Testimony before Subcommittee on Domestic Policy, Committee on Oversight and Government Reform by William E. Rinehart, Vice President and Chief Risk Officer, Ocwen Financial Corporation on March 21, 2007

Chairman Kucinich, Ranking Member Issa, and Members of the Committee, it is a pleasure to have been invited by the Committee to provide insights into the nature of the subprime lending problem as faced by borrowers. In addition, I have also been asked for my views on the effectiveness of federal regulators, the industry and on the ways in which cities are affected by the rise of foreclosure, and my views on the ways in which consumers and the stock market are affected by the proliferation of the subprime mortgage industry.

Let me start with some background on my employer, Ocwen Financial Corporation. Ocwen is a publicly traded company (NYSE: OCN) headquartered in West Palm Beach, Florida, specializing in the servicing of subprime residential mortgage loans. We currently service approximately 480,000 loans totaling $55 billion in unpaid principal. Ocwen neither originates nor owns the loans we service; rather, we provide loan servicing for various investors who own the loans, typically large fixed-income institutional investors. Most of the loans we service are considered subprime and they are part of REMIC Securities.

I think it is important to stress at the onset that foreclosure is clearly a lose/lose/lose proposition for all parties involved in lending. It is especially most painful on families that lose their homes. As Members of this Committee know all too well, as do all the witnesses that will appear before this Committee today, homeownership is not only an American dream, but many times the first step in financial security for millions of Americas. We must do all we can to ensure this for today and tomorrow's homeowners. As I will discuss, Ocwen is always looking for ways to make this so.

In order to better understand what Ocwen does, it would be helpful to provide an overview of the subprime mortgage industry and put in context our role in that process.

Most subprime loan transactions start with a mortgage broker who has direct contact with the consumer. The mortgage broker is responsible for understanding the consumer's requirements and helping the consumer complete the loan application. The broker then submits that application to one or more lenders or originators. The lender is responsible for underwriting the loan by reviewing the loan application, a credit report on the applicant, an appraisal on the property and other information.

The lender will base the credit decision on the applicant's credit history, income, assets and liabilities and the value of the property. The interest rate offered will reflect the overall risk of the transaction as determined by the underwriting process and the type of product requested. Certain loan characteristics (income documentation type, prepayment penalty, loan to value) and applicant characteristics (credit score) will determine the offered rate.

When the loan is funded and closed, the lender will either hold the loan in its portfolio or sell the loan. Most subprime loans are originated by lenders that are not operating under federal charters or federal regulation. These lenders are sometimes referred to as "non-depositories" as they are not banks or thrifts that accept deposits as a means of financing their loans. As these non-depositories rely on lines of credit to finance the closed loans, they typically sell the loans as quickly as possible to avoid both interest costs on carrying the loan and interest rate risk.

Most of these loans are sold to an investment bank. The investment bank purchases loans from multiple lenders, assembles the loans into a loan pool, creates a security and sells the security (or securities) to various investors. The investors are large institutional investors, hedge funds, pension funds and other fixed-income investors. The investment bank also sells the servicing rights to a servicer such as Ocwen through an auction process. Ocwen buys the right to service the loans in the security and collect a servicing fee for its work.

This is a critical element of the economics of subprime mortgages. Ocwen only collects that servicing fee as long as the loan is outstanding. If a loan goes through foreclosure, Ocwen loses the servicing fees that it already paid for.

This is an important fact because it explains why foreclosure it not a good economic proposition for Ocwen as servicer. We lose the servicing fee if the loan goes through the foreclosure process. It is also important to note that foreclosure is not an event that benefits the investor who owns the loan. Our experience is that the investor sustains a loss on 97% of foreclosures. And, of course, the consumer loses his/her home and the neighborhood has another vacant property for some period of time until the property is resold.

Foreclosure is clearly a lose/lose/lose proposition for all parties. Under the contracts that spell out our duties as servicer, we are required to take actions to return the maximum amount of contractual principal and interest to the investor. In the vast majority of cases, finding a way to keep a customer in their home and continuing to pay their mortgage is the best economic proposition for the customer, the servicer and the investor.

Ocwen is proud of our industry-leading loss mitigation efforts. During 2006 we were able to resolve the loans of more than 80% of severely delinquent customers in a way that avoided foreclosure. We do this through a consultative approach with each customer to determine the optimal resolution to their delinquency. We first determine if the customer wants to stay in their home. In some cases they do not, and we work with them to dispose of the property in the most timely and value-maximizing manner. If the customer wants to stay in the home, we review their financial situation to determine their ability to pay, and work hard to find a payment plan that will accommodate their situation.

In the less than 20% of the cases where we are unable to avoid foreclosure, the reasons are varied. In some cases the customer has abandoned the property. In a small number of cases the customer just does not have the income to be able to stay in the home. In about half the cases of foreclosure, we are unable to make contact with the customer. Despite repeated telephone calls and letters, several of which are certified, we are unable to talk to the customer to try and work out an arrangement. To clarify this, we may attempt to contact a customer multiple times over many months and still make no contact. We even send our customers a DVD that explains to them why it is so important that they speak with us so we can help them. I have brought copies of this DVD to for the Committee Members and staff to review.

We consider foreclosure to be a failure. In fact, our incentive compensation plan for our late-stage loss mitigation employees includes a deduction for every loan that completes the foreclosure process. This is why we do everything we can to contact the customer to find an alternative to foreclosure.

One of the innovative approaches we take is to partner with non-profit housing groups in various cities to help us contact our customers. Groups like the East Side Organizing Project (ESOP) in Cleveland, Ohio reach out to Ocwen customers who have otherwise not made contact with us. Our hope is that a contact from a local, trusted consumer-advocacy group will be successful where our efforts have not been successful. If ESOP is successful in making contact with the customer, they will often meet face-to-face with the customer, collect financial information, understand their situation, and bring the customer to Ocwen to negotiate a non-foreclosure resolution.

Currently we have this program in place with nine affiliates of the National Training and Information Center (NTIC) based in Chicago. In addition to ESOP in Cleveland, we work with other NTIC affiliates in Chicago, Cincinnati, Pittsburgh, Indianapolis, Kansas and Iowa and the St. Ambrose Housing Aid Center in Baltimore. We are currently discussing this program with other national and local consumer groups. While we can only count our successes with this program in the hundreds so far, each success preserves homeownership for a family and helps maintain some stability in their neighborhood.

Our experience in this program and our daily loss mitigation efforts reveals many of the problems faced by subprime borrowers. The most common cause of delinquency and default is a change in borrower circumstances. The most prevalent cause is job loss or reduction in hours. Many subprime borrowers live from paycheck to paycheck. A reduction in income is critical to these borrowers. Death or disability of a wage earner in a household is another primary reason for repayment difficulties. Additionally, as many subprime borrowers have little or no savings, any unexpected expense can cause a financial crisis for these households. A broken hot water heater, leaky roof, or even a transmission repair on a vehicle is enough to put these families in crisis. Medical bills for a household member can also force borrowers to make painful decisions as to how to prioritize their limited resources.

An all too-frequent problem we see in our servicing business is the borrower who is unable to pay their annual bill for property taxes and hazard insurance. While most prime mortgage loans involve monthly escrow payments toward these major outlays, only 47% of the subprime first lien loans we service come to us with escrows in place. These are the borrowers who most need the discipline of contributing to these amounts each month. Ocwen makes an effort to communicate to all new servicing customers the importance and benefits of escrow accounts, but for many of them the additional monthly amount on top of their principal and interest cannot be accommodated.

I have been asked to address the effectiveness of federal regulators. It is important to reiterate that most subprime loans are originated by non-depositories, companies that are not federally regulated. The largest specialty subprime lenders are generally state-licensed and not subject to oversight by the Federal Reserve, the Office of Thrift Supervision, the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation. Notwithstanding their lack of direct supervision, these regulators do influence all mortgage lenders. An example is the FFIEC guidance released in the fall of 2006 pertaining to interest-only and option ARM loans. Only months after this guidance was released, it was quickly adopted by most state regulatory bodies. Even without the force of law, it quickly became an industry standard.

However, as many consumer advocates and others observed, interest only and option-ARM loans are not as prevalent in the subprime industry as “regular” ARM loans, including “2/28” loans and “3/27” loans. These loans generally have a lower rate than similar fixed rate loans, but the introductory fixed rate of these ARM loans resets to a spread over an index after either 24 months or 36 months. Generally, the first rate reset with be in the range of 2.5% to 3.0% above the introductory rate, and subsequently reset every six months thereafter. So, a loan initiated at 7.0% could increase to 10.0% within two to three years after origination.

In addition to the rate resets, these loans were underwritten with the assumption that the borrower was repaying a 7.0% loan, not a 10.0% loan. With the proposed new federal guidance now including regular ARM loans, underwriting standards for the subprime industry will likely change just as they did with the prior guidance.

In the recent past, borrowers facing these rate resets could simply get a new loan to avoid paying the higher reset rate. Coupled with steadily increasing property values, many borrowers not only refinanced but also pulled out more of this newly-created equity and used the cash for other personal purposes. Even borrowers facing some difficulty in repaying their current loans were able to borrower more money in a new loan to help stave off financial crisis (for a little while, anyway).

However, this game of musical chairs, borrowers getting a new loan and more money to pay out the prior loan, is over. The music has stopped. Property values are no longer increasing. In many overheated markets, property values are dropping. Moreover, more rational underwriting standards now in place or proposed will preclude these borrowers from qualifying for a new loan. These tighter underwriting standards will reduce the number of new borrowers receiving a mortgage loan they can't repay, but it locks out many current borrowers who are now stuck in a loan with increasing interest rates. These borrowers who qualified for a loan only months ago will no longer have access to mortgage credit and will have to find a way to deal with their current loan.

What is the impact of these issues? As discussed, many borrowers who currently have loans will no longer qualify for a new loan to help solve their current problems. Many of these borrowers may experience delinquency, default and foreclosure. Relaxed underwriting allowed many of these borrowers to buy a home with no cash down payment. In some cases, as a result of cooling property values, many of these borrowers now have loans with balances in excess of the value of their homes. With no investment in the property, many of these borrowers will walk away from their homes and their obligations.

Unfortunately, those who do walk away from their obligations further tarnish their credit histories, potentially eliminating any future opportunity at homeownership. Their effort to participate in the American dream of homeownership has, for some, become a bad dream.

Foreclosures result in vacant properties. These vacant properties, if not properly secured and maintained, can quickly become a blight on their neighborhoods and depress surrounding property values. There is some evidence that the "easy credit" offered by some subprime lenders fostered property flipping where unsuspecting borrowers were sold inner-city properties at greatly inflated values. Clearly neighborhoods and cities are impacted by an increasing number of foreclosed properties.

I have also been asked to comment on the impact of subprime mortgages on the stock market. We have all read the recent impact on the stock prices of specialty subprime lenders. Some of these companies may not survive the current dislocations in the industry. Moreover, the stock prices of many companies with even modest subprime exposures are down. I am not an expert in the machinations of the stock market, but some who are suggest that investors are overreacting to the current negative news of subprime lenders. Perhaps with the exception of home builders, it is difficult to conceive that the stock prices of other businesses or industries will be affected by the poor performance of some subprime loans.

The cooling of real estate markets is not a result of issues in the subprime industry, but rather a result of rising interest rates and hyper-speculation. The increase in property values did not reflect normal supply and demand factors but irrational demand. Markets are returning to a more rational equilibrium. Will the removal of some number of potential homebuyers due to changes in subprime underwriting aggravate the downturn in the housing industry? Quite possibly. But market corrections are inevitable, particularly a market that was heavily influenced by speculation and not true buyer demand.

Changes in the subprime industry are appropriate and necessary. In their zeal to maintain their growth rates, many subprime lenders forgot (or ignored) the basic tenet of lending- the borrower should be able to repay the debt. Market forces have already brought about change. The high delinquency of many subprime loans in mortgage-backed securities has caused investors and investment banks who buy the loans to impose tighter underwriting requirements. Regulation and, perhaps, legislation may bring about additional changes in how new loans are granted.

In the meantime, Ocwen and other servicers, investors, investment banks and groups likes NTIC and ESOP in Cleveland will have to continue to work hard and work together to help borrowers try and keep their piece of the American dream.

Respectfully submitted by:

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