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MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

THE CAUSES AND CONSEQUENCES OF THE TURMOIL WITHIN THE MORTGAGE MARKET

THURSDAY, MARCH 22, 2007

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C O N T E N T S

THURSDAY, MARCH 22, 2007

WITNESSES

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MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES

THURSDAY, MARCH 22, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

We again thank you all for being here this morning. The title of today's hearing is "Mortgage Market Turmoil: Causes and Consequences," and I want to welcome all of our witnesses here and other guests who are in the hearing room this morning.

You cannot pick up a newspaper lately without seeing another story about the implosion of the subprime mortgage market. The checks and balances that we are told exist in the marketplace and the oversight that the regulators are supposed to exercise have been absent until recently, in my view. Our mortgage system appears to have been on steroids in recent years, giving a false sense of invincibility. Our Nation's financial regulators are supposed to be the cops on the beat, protecting working Americans from unscrupulous financial actors. Yet they appear for the most part to have been spectators for too long. Risky exotic and subprime mortgages, all characterized by high payment shocks, spread rapidly through the marketplace. Almost anyone, it seemed, could get a loan. As one analyst put it, "Underwriting standards became so lax that if you could fog a mirror, you could get a loan."

Some of these loans have legitimate uses for major sophisticated borrowers with higher incomes. But a sort of frenzy gripped the market over the past several years as many brokers and lenders started selling these complicated mortgages to low-income borrowers, many with less than perfect credit, who they knew or should have known, in my view, would not be able to afford to repay these loans when the higher payments kicked in.

I am going to take a few minutes to lay out what I can only call a chronology of neglect, in my view. Regulators have told this Committee that they first noticed credit standards deteriorating in late 2003. By then, ratings had already placed one major subprime lender on a credit watch, citing concerns over their subprime business. In fact, data collected by the Federal Reserve Board clearly indicated that lenders had started to ease their lending standards by early 2004.

Despite those warning signals, in February of 2004 the leadership of the Federal Reserve Board seemed to encourage the development and use of adjustable rate mortgages that today are defaulting and going into foreclosure at record rates. The then-Chairman of the Fed said in his speech to the National Credit Union Administration, and I quote him, "American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage." That was in February of 2004.

Three or 4 months after that, the Fed began a series of 17 interest rate hikes in a row, taking the Fed funds rate from June of 2004 at 1 percent to 5.25 percent by June of 2006.

So, in sum, by the spring of 2004, the regulators had started to document the fact that lending standards were easing. At the same time, the Fed was encouraging lenders to develop a market alternative, adjustable rate products. Just as it was embarking on a long series of hikes in short-term rates.

In my view, these actions set the conditions for almost a perfect storm that is sweeping over millions of American homeowners today. By May of 2005, the press was reporting that economists were warning about the risks of these new mortgages. In June of that year, Chairman Greenspan was talking about froth in the mortgage market and testified before the Joint Economic Committee that he was troubled by the surge in exotic mortgages. That indicated that nearly 25 percent of all mortgage loans made that year were interest-only. Yet, in December of 2005, the regulators proposed guidance to rein in some of the irresponsible lending. Yet we had to wait another 7 months, until September of 2006, before the guidance was finalized.

Even then, even now, the regulators' response is incomplete. It was not until earlier this month, more than 3 years after recognizing the problem, that the regulators agreed to extend these protections to more vulnerable subprime borrowers—borrowers who are less likely to understand the complexities of the products being pushed on them and who have fewer reserves on which to fall if trouble strikes.

We still await final action on this guidance, which I urge the regulators to complete at the earliest possible moment. Let me explain why these rules are so important.

The subprime market has been dominated in recent years by hybrid ARMs, adjustable rate mortgages, loans with fixed rates for 2 years that then adjust upwards every 6 months thereafter. These adjustments are so steep that many borrowers cannot afford to make the payments and are forced to make one of three choices: either to refinance at great cost, sell their homes, or default on the loans. No loan should force a borrower into this kind of devil's dilemma. These loans are made on the basis of the value of the property, not the ability of the borrower to repay. This is, in my view, the fundamental definition of predatory lending.

Frankly, the fact that any reputable bank or lender would make these kinds of loans so widely available to wage earners, to elderly families on fixed incomes, or to lower-income, unsophisticated borrowers strikes me as unconscionable and deceptive. And the fact that the country's financial regulators could allow these loans to be made for years after warning flags appeared is equally unconscionable.

We have invited top five subprime lenders to testify today to explain these practices to us. Unfortunately, New Century declined to appear, even as they faced a blizzard of loans going into early default. Their absence from this hearing is regrettable. New Century played a leading role in pushing the unaffordable subprime loans, and they should be here to explain their actions.

By implication, I want to thank the others who appeared here today to be a part of this hearing. I am deeply grateful to all of you for coming out, not only the regulators but also the other lending institutions that are here to talk about some of these issues, and I thank them for coming.

How many homeowners were sold loans they could not afford in the time the regulators delayed? How many of these borrowers are still receiving these loans? The people paying the price for the regulators' inaction are homeowners across our country, struggling to maintain their piece of the American dream. Home ownership is supposed to be the ticket to the middle class. Predatory lending reverses that trip. A study done by the Center for Responsible Lending estimates that up to 2.2 million families with subprime loans could lose their homes at a cost of some $164 billion in lost home equity.

In the words of former Fed Reserve Board Member Edward Gramlich, "We could have real carnage for low-income borrowers." I am quoting him here. Yet these numbers—these are just numbers—beyond these large numbers. I hope we can stay focused on the human tragedies behind them. We need to keep them in mind, people like Mrs. Delores King, an elderly retired woman who testified before us last month regarding her circumstances. Mrs. King was advised by her mortgage broker to take out a loan whose payments quickly shot up beyond her means, simply to pay off a $3,000 debt.

Or Amy Womble, a small business woman and widow with two children, who was promised a mortgage of $927 per month, ended up with one, as a result of her financial adviser—at least what she thought was her financial adviser—with a mortgage costing her over $2,000 a month. Both of these women are now struggling to keep their homes. We should not let them struggle alone, obviously. We need to let them know and the American people know that we intend, all of us here, to fight for them to see that this kind of practice is stopped.

We will hear this morning from another woman, Mrs. Jennie Haliburton, about how those practices caused so much hardship in her case.

The challenges are clear, in my view. We need to take several steps. First, we need to put a stop to abusive and unsustainable lending. The regulators must finalize decent subprime guidance as quickly as possible.

Second, the Federal Reserve should exercise its authority under the Home Ownership and Equity Protection Act, the HOEPA bill, which was adopted, I think, in 1994, is that correct? Some 13 years ago—which, by the way, uses the words very clearly, to quote the

HOEPA legislation, "The Board, by regulation"—I am quoting now. "The Board, by regulation or order, shall prohibit"—"shall prohibit"—"acts or practices in connection with—" and it goes on, "[(A)] mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower." It is not advisory. It is not a voluntary question. It is a demand. Thirteen years ago that legislation was adopted.

And under the FTC Act, by the way, it prohibits these abusive practices and products for all mortgages and mortgage participants, including, by the way, not only federally chartered but State-chartered. I was stunned this morning to read in the *Wall Street Journal* a quote from a Federal Board member that does not know the distinction here, saying that it is only under federally chartered. You can go back and the law is very clear, when it comes to these universal fair credit practices here, that any kind of lending practice, whether it is done by a State or a federally chartered institution. And under the FTC Act—and I will quote it as well here—"The Board of Governors of the Federal Reserve System shall prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices and containing requirements prescribed for the purpose of preventing such acts or practices." Again, the language is very clear about shall act here.

Anyway, the third point I want to make is that I intend to work with our colleagues here and others who are interested to introduce legislation to attack the problem of predatory lending generally. Passing such legislation will be hard. I understand that. And there are plenty of market players out there who stand to lose if we provide decent protections for consumers. But we must push forward in this area.

And, finally, we need to deal with the problems of the millions of homeowners who may face foreclosure after being hit with the payment shocks built into their mortgage. The solution to this problem may not be legislative. Instead, I would seek to ask leaders from all the stakeholders—regulators, investors, lenders, GSEs, FHA, consumer advocates—to come together and try to work out an efficient process for providing some relief for these homeowners who will be caught in this bind. And I will have more to say on this in the coming weeks.

One thing I know for sure, we simply cannot sit back and watch 2.2 million families lose their homes and, with them, their financial futures.

Let me be clear. The purpose of this hearing is not to point fingers per se, but to try and find some solutions to this issue. We need to get to the bottom of this problem, understand thoroughly what went wrong, and then work to make sure we don't see a repeat of this problem.

With that, let me turn to my colleague from Alabama for any opening comments he may have, and we will go to our witnesses unless any of my colleagues want to make any brief opening statements.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Senator Dodd. Thank you for calling this hearing.

It is clear from recent headlines and from our observations of the mortgage market that there are significant problems in the subprime sector. This Committee has a responsibility to examine fully all aspects of what appears to be a deep and a growing problem. While I believe it is important to hear from the bank regulators and some lenders, we must also hear from other relevant market participants because we have a number of questions that need to be answered, such as: What is the full scope of this problem? What caused it? In other words, was it a single factor or a series of factors? Who are all the market participants? And what role does each of them play here? What type of products are involved? How is the market responding to this crisis? And what effect is it having? Is there a role for Congress, or is it too early to tell?

In order to answer these questions, Mr. Chairman, I believe that we will need to hear from not only regulators and lenders but from mortgage brokers, bankers, the Wall Street firms involved in securitizing these mortgages, and the credit rating agencies whose ratings make the sale of these securities possible.

As always, I remain interested in facilitating market-based solutions to market-generated problems. But when the market fails, I am not altogether opposed to seeking some alternative solutions. My hope, Mr. Chairman, is that we today will hear that our witnesses are taking meaningful steps to mitigate damage done by the changing real estate market and a growing number of mortgage delinquencies and foreclosures. We might be at the tip of an iceberg in the subprime area. I hope that we are making headway, but I am not sure.

Thank you.

Chairman DODD. Thank you very much, Senator.

Let me ask briefly if any of my colleagues want to make a brief opening statement. Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. I want to thank you for calling today's hearing. I want to thank the many witnesses who have joined us to help us understand the crisis we face and what options we have for limiting the damage.

Viewed from the supervision of financial markets or from the vantage point perhaps of Federal regulators, "crisis" may seem like too strong a term. That is probably true. I do not think what is happening in the subprime mortgage market will undermine the safety and soundness of our banking system, and the companies who will testify today will no doubt weather the storm. But "crisis" exactly describes what is going on in Ohio and in many other States. My State has a greater percentage of properties in foreclosure than any other. Families are losing not just their homes, but in many cases their life savings. Neighborhoods are being dragged down as one foreclosure piles upon the next.

Ohio had some of the weakest consumer protection laws in the country, so the State shoulders some of the blame. But the Federal response has been far too slow. The mortgage industry seems almost to have turned on a dime in 2004, pushing subprime and exotic mortgages on consumers so as to keep the pipeline full for investors. But here we are 3 years later still talking about these problems.

Certainly Congress should have acted more quickly, could have acted more quickly, but by design, our process is cumbersome. We rely on our regulatory agencies to be as nimble as the industries they regulate, and that has not been the case with respect to nontraditional and subprime loans. It is better that we act now—certainly better now than never, but hundreds of billions of dollars worth of dubious mortgages have been made while we dithered, and the futures of thousands upon thousands of Ohio families and others around the country have been jeopardized.

The Cuyahoga County Treasurer, Jim Rokakis, has been a leader in my State in calling attention to the mortgage crisis. Exactly 1 week ago, he attended an auction of the house he grew up in on Cleveland's Garden Avenue. The house had an $85,000 mortgage on it. It sold for $19,000.

Ohio will do everything it can to address this crisis. Governor Strickland has formed a high-level task force to figure out how best to help people hang onto their homes, but Ohio needs and deserves our help. It needs the help of the regulatory agencies. It needs the help of Congress. It needs the help of the companies that have been doing and continue to do business in my State. Mortgage companies have demonstrated they can be innovative and they can be persuasive. I hope we can count on the same level of energy from them being devoted to solving this crisis that we have seen from them over the past several years.

Thank you, Mr. Chairman.

Chairman DODD. Senator Bennett, do you want to make any opening comments at all?

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Just one quickly, Mr. Chairman. You go back to the Dutch in tulip time; in our own time, you go to the dot-com bubble and then the housing bubble. It seems we never learn that things that are too good to be true are. And this was stoked by the tremendous increase in housing prices and housing assessments, appraisals, and they got very much out of hand. And then everybody came to the same conclusion the Dutch did in the 1600's, that the price of tulips was never going to come down. And when the housing prices started to come down, everybody had to pay the price.

So here we are once again, whether it is the dot-com bubble or the housing bubble or whatever the next one will be, once again we are dealing with the consequences of that, and I think it is appropriate that we have the regulators here to remind them once again that when these bubbles come up, there is always a burst somewhere at the end of the line.

Chairman DODD. Excellent.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you, and thank you for calling the hearing. I will be very brief.

I want to thank those witnesses who are here for your testimony today, but I want you to understand something, and many of you do, and I hope you do: that this issue is real for a lot of people out there, people that have to work two jobs and sometimes more, and people that have to try to make ends meet. And the cost of everything in their life is going through the roof. Health care especially, college tuition, you name it, the cost is going up for these people.

The last thing they need is to be scammed in a subprime mortgage or some other deal that puts them at a disadvantage. And it is up to you as regulators, not just to understand that but to crack down on it in a way that will bring some measure of relief to these people.

It is great we are here at a hearing, and we have got a lot people. That is wonderful. But where the rubber hits the road on this is how you do your jobs in a way that fulfills your obligation. We have got an obligation here, everybody around this panel has an obligation, to do the people's business, and not just to talk and pontificate and give speeches, but to get to work to fix this problem. And until that happens, all the hearings and all the discussions in the world are not going to mean anything to real people.

So you have got an important obligation, and we do as well. But I think what people expect us to do is to discharge the duties of our office. You know what your duties are, and I hope today is one way to remind all of us about that basic obligation to real people in their real lives in the real world.

Thank you.

Chairman DODD. Thank you, Senator Casey.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I will be brief as well.

I want to associate with the comments of Senator Shelby about hoping that we can focus as much as possible on market-based solutions rather than trying to assume a higher regulatory burden than is necessary. But once again we are in a circumstance where there are problems. The hearing that we had in February showed very clearly that the system got ahead of us.

I can remember just back a few months, 3, 4, 5 months ago, when we were all extolling the manner in which the housing market in our country was keeping the economy strong and stable. Now we are talking about problems in the housing market as it overheated. And as Senator Bennett indicated, as the bubble reached its popping point and prices of real estate started to drop, now we have seen that yet once again a market is operating. And there are problems in this market, and I hope that we as a Committee and our regulators are able to recognize the right adjustments that need to be made. Already, if you look at the market itself, adjustments are occurring. Stock prices of major subprime specialists have plummeted. Credit spreads on lower-rated tranches of subprime securities have widened appreciably as investors demand a greater return on the riskier investments. Various segments of the subprime market have already raised credit standards on their own, and we see that credit is tightening for consumers with lower credit ratings, all of which should have occurred and should have occurred sooner.

In fact, I think that the biggest lesson I learned from our last hearing was that although we do have pretty significant market discipline in place that occurs, it lags as we face one of these types of things, and a lot of damage occurs in the wake of the slow reaction of the market and the slow reaction of the regulators and the Congress to the issue.

It would be good if we all had the prescience to be able to see when these bubbles were going to occur and when we needed to be prepared to act. But I think the real lesson here is that we have to contemplate them. We have to recognize that they will come, and we need to have the right regulatory model in place, and we need to have the right oversight at Congress in place. And, frankly, the markets need to be recognizing this same type of thing as markets operate with their internal mechanism and market-driven responses.

So I guess the overall message I want to deliver here is that I am very pleased that we are having this hearing. It is a very, very significant issue, and there are significant problems in the subprime markets. But yet once again I wanted to be sure that as we address it, we don't swing that pendulum too far back to the point where we start restricting credit to people who should have credit or who should have some amount of credit but maybe not as much as the hot markets were driving onto them in the last little while. It is a very delicate balance that we have to reach here, and I appreciate and applaud the Chairman's efforts to shine a spotlight on this so that we can try to help us get to that balance.

Chairman DODD. Thank you, Senator. Very thoughtful statement. I appreciate it very much.

Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Mr. Chairman, I would like to begin by thanking you. Today's hearing deals with one of the most pressing economic challenges that our country faces. Yesterday's hearing dealt with one of the most significant national security challenges that our country faces. And so I am delighted to see the Committee being so aggressive in taking on some of the major issues of our time, and I want to thank you and Senator Shelby for that.

I, too, will be very brief. This is an important issue for my State. We rank second in the country in delinquencies and fourth in foreclosures for reasons that are similar, I think, to Senator Brown's statement about his own State of Ohio. Many people are struggling in the Midwest and places like Ohio and Pennsylvania and Indiana because of the changes in the manufacturing economy and also, Mr. Chairman, because of the overall middle-class squeeze that is going on, with rising health care costs and college tuition and people having trouble making ends meet. And we see that reflected in the mortgage markets.

We rely upon markets to allocate resources and risks, and we have learned over history that markets do that better than any other mechanism that we have been able to come up with. But markets, as we have all learned and as Senator Bennett reminds us, are not perfect. And that is why we have regulation, particularly when information is not perfect. And we rely upon regulators to ensure that markets operate efficiently, but within some bounds of reason so that people are not hurt for reasons that are not adequate to them.

So, Mr. Chairman, I thank you for this. Senator Bennett, I want to thank you for your comments about the tulip bubble. I am going to date myself. I was having a Tiny Tim moment here with your discussion about tulips. But I will just end on a statement about "A Tale of Two Cities," maybe on a more literary note, in "A Tale of Two Cities," when Dickens said, "It was the best of times, it was the worst of times." We see that in our country today. Many people are doing quite well. Others are struggling to make ends meet. We see the manifestations of the latter here today, and we are gathered to do something about it, Mr. Chairman, and I thank you for that.

Chairman DODD. Thank you very much, Senator.

With that, let me turn to our witnesses, and I thank our panel for being here.

Senator BUNNING. There are others on the Committee——

Chairman DODD. I am sorry. I apologize.

Senator BUNNING. That is all right, Mr. Chairman. I notice that everybody else has been taken care of.

[Laughter.]

Chairman DODD. Mea culpa, mea culpa, mea maxima culpa.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. That is OK. Thank you very much. I am amazed that sitting here, listening to all of our colleagues on this Committee, and they forget about who used to come here before this Committee and brag about the housing market carrying the economy: none other than our former Chairman of the Federal Reserve, Alan Greenspan. And, he was in charge of bank regulation at the time that all these kind of sophisticated mortgages came into being. I did not hear him say a word about those mortgages when he was here, and now I hear him criticizing everybody that is in the business of lending.

We have a lot of people in housing over their heads, and they are over their heads because of the subprime market lending practices that went on under Greenspan's watch. I think if you are going to criticize and watch a bubble burst, as Greenspan did not only in the housing market but in the market prior to that where he predicted the dot-com downfall before it came, you ought to at least take some of the responsibility on your shoulders for having it happen under your watch.

I say that knowing that we are going to try to fix this problem. It is real. It is a problem centered in the Midwest because of the manufacturing base that has been lost in the Midwest; Kentucky has not been affected nearly like Ohio or Indiana because we have not lost our manufacturing base nearly as bad. We do have some foreclosures, but we also have a lot of people that did not get in over their heads, and they were subject to people trying to entice them into overbuying. And I say that as kindly as I can, because I know—I have a lot of children that are buying houses, and the first thing I told them is don't take an interest-free mortgage on your house or just an interest-only mortgage on your house. Take one that you have to pay some of the principal off, because, you are never going to have a change or be able to capture and buy that house if you just are paying interest, because if the interest rates change you are going to get stuck. And that is what we have had with subprime lending as a problem right now.

And I say that, Mr. Chairman, as kindly as I can, hoping that we find a nice, reasonable solution to this problem.

Thank you.

Chairman DODD. I should point out, and I apologize for missing my colleague from Kentucky here, but I should also note for the record that the one individual a year or so ago who held two hearings on this subject matter was the Senator from Kentucky, along with Senator Allard. And I am grateful to him for raising the issue early on, and what we did in February and what we are doing here today is a continuation of your efforts in this regard. So I want the record to express my appreciation for your work on that, in addition to apologizing to you. How did I miss a white-haired guy on the Committee?

[Laughter.]

Well, let me introduce our witnesses here and thank them once again for being with us.

Ms. Sandra Thompson—and we thank you, Ms. Thompson, for being here—is the Director of the Federal Deposit Insurance Corporation's Division of Supervision and Consumer Protection. I want to recognize the leadership, by the way, and the role that the FDIC and Chairman Bair have exercised in the effort to put out the proposed subprime guidance. I am very, very grateful to the leadership that Ms. Bair has shown in this area, and I am hopeful that she will be able to bring this effort to fruition sooner rather than later, as I mentioned in my opening comments.

Emory Rushton—we thank you as well, Mr. Rushton, for being with us—serves as the Senior Deputy Comptroller and Chief National Bank Examiner in the Office of the Comptroller of the Currency. He is also Chairman of the Committee on Bank Supervision.

Roger Cole—Mr. Cole, we thank you—is Director of the Division of Banking Supervision and Regulation at the Federal Reserve Board. In his capacity, he is the senior Federal Reserve Board staff official with responsibility for banking supervision and regulation.

Mr. Scott Polakoff in November of 2005 was named as the Deputy Director and Chief Operating Officer for the Office of Thrift Supervision. He joined the OTS after serving 22 years with the FDIC, and we thank you for being here.

And Mr. Joseph Smith, Jr., was appointed the North Carolina Commissioner on Banks in 2003. He is a member of the Conference of State Bank Supervisors and currently serves as the organization's secretary, and we are very grateful to have you here representing your fellow bank supervisors from all across the country. Thank you for being with us.

We will begin with you, Ms. Thompson, and, again, what I would like to do here is, all of your statements, any supporting documentation you want to make sure is a part of this Committee hearing will be included in the record. That will go for all of the witnesses here today, and any of my colleagues that want to have opening statements or additional background information they think may be of assistance to the Committee will be included. So we do not need to repeat that again.

I am going to urge you, if you can, each of you here, to try and keep your remarks down to about 5 minutes apiece so we can get to the question-and-answer period for us here. I am not going to hold you rigidly to that, but keep in mind the clock ticking so we can try and move along.

Ms. Thompson, thank you.

STATEMENT OF SANDRA THOMPSON, DIRECTOR, DIVISION OF SUPERVISION AND CONSUMER PROTECTION, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. THOMPSON. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to testify on behalf of the FDIC regarding the residential mortgage market. My written testimony covers the impact that nontraditional and subprime mortgages are having on consumers, on FDIC-supervised institutions, the supervisory standards the Federal banking agencies have imposed, enforcement actions the FDIC has taken, and options for troubled borrowers. I will touch briefly on a few of the key points in my testimony.

The current U.S. mortgage market reflects a number of trends that substantially change the marketing and funding of mortgage loans. These factors include rising home prices, historically low interest rates, intense lender competition, mortgage product innovations, and an abundance of capital from lenders and investors in mortgage-backed securities.

Lenders diversified mortgage offerings and eased lending standards as they competed to attract borrowers and meet the financing needs of prospective home buyers. While liberalized underwriting standards allowed more borrowers to qualify for home loans, competitive pressures eventually led to the abandonment of the two most fundamental tenets of sound lending: approving borrowers based on their ability to repay the loan according to its terms, not just at the introductory rate, and providing borrowers with clear information to help them understand their loan transaction. As a result of lenders' failure to follow these principles, many borrowers find themselves with loans they do not understand and loans they cannot afford.

With respect to mortgage lending, over the past 2 years the Federal banking agencies have published a number of examiner and industry guidance documents warning about deteriorating underwriting standards. The agencies' concerns included interest-only and negative amortization features; limited or no documentation of borrowers' assets, employment, or income; high-loan-to-value and debt-to-income ratios; simultaneous second liens; and increased use of third-party or broker transactions.

The agencies' recent mortgage guidance says that consumers should be provided with clear and accurate information about these products. To help the industry provide necessary information to borrowers, the agencies proposed model disclosures that institutions may use to assist customers as they select products or choose payment options. Collectively, the standards articulated in the various guidance build on fundamental and longstanding consumer protection and risk management principles.

The FDIC enforces mortgage lending standards through examinations and supervisory actions. We have identified those insured institutions that are engaged in subprime lending, and we are closely monitoring their practices. Our examination processes led to the issuance of more than a dozen informal and formal enforcement actions that are currently outstanding against institutions that fail to meet prudential mortgage lending standards.

While the Federal bank regulators have issued guidance to address the issues raised by nontraditional and subprime loans, as well as taking appropriate enforcement action, there remain a large number of borrowers who obtain these loans and face potential economic hardship. Some borrowers with loans due to reset may be able to take advantage of the current interest rate environment and refinance into a fixed-rate mortgage. However, this is not going to be an option for everyone. In many cases, these loans have been securitized, which makes it more challenging to apply the flexibility necessary to develop solutions for borrowers because the terms of the securitizations limit loan workout options.

The FDIC has already begun discussions with lenders, servicers, and other participants in the subprime market. With regard to subprime loans held in insured depository institutions, the FDIC is working to reassure financial institutions that they do not face additional regulatory penalties if they pursue reasonable workout arrangements with borrowers who have encountered financial difficulties.

In addition, programs that transition borrowers from higher-cost loans to lower-cost loans may receive considerable favorable consideration as a lender's Community Reinvestment Act performance is assessed. The FDIC strongly supports such programs.

Simply put, we want people not only to be able to buy a home, but also to keep their home. It is in the long-term best interest of both the borrower and the lender to have a loan product that is prudently made and appropriately meets the borrower's need and financial capacity.

This concludes my statement, and I will be happy to answer questions that the Committee might have.

Chairman DODD. Thank you very much. You did it on time. You were right on the button.

Mr. Rushton.

STATEMENT OF EMORY W. RUSHTON, SENIOR DEPUTY COMPTROLLER AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. RUSHTON. Thank you, Chairman Dodd, Ranking Member Shelby, and members of the Committee. I appreciate this opportunity to answer your questions about mortgage lending in national banks and our supervision of it, especially in regard to the subprime sector, now so much in the news.

I bring the perspective of 42 years as a national bank examiner, during good times and bad. I have had the opportunity to examine banks throughout the country, and I have spent a number of years here in Washington working on bank supervision policy.

We are very concerned about declining loan performance and rising foreclosures in the subprime market. It is easy to forget in this environment that such loans have enabled homeownership for millions of Americans. Even today, most subprime borrowers are paying their loans on time and are expected to continue doing so. Subprime loans are not inherently predatory or abusive, but those that are have no place in the banking system.

Underwriting standards in certain segments of the mortgage market have been declining for several years. This trend was epitomized by the growing popularity of so-called nontraditional mortgage products, such as interest-only and payment-option ARMs.

The OCC signaled its concern about this trend in a series of escalating steps beginning in the fall of 2002. By 2005, we had instructed our examiners to more aggressively address these risks in national banks that were making them, even though home prices were still rising. Comptroller Dugan and other OCC officials spoke publicly and privately about this problem with industry leaders, and we initiated the interagency process that resulted in the nontraditional mortgage guidance last year.

That guidance addressed the underwriting and consumer protection issues associated with payment shock for borrowers who were qualified on the basis of low start rates in effect during the early years of their loans. The guidance required financial institutions to evaluate the borrower's repayment capacity, making fully amortizing payments at the fully indexed rate. It also addressed the increasingly common practice of reliance on reduced documentation, especially unverified income, and it directed lenders to provide borrowers with better and more timely information about these products.

Because we had not included all categories of mortgages with the potential for payment shock in that nontraditional guidance, and, Mr. Chairman, in response to the constructive recommendations we received from you and others, we have turned our attention to the subprime sector, and especially to hybrid ARMs. These make up the biggest portion of the subprime mortgages being originated today.

As compared to nontraditional loans, reset margins on hybrid ARMs tend to be much bigger and the potential for payment shock even more severe. We are also concerned about the structure and size of prepayment penalties that can be a major obstacle when borrowers try to refinance. As with the nontraditional guidance, the proposed subprime statement calls for higher standards of underwriting, disclosure, and consumer protection.

Having said this, Mr. Chairman, we are keenly aware that any steps we take to address problems in this area—prime or subprime—must be sensitive to the potential impact on existing and future homeowners and on the broader economy.

I want to emphasize that national banks are not dominant players in the subprime market. Last year, their share of all new subprime production was less than 10 percent. We know of some subprime lenders that have abandoned their plans for a national bank charter rather than submit to the supervision of the OCC.

Moreover, subprime lending in national banks tends to be higher-quality lending, with delinquency rates only about half the industry average. When delinquencies do occur, we strongly urge national banks to work closely with borrowers to help resolve their problems.

Unfortunately, regulatory oversight tends to be less rigorous in precisely those parts of the financial system where subprime practices seem most problematic. We hope the subprime guidance that we have proposed will inspire comparable measures by other regulators, just as occurred with the nontraditional guidance last year.

In conclusion, let me assure you that my colleagues and I at the OCC are committed to bank safety and soundness and fair treatment of consumers, and we do this through supervision that addresses abuses without stifling healthy innovation.

We look forward to working with you, Mr. Chairman, and members of the Committee. I will be pleased to answer your questions.

Chairman DODD. Thank you very much.

Mr. Cole.

STATEMENT OF ROGER T. COLE, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. COLE. Chairman Dodd, Ranking Member Shelby, Members of the Committee, I appreciate the opportunity to discuss the problems in the subprime mortgage sector and the Federal Reserve's supervisory response.

I have been in banking supervision for more than 30 years. To date, the deterioration in housing credit has been focused on the relatively narrow market for subprime adjustable rate mortgages which represent fewer than one in ten outstanding mortgages. There also is some deterioration in Alt-A mortgages. Borrower performance deterioration has been concentrated in loans made during the past 18 months. Problems in those loans started to become apparent during the latter half of 2006.

The Federal Reserve is concerned about the human dimension of these developments. Some subprime borrowers are clearly experiencing significant financial challenges, and more may join these ranks. At the same time, some subprime lenders and investors have faced financial difficulties as the subprime market corrects. There also may be additional fallout in this market segment.

The Federal Reserve has been monitoring developments in the subprime mortgage market over the past 10 years and has adjusted our supervisor activities as facts and circumstances have warranted. In our examinations of supervised institutions, most risk management practices we have observed in the subprime lending area have been sound; however, in cases where we observe weaknesses, either from a safety and soundness or from a consumer protection perspective, we have directed management to take corrective actions.

As early as the late 1990s, we became increasingly concerned about institutions with significant concentrations in subprime lending. As a result, Federal Reserve examiners conducted reviews of underwriting standards, management information systems, appraisal practices, and securitization processes. In some cases, supervisors took formal enforcement actions to address deficiencies identified in these examinations and, I might also add, levied significant fines.

More recently, we have conducted examinations on stress testing economic capital methods and other quantitative risk management techniques to ensure that banks are assessing the level and nature of the risks of subprime and nontraditional lending appropriately. Since the early 1990s, the Federal Reserve and the other agencies have issued a number of guidance statements on residential real estate lending that have focused on sound underwriting and risk management practices, including the evaluation of the borrower's repayment capacity and collateral valuation.

In 2005, the agencies issued guidance on nontraditional mortgage loans that permit the deferral of principal and in some cases interest. As the principles of sound lending have been with us for generations, most of the guidance we issue is to remind bankers what they should already be doing.

Earlier this month, the agencies proposed additional guidance in subprime mortgage lending which emphasizes the added dimensions of risk when such products are combined with risk-layering features. The Federal Reserve also has significant rule-writing responsibilities for consumer protection laws. In 2002, the Federal Reserve expanded the information that lenders are required to collect under the Home Mortgage Disclosure Act for certain higher-priced loans and extended reporting responsibilities to more State-regulated mortgage companies. The Federal Reserve also has responsibility for the Truth in Lending Act and its required disclosures and has begun a comprehensive review of Regulation Z, which implements that act.

As you are aware, the Federal Reserve and the Office of Thrift Supervision recently added information about nontraditional mortgage products to the Consumer Handbook on Adjustable Rate Mortgages. We also published a consumer education brochure on interest-only mortgages and option ARMs.

The Federal Reserve believes that the availability of credit to subprime borrowers is beneficial when such loans are originated in a safe and sound manner. Our focus is on sound underwriting and risk management practices and on promoting clear, balanced, and timely consumer disclosures. Lenders and investors should take an active role in working through the current problems in the subprime market and in understanding how a stressed environment may affect credit quality. The Federal Reserve also recognizes that a rising number of borrowers are having difficulty meeting their obligations. Examiners will not criticize institutions if they pursue reasonable workout arrangements with borrowers. Working constructively with borrowers is in the best interest of lenders, investors, and the borrowers themselves.

That concludes my oral remarks. Thank you.

Chairman DODD. Thank you very much, Mr. Cole.

Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, DEPUTY DIRECTOR AND CHIEF OPERATING OFFICER, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Mr. Chairman, Ranking Member Shelby, Members of the Committee. Thanks for the opportunity to represent OTS' views today.

In the limited time that I have this morning, I would like to focus on three key areas: No. 1, the difference between subprime and predatory lending, including the importance of this distinction; No. 2, the extent of subprime lending in OTS-regulated thrift industry and our concerns with subprime lending activity outside of the insured depository arena; and, No. 3, OTS' efforts in examiner training on overseeing subprime and nontraditional mortgage lending programs combating predatory lending.

First, it is important to recognize that subprime lending and predatory lending are not synonymous. Specifically, not all subprime lending is predatory, and not all predatory lending is in the subprime market. Appropriately underwritten loans to the subprime borrower are an important element of our financial economy. We believe that timely and appropriate regulatory responses will effectively address the issues of predatory lending in our regulated financial entities, without, most importantly, restricting appropriate credit to worthy borrowers.

As I explain more fully in my written statement, a significant and ongoing OTS concern is striking the right balance with guidance that is targeted at the subprime market. We want to promote responsible lending by the institutions we regulate. We do not want to divert subprime borrowers to less regulated or unregulated lenders.

The next issue I would like to highlight for you is where subprime lending activities are concentrated, and it is not the thrift industry. Recent data indicates that nearly 69 percent of all U.S. households are homeowners, with national home mortgage debt around $10 trillion. Subprime mortgages account for about $1.3 trillion, or roughly 13 percent of the national mortgage debt, and hybrid ARMs are the predominant product in the subprime market.

2006 data shows that only 17 of our 850 thrifts have significant subprime lending operations. These institutions have $47 billion in subprime mortgages, which represents less than 4 percent of the nationwide subprime market.

We believe that up to 80 percent of the subprime loans are originated through mortgage brokers, and currently there are roughly 44,000 licensed mortgage brokers in the United States. Mortgage brokers are typically required to obtain a State license, but frequently there are no testing or educational requirements as part of that process. Complicating the picture is the difficulty in doing reliable background checks to draw from a national criminal data base, such as the FBI's system.

It was recently reported in the American Banker that eight States have no regulation of mortgage bankers and lenders. Two of these States have the highest delinquency rates in the country for subprime hybrid ARMs, with delinquency figures substantially above the national average. We understand that the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are currently working on a nationwide residential mortgage license program to address part of the problem, and we applaud that effort. Addressing subprime lending abuses requires attention at the point where the abuse occurs. This is almost always the point of contact between the borrowers when they make their loan decision and the mortgage brokers.

Finally, I would like to address OTS' efforts aimed as overseeing subprime and nontraditional mortgage lending programs in combating predatory lending. OTS-regulated institutions that engage in significant subprime lending programs are subject to heightened OTS supervision with respect to the conduct and operation of these programs. Institutions are reviewed from the safety and soundness perspective, and they are also scrutinized to ensure that their institution is lending responsibly and following applicable consumer protection laws and regulations. Our review includes an assessment of any unusual consumer complaint activity regarding their mortgage lending operations.

We also stress the need for institutions to work with their borrowers to resolve payment delinquencies in a timely manner. Strategies to prevent foreclosure can often be beneficial to the lender, the borrower, and the community. We encourage all of our regulated institutions to consider and adopt such programs in a manner consistent with safe and sound practices and consumer protection regulations.

The OTS has an effective formal and informal enforcement program to address problematic and potentially abusive consumer lending practices. A few of our regulatory actions resulted in the institutions surrendering their charter.

A final point regarding OTS efforts to improve and promote compliance with applicable consumer protection programs is our robust consumer complaint process. We continually track consumer complaints on both an institution-specific basis and complaint category basis to ensure both timely and appropriate regulatory responses. Consumer complaint data is reviewed again as part of our examination process to focus our examination resources properly.

That concludes my remarks. Thank you for the opportunity, and I look forward to answering any questions.

Chairman DODD. Thank you very much.

Mr. Smith, thank you for being here.

STATEMENT OF JOSEPH A. SMITH, JR., COMMISSIONER OF BANKS, STATE OF NORTH CAROLINA

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Shelby, it is an honor to be with you today. In addition to being the Commissioner of Banks, which is the job I thought I took in 2003, I am also Commissioner of Mortgages. My office licenses 1,600 mortgage firms and 16,000 individual mortgage loan officers, so I have a little experience in this business. I would like to emphasize I am speaking today on behalf of my colleagues in CSBS, and I guess indirectly on behalf of AARMR. I would like to talk about three or four points and then answer any questions to the best of my ability that you may have for me.

First, how did we get here? One of your questions in your kind invitation was how the heck did we get in this fix anyway. There has been, in fact, a revolution in mortgage finance, generally IT driven, that has changed the mortgage market since I borrowed my first home loan in Norwalk, Connecticut, in 1978 from the Norwalk Savings Society, when loans were made by local institutions and held by those institutions, to a situation now where in the mortgage market a majority of the home loans are made through networks of independent contractors, mortgage brokers, independent mortgage bankers, vendors, securitizers, investors, and servicers, all of whom are different institutions, many of whom have never seen the customer.

The result of this revolution has been—there is the good, the bad, and the ugly, as I have said sometimes. The good has been increased liquidity in the marketplace, increased availability of mortgages to people who used not to be able to get them. That has been the good news. The bad news has been increased foreclosures, and the bad news is also—well, the bad news really had been fraud, an increase in fraud because of the moral hazard that this independent contractor network situation sets up. And the ugly has been increased foreclosures.

My second point is this: The States have been the first responders to crises from this revolution. Many States—my own, North Carolina, I am proud to say was the first to adopt predatory lending laws to address problems in 1999, which in those days were asset stripping through the flipping of loans and through other inappropriate conduct. We then went into the mortgage licensure, and I think it is fair to say today I believe the correct answer to the question about how many States act in this area is 49. Alaska has not. I guess they haven't gotten the memo yet. Anyway, we hope to bring them in soon so that all 50 States act in some way or other to try to regulate the mortgage market.

I would have thought that we would have been applauded by the industry and our colleagues in Government at the Federal level for these activities. In fact, we were not. We were criticized. We were accused, among other things, of reverse redlining, of being well-meaning chuckleheads who were denying mortgage finance to people who needed it. And we were preempted. That is the bad news.

The good news is recently, in terms of our cooperation between States—Mr. Polakoff, my good friend, is correct—the States are working together to form a national licensing system. It will be ready for operation, we hope, in early 2008, and 29 States are pledged to be on board by the end of 2009. And we also have, working with our Federal colleagues, we were glad to follow them, have adopted the nontraditional mortgage guidance, and I look forward to also adopting comparable additional guidance with regard to the subprime release. So I think it is fair to say we have acted.

I would like to talk a minute now in the little time I have about people, because I agree with you, we in the States live with the problem. When there is a problem in our neighborhoods and our communities, we see it firsthand.

I would suggest, Mr. Chairman, that you are correct to suggest that a way to deal with this is more locally or through the cooperation of the many stakeholders. My good friend and colleague, Steve

Antonakes, who is the Commissioner in Massachusetts, has just gotten an award from NeighborWorks for calling a mortgage summit in Massachusetts to try to bring people together to solve—to deal with the issue. I do think a local treatment of these issues of rescue is important, because the reasons, frankly, vary around the Nation. There are structural issues in Ohio and Pennsylvania. There are other issues in other States. Lord knows what the issues are in California. I do not envy them.

Finally, I have, I hope not too presumptuously, suggested in our testimony a few things that Congress could do, if you wish, to help set broad rules of the road for the mortgage market as we go forward, and I would be happy to discuss those or anything else you would like us to discuss with you. But, again, thank you very much for this opportunity.

Chairman DODD. Well, thank you very, very much. It is very worthwhile to have your presence here with us, giving us a good local perspective on how you grapple with these things at the local level.

I am going to ask the clerk here to allocate 7 minutes to each of us here in our question period so we give everyone a chance to move through. We have a second panel as well. And, by the way, there may be some additional questions in writing that members will submit. We would ask the witnesses to respond in a timely fashion to those requests for the record as well.

Let me, if I can, Mr. Cole, focus a bit on the Fed, if I can, in my line of questioning for you. The Chairman of the Federal Reserve—I made note earlier of the speech given to the credit unions back in February of 2004 in which—where is that opening? Well, you got the quote from him. You can put that one down from a second, when he says, "the American consumer might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgages. A traditional fixed-rate mortgage may be an expensive method of financing a home." That is the quote. You can take that one down. That is from the Chairman of the Federal Reserve in February of 2004.

I then want to put up this chart here because this one really—this is now—the zero line indicates sort of a neutral position, if you will, on credit standards. And what you see above the line is sort of increasing credit standards; the blue lines that go below are lessening of credit standards. And what you have happening here, beginning in the first quarter of 2004, ironically, about the very same time the Chairman gives his speech, running all the way through until the third quarter of 2006 is a lessening of these credit standards, really dropping down.

Now, again, it is one line in a speech that day. I do not know what all the other remarks were about, but clearly when the Chairman of the Federal Reserve talks about proposing these exotic or alternative instruments, and you get a reaction from the lending institutions that begin to lessen those standards, you begin to see a pattern coming in.

Then what you watch happen here—and I just want to get through this quickly, if I can. We then watch during virtually the same period of time, beginning right around the first quarter of 2004, you find a record number of these adjustable rate mortgages jumping up to as high as 33, 34 percent of these instruments going out.

So you have the speech, you have the lessening of the credit standards, and you have a jump in these rather exotic instruments coming up that have resulted in, of course, much of what we are looking at here today.

Then you have beginning about 3 months later, of course, the raising, going from the 1-percent interest rate and beginning those 17 increases in the short-term rates for the next 24 months, concluding in June of 2006, here with up to 5.25 percent. All of this is happening at a time when obviously people are getting involved in these issues. You have as the underlying statute, which I quoted earlier to you, from the FTC Act, which dates to 1975, and the HOEPA Act in 1994, not a voluntary request of the Fed to adopt and prescribe certain regulations and rules but, rather, a requirement, it shall prescribe, it shall promulgate regulations.

The obvious question is: Why hasn't the Fed acted—first of all, going back earlier, but second, when all of this begins to show up, according to the testimony of the Fed, talking with our Committee Members, the examiners of the Federal Reserve observed a deterioration in credit standards in late 2003, early 2004. So the credit standards begin to drop. The Fed takes note of it here. You have the increase in the rates occurring in June. You have this jump in the ARMs, these exotic instruments in here. And yet it takes up until now, still waiting here, for any clear indications of how the Fed is going to step in and do something about this. Here we are into 2007.

How does the Fed respond to this criticism?

Mr. COLE. All right. Well, thank you for the opportunity to respond. I believe a timeline was distributed earlier this morning that we are making part of the record, and in that regard, we have laid out a number of actions that we, as well as the other agencies, have taken in response to what we have identified even going back into the late 1990s as a problem with subprime lending and predatory practices.

But, you know, kind of picking up at 2003, we did issue appraisal guidance clarifications indicating the importance of appraiser independence from the loan origination and credit decision process. Then in 2003 through 2006, we have issued formal enforcement actions as well as informal enforcement actions against institutions that we identified engaged in predatory lending and ill-advised subprime lending activities from a safety and soundness perspective.

Chairman DODD. That is safety and soundness from the lending institution's perspective.

Mr. COLE. Correct.

Chairman DODD. But the statutes I quoted to you talk about protecting the borrower as well here.

Mr. COLE. And one of the key points that we have made along the way in this guidance is—a key aspect of underwriting standards that we hold these institutions accountable for is judging the ability to repay of the borrower. That is a very important part of our guidance going back throughout this period, and, in fact, I think it goes back for generations, actually, as sound underwriting.

So as we saw the problems developing, we did increase our focus on efforts to review what the banking industry and the mortgage origination firms under our responsibility were doing.

In 2004, the Federal Reserve and the FDIC issued interagency guidance on unfair or deceptive acts or practices by State-chartered banks, and, in fact, what we did here was in part a response to your question with regard to the Home Ownership and Equity Protection Act. What we were doing in terms of the 2004 guidance was using our authority under the Federal Trade Commission Act to enforce provisions against predatory and unfair and deceptive lending.

Chairman DODD. Could I ask you, Mr. Cole—the chronology is interesting, but it seems a very simple thing would have been here with these new adjustable rate mortgages, which have the teaser rates coming in at a very low number, and then every 6 months those rates moving up. It seems common sense that you would want to determine whether or not the borrower was in a position to financially pay at the fully indexed rate. This is not terribly complicated.

Mr. COLE. That is right.

Chairman DODD. Why didn't you do that?

Mr. COLE. Well, that is part of the underwriting requirements.

Chairman DODD. Well, I know, but you did not—you had the authority under HOEPA that says you shall do these things, and the FTC Act. Why wouldn't you have just done that?

Mr. COLE. Well, under the FTC Act, we were providing this type of guidance to do it.

Chairman DODD. Why not specific regulations? Why not saying you have to meet that fully indexed rate, require that as an underwriting regulation?

Mr. COLE. In terms of judging the ability to repay, we would hold the institutions responsible for considering those types of teaser rates. In terms of what the Chairman said with regard to ARMs, you know, I understand there have been some clarifications going through that, but what I would take that as meaning was that ARMs per se are worth considering. There are many different types——

Chairman DODD. No one is arguing with that. I understand that. But if you are going to make—for underwriting purposes here, you want to make sure that that borrower here is going to be able to meet the obligations of the fully indexed rate is a requirement to meet underwriting requirements here. Why wouldn't that simple rule have been promulgated earlier when you began to see these problems emerging as late as late 2003, early 2004, 3 years ago? Why wouldn't there have been a promulgation saying this is a requirement, an underwriting requirement? Why wouldn't that have happened?

Mr. COLE. Well, what we did was in November or December of 2005 put out the draft statement on nontraditional mortgages which had that specific language in it. And when that went out, our understanding is that that had quite an effect on the industry. The notice was taken by the industry.

But I would say, you know, as a supervisor, that I would hold an institution to doing that type of analysis when they came up with this idea of these teaser rates. In designing these products and layering these additional risk dimensions to these products, they are responsible for making a determination on an individual basis of ability to repay.

Chairman DODD. Well, last here, can I—I made the request in the opening statements about getting some prompt response on finalizing and formalizing this guidance. Do you have any indication when that might happen?

Mr. COLE. Well, the comment period ends May 7. It will take us several weeks to review the comments, and then hopefully shortly after that we will be able to move forward on a final.

Chairman DODD. And, by the way, you wouldn't disagree, if you did this, you took the authority under the HOEPA Act, that would apply to States as well, not just federally chartered institutions.

Mr. COLE. That is correct.

Chairman DODD. Yes.

Mr. COLE. That broadly applies.

Chairman DODD. Well, are you going to do that? Is that going to happen?

Mr. COLE. I will go back to the Federal Reserve Board, talk to the Governors. We will have discussions.

Chairman DODD. Well, I would urge you to do that again here. Again, that covers that purview generally under fair credit, but people when borrowing expect certain standards to be met. You have the authority granted 13 years ago under that act. It is not a request. It is a demand in many ways, and we hope you would do that. I would certainly hope you would do that. Thank you.

Senator Shelby.

Senator SHELBY. I will start with you, Ms. Thompson. What is the percentage of subprime loans outstanding that are nonperforming, that are 30 days late or more, in your best judgment today?

Ms. THOMPSON. Well, Senator Shelby, the total outstanding balance of subprime——

Senator SHELBY. Would you speak up where we can hear you?

Ms. THOMPSON. Sorry. The total outstanding balance of subprime loans is about $1.28 trillion as of——

Senator SHELBY. That is total loans outstanding?

Ms. THOMPSON. Total outstanding——

Senator SHELBY. One-point-two——

Ms. THOMPSON. Trillion, total outstanding——

Senator SHELBY. $1.2 trillion.

Ms. THOMPSON. Correct.

Senator SHELBY. Now, what percentage of those loans are 30 days in delinquency or more?

Ms. THOMPSON. According to the Mortgage Bankers Association data, as of the fourth quarter 2006, subprime loans are roughly 14.4 percent delinquent.

Senator SHELBY. Do you believe that that has gone up since the end of December of 2006?

Ms. THOMPSON. I believe it has gone up since the end of December 2005, and I am not——

Senator SHELBY. And continues to go up, but you don't have the data as to the percentage——

Ms. THOMPSON. I do not have the data.

Senator SHELBY. So you cannot say if it is 14 percent, 16 percent, or 20 percent of the outstanding $1.2 trillion portfolio.

Ms. THOMPSON. Senator Shelby, we get the data for the fourth quarter soon in the——

Senator SHELBY. The fourth quarter of last year?

Ms. THOMPSON. Of last year, yes, sir. It is about 3 months' lag time.

Senator SHELBY. Do you have any preliminary figures on that?

Ms. THOMPSON. Yes, sir. From the Mortgage Bankers Association, it is about 14 percent.

Senator SHELBY. 14 percent of that, so that means out of a $1.2 trillion portfolio, so to speak, so you have got, say, $150 billion, at least, of delinquent mortgages in the subprime area.

Ms. THOMPSON. As of fourth quarter 2006, yes.

Senator SHELBY. Do you anticipate that that will continue to escalate?

Ms. THOMPSON. Well, we believe that there is about a million loans that are scheduled to have their interest rates reset this year, and that means that they are going to have these payment changes.

Senator SHELBY. And that means that interest rates are going to go up on them, not down. Is that right?

Ms. THOMPSON. That is absolutely correct, sir. And——

Senator SHELBY. And that will exacerbate the problem, will it not?

Ms. THOMPSON. Yes, sir. And next year, in 2008, there is just over 800,000 adjustable rate mortgages that will have their interest rates reset, and the payments will change as well.

Senator SHELBY. And by "reset," that means adjusted, the interest rate, upward not downward?

Ms. THOMPSON. Yes, sir.

Senator SHELBY. So we are probably just touching the tip of the iceberg, maybe, as far as subprime. Is that fair?

Ms. THOMPSON. That would be a fair statement to say, sir.

Senator SHELBY. OK. Is there enough capital in the banking system and the private banking system and the people who have underwritten a lot of these mortgages, you know, as securities, is there enough capital to underwrite this to absorb this loss? Because I believe it is going to be big.

Ms. THOMPSON. There is a lot of capital in the banking system, sir, but many of the banks do not hold these mortgages——

Senator SHELBY. They have sold them, have they not?

Ms. THOMPSON. They have sold them to securitization structures and they are now existing in the form of secure——

Senator SHELBY. But have some of the banks bought those securities back?

Ms. THOMPSON. Yes, there have been some early payment defaults and first payment defaults from some of the securitizations that have been issued that comprise these hybrid subprime ARM loans. And to the extent that they violate representation and warranties, then the institution will have to purchase them back.

Senator SHELBY. Well, who is holding the risk here, ultimately? If you securitize mortgages that are subprime, that are questions to begin with, and you put a stamp on them, and then the banks sell them, then they buy them back as securities, there is still a risk there, is there not?

Ms. THOMPSON. That is correct, sir.

Senator SHELBY. And who is holding the risk?

Ms. THOMPSON. When the securities are created——

Senator SHELBY. The people that hold the securities?

Ms. THOMPSON. The investors that hold the securities have the risk.

Senator SHELBY. And that could be part of our banking system holding the securities, could it not?

Ms. THOMPSON. Our financial institutions typically hold highly investment grade or highly rated securities, AAA through BBB.

Senator SHELBY. Now, how do the rating agencies rate subprime loans that are questions to begin with, high risk, and they underwrite them and they rate them as high-grade investments? How do they do that? Is that stretching your imagination a little bit? Does that concern you?

Ms. THOMPSON. Sir, subprime ARMs generally—the hybrid ARMs concern us generally. We are very concerned about the increase in delinquencies. We are very concerned about the increase in foreclosure. And when the FDIC looks at this issue, it is not just a market issue; it is about the people.

We have said that we want to make sure that borrowers have information, that the lenders that originate these loans have some responsibility to work with the borrowers to restructure these loans so that the borrower can keep their homes and continue to make payments that they can afford.

Senator SHELBY. Do you believe that you as a regulator and the other regulators bear some responsibility in lax underwriting standards in this area?

Ms. THOMPSON. Sir, I believe that we do have a responsibility to make our institutions adhere to prudent underwriting standards, which means that borrowers have to know what kind of loan products they are eligible for and are entering into. They have to understand that they are going to get a loan where the payment changes. They need to make sure they understand that. They absolutely have to—the lenders have to make sure that they are underwriting these borrowers to the ability where they can really afford to repay the loan, because we want to make sure that borrowers not only can get the loans but that they can keep their homes as well.

Senator SHELBY. Well, I think that is the whole idea behind this, is pushing home ownership. But if you put people in houses because money is so lax and the standards are so loose and you have—it defies common sense to say they are going to make those payments when their incomes were never verified. Everybody wants a better house. We understand that. That is the American way. But can they afford this? And if the standards are so low, you are not doing the average American any favor to put them in a house that they are going to lose and put them in a quandary as far as their credit is going to follow them all their life.

Ms. THOMPSON. We agree, Senator Shelby, which is why we have the standards out there that will require our lenders to underwrite these loans to the fully indexed, fully amortized rate. And, again, we do want to make sure that borrowers are getting loans that they can afford because we do not just want to promote home ownership, we want to preserve it.

Senator SHELBY. Well, Mr. Rushton, are you concerned at all about the ability of the banks, the banking system, to absorb losses in this area? And there will be some, and they will be big. This could be the beginning of a real crisis that will continue to creep and creep and creep until it reaches a certain point, maybe 2, 3 years down the road.

Mr. RUSHTON. We are always concerned about losses in the banking system, but we have tried to put some parameters on this one, and right now it does not appear to pose any viability threat to any national bank or any other bank that we know of.

Senator SHELBY. Are you saying that these are going to be minimal losses?

Mr. RUSHTON. They are not going to be minimal.

Senator SHELBY. No. They are going to be big.

Mr. RUSHTON. In terms of capital, the net exposure of the national banks that are most heavily exposed in this market amounts to only about 5 percent of their total capital. So it does not really threaten the bank, and we are not concerned about bank viability. It could affect some of their earnings, to be sure.

We are more concerned, quite frankly, about the continued availability of credit and how a sudden contraction of market liquidity for these sorts of securities in the secondary market could affect the ability of homeowners to refinance to get new loans. A great deal of this paper is in the hands of unregulated investors, both from the U.S. and abroad, who are not driven by the same incentives of working with customers that banks are.

Senator SHELBY. How do the rating agencies rate some of these securitized subprime loans that they package in the——

Mr. RUSHTON. Well, those are the——

Senator SHELBY. How do they rate them highly—or if they are rated high—and they are, a lot of them are—how can they justify that?

Mr. RUSHTON. I think some of those ratings are getting quite shaky right now. The ratings are most important to regulated financial institutions that want to buy the securities and other investors that have some criteria for quality. They pay attention to the ratings. A lot of the money, however, flows into this market from investors who are looking for risk and are willing to accept extremely high risk in return for an extremely high return. They are not so much concerned about ratings as they are with their ability to make money on the securities, and those are largely the unregulated entities.

Senator SHELBY. Well, I think they better be concerned with the risk.

Thank you, Mr. Chairman, for calling this hearing.

Chairman DODD. Thank you very much.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and I appreciate this hearing.

I wanted to focus, I guess, on two areas, which is probably all I will have time for. One is in the area of enforcement, and, Ms.

Thompson, I know you were speaking to that in the abbreviated version of your testimony. I know you did not have time to read all of it, to go through all of it. But I am looking at page 9 of your testimony, and you say in part there that—you are talking about taking action. In the second paragraph on page 9 under "Enforcement," you say, "Our examination process has led to the issuance of more than a dozen formal and informal enforcement actions that are currently outstanding against FDIC-supervised institutions that failed to meet prudent mortgage lending standards." And it goes on from there.

Tell me about your current enforcement actions in terms of the specifics, but also if you can briefly—and I know we do not have much time, but briefly describe the enforcement process, the actions that you take and how that unfolds, how long it takes and what the penalties are.

Ms. THOMPSON. OK. When we go in and conduct examinations on institutions, if we find problems, then we usually try to work with—we will cite a violation, and we will talk to the institution's management, board of directors, and let them know what those problems are. To the extent that they do not correct those, we cite—it is called "progressive supervision," and we will have a cease-and-desist order, which is a formal enforcement action. We might have a memorandum of understanding with the board if we have particular issues, and we will give them the opportunity to correct. So a lot of violations go through the informal process before they reach the formal process.

The FDIC currently has a couple of cease-and-desist orders outstanding on financial institutions that were engaged in subprime mortgage lending, and they are public. And to the extent that you have questions or comments, what I would say is that we do go into the institutions, we examine them for safety and soundness and good risk management and consumer protection principles. And to the extent we find issues, we cite violations. We communicate those violations to board management and boards of directors, and we also engage in memorandums of understanding with board and bank management. And to the extent that they do not comply, we go to the formal process, and we might issue a cease-and-desist order.

Senator CASEY. So the cease-and-desist order is as a result of the initiation of a formal process?

Ms. THOMPSON. Yes, sir.

Senator CASEY. OK. Now, how does that play out in terms of time? How long does the informal part of this take? Is there a time limit on that?

Ms. THOMPSON