy to figure out who holds stock in subprime lenders, figuring out who holds the mortgage-related debt of those lenders is far more difficult. Once mortgages are bundled, securitized, and sold, their risk can be spread across multiple bondholders a world apart.

Richard Kovacevich, chief executive of Wells Fargo, was recently quoted in the Wall Street Journal as saying, "The thing none of us know, including the Federal Reserve, is who is holding this stuff. The assumption is that it is well-diversified. If it's concentrated, it's going to be a disaster." Echoing these thoughts are the comments of Joshua Rosner, co-author of a paper on mortgage-backed securities and collateralized debt obligations with a professor of finance at Drexel University's LeBow College of Business. "The danger in these products is that in changing hands so many times, no one knows their true make-up, and thus who is holding the risk."

The process by which loans are packaged and by which the packages are divided into different layers of risk called tranches is beyond the scope of this background paper due to its complexity. However, the packaging and slicing of these loans and their ultimate sale to investors often means that a borrower's loan may be owned by one or more investors located halfway around the globe.

Collateralized debt obligations (CDOs) have been compared to mutual funds in that they allow a single investor to invest in multiple mortgage-based securities of varying qualities. Increasingly, CDOs, which are particularly popular with Asian and European investors and hedge funds, have become large buyers of the riskier slices of mortgage-backed securities. CDOs help spread the risk of lower-rated subprime mortgage-backed securities, but they also make it almost impossible to identify those who hold the debt – and to adequately warn the debt holders of their potential exposure to subprime risks. Further increasing their complexity is the fact that CDOs can purchase other CDOs, adding even more layers of anonymity to the mortgage market and placing even more layers between the investors and the collateral.

The widespread nature of CDO holdings is an important point to recognize when evaluating the ability of a lender to work with a borrower who finds himself or herself in payment default. The borrower may not know who holds his or her loan, and may be left to negotiate with a company that holds only the servicing rights to that loan.

How risky are mortgage-backed securities?

The rating of mortgage-backed securities and CDOs has increasingly come under scrutiny. Some have questioned why the rating agencies have failed to downgrade large numbers of mortgage securities to reflect what many have referred to as a subprime implosion. According to a recent article in the New York Times, Standard & Poor’s has put 2 percent of the subprime loans it rates on watch for a downgrade; Moody’s has downgraded only 1 to 2 percent of the subprime mortgages it rates that were issued in 2005 and 2006; and Fitch has downgraded 4 percent of its subprime mortgages. According to the Times article, “The agencies say that they are confident that their ratings reflect reality in the mortgages they have analyzed and that they have required managers of mortgage pools with risky loans in them to increase the collateral.” However, a separate NY Times article noted that the increased collateral doesn’t necessarily involve cash. Instead, it can mean additional mortgages, which may or may not create additional vulnerability for the pools.

In May 2005, Alan Greenspan noted the complexity of CDOs and the challenges they post to “even the most sophisticated market participants.” He warned investors not to rely solely on rating agencies to identify the risks in these securities.

Some have also questioned whether the rating agencies are holding back on downgrading mortgage-backed securities to stave off a selling frenzy. Many buyers of mortgage-backed securities are not allowed to hold securities rated below investment grade (e.g., insurance companies, pension funds). For this reason, if the rating agencies did downgrade mortgage securities, a forced sell-off could occur, which could create even more downward pressure on the mortgage securities market. Fewer investors interested in purchasing mortgage-backed securities means less money available to fund new loans.

Of additional interest is the fact that owners of mortgage securities that have been pooled do not have to reflect the prevailing market prices of those securities each day, as stockholders do. Only when a security is downgraded by a rating agency do its investors have to mark their

holdings to market. For this reason, many investors are currently reporting the values of their holdings at inflated prices.

How is the stock market responding?

The group of banking stocks in the S&P 500 has fallen 6.4% since early February, over a time period during which the overall S&P 500 fell 4.3%. H&R Block shares are down about 20% in the past six weeks amid concerns about Option One, its subprime mortgage unit now up for sale. Shares of HSBC, Washington Mutual, BankUnited Financial, IndyMac Bankcorp, FirstFed Financial, and Countrywide Financial have also dropped sharply in the last month, but have inched up more recently as they've been able to assure investors that their subprime exposure is minimal and that they are taking steps to tighten underwriting standards where they do have subprime exposure.

There have also been reports that loan origination volume is increasing at some of the remaining lenders, as they pick up market share previously held by the now-closed lenders. Michael Perry, IndyMac's chairman and chief executive, is quoted in an American Banker article as saying, "While we don't wish any of our competitors ill, the current firestorm in our industry is exactly what is needed to restore rationality and discipline to the mortgage business, and this will ultimately be very positive for strong companies…" Robert McGee, the chief operating officer of Wachovia Corporation's general bank, said in early February that turmoil in the subprime market "bodes very well for us…because people are going to have to change the terms of their products, and we are not…We're starting to see some volumes move towards us, because of challenges that other folks are having." In mid-March, American Banker reported that Countrywide Financial had moved ahead of Wells Fargo & Co. as the largest retail home lender in the US, due in part to what a Countrywide spokesman characterized as the current turmoil hitting the subprime and Alt-A sectors.

What are the broader ramifications of the subprime collapse?

There are as many answers as there are people offering them.

"There's not much indication that subprime issues have spread into the broader mortgage market." -- Federal Reserve Board Chief Ben Bernanke testifying before Congress in February 2007.

"The distress of the subprime-mortgage market is something that should have been anticipated, given the housing correction…From the standpoint of the overall economy, it's largely contained." -- Treasury Secretary Henry Paulson

"I think it's possible that the monoline subprime lending model goes away. Clearly with so many companies for sale, the subprime product will become a smaller piece controlled by lenders who can weather the cycles easier." -- Bose George, an analyst with Keefe, Bruyette, & Woods, Inc.

The data “show that mortgage credit-quality problems go well beyond the subprime sector,” – Jan Hatzius, chief U.S. economist at Goldman Sachs.

“Our biggest concern is that any tightening of lending standards in the mortgage market – even if confined to lower-quality borrowers – is going to constrain overall housing demand. Home prices could drop 10% this year, and such a drop would in turn hurt the gross domestic product.” David Rosenberg, economist at Merrill Lynch & Co.

“The mortgage market is vast, and the vast majority of the mortgage market is fine.” -- Lewis Ranieri, a pioneer in mortgage-backed securities

“Economists don’t expect the tightening of [underwriting] standards to tank the economy because loans remain plentiful for borrowers with good credit.” -- “Home Lenders Cut The Flow of Risky Loans,” Wall Street Journal, Feb. 26, 2007.

“Despite all of the housing angst, global growth remains strong, and worries about a recession in the U.S. might be overdone. That suggests that the recent pullback for stocks may have created a buying opportunity for companies that won’t be impacted by the mortgage malaise.” -- “Mortgage Woes Cloud the Stock Market, Wall Street Journal, March 18, 2007.

“…much of what people are worried about seems a result of what already is happening in the past year rather than an indicator of additional weakening now,” James Paulsen, chief investment officer of Wells Capital Management.

“Decreased funding for residential mortgage-backed securities could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy.” -- Joshua Rosner, managing director at Graham & Fisher & Company and Joseph Mason, associate professor of finance at Drexel University’s LeBow College of Business

Among the questions that remain

Will subprime lender failures continue? How many more will we see? Will Wall Street’s flow of repurchase requests increase, level off, or decrease in the coming months?

Will lenders pursue compensation from mortgage brokers when the lenders are faced with repurchase requests?

Will the recent problems in the subprime market extend to the Alt-A and prime markets?

How has Wall Street reacted to increased defaults and subprime lender failures? Has Wall Street’s response been uniform?

By how much have lines of credit been reduced for subprime loans? Are lines of credit still available for subprime lending? Are certain underwriting practices being halted?

Is the market correcting itself?

Are federal and state regulatory efforts having any impact on underwriting standards and risk management by financial investors and institutions? What impact will the recent issuance of proposed guidance for subprime hybrid adjustable rate mortgages have on home ownership rates, the housing market, and the subprime mortgage lending market?

Will recent lender failures have broad reverberations across the stock market? Across the bond market? Will rating agencies be willing to downgrade mortgage-backed securities if doing so would push them below investment grade? Will a downgrade to below investment grade cause an exodus of buyers out of the mortgage-backed securities market?

Will lender failures in the subprime market restrict access to credit? Will credit become more expensive to obtain?

Will the restriction of credit/increased cost of credit slow the housing market by reducing the number of first time homebuyers? Will it drive up rental costs?

Will restrictions of credit/increased cost of credit cause some people to lose their homes through their inability to refinance out of mortgages they are unable to afford?

Will lenders renegotiate the loan terms of borrowers who find themselves in payment default? Who will renegotiate the loan terms of borrowers whose loans have been sold on the secondary market? Will government step in with foreclosure assistance? If so, what does that foreclosure assistance look like?

Will there be widespread increases in foreclosures? Alternately, will foreclosures be concentrated in certain geographic locations?

Will mortgage debt-laden consumers reduce consumer spending?

Will foreclosures push down the cost of housing?

Will a housing slowdown cool the California economy? Will a housing slowdown fueled by the subprime crash have broader implications for California's population? Will an exodus of subprime lenders from Southern California hurt the office space sector?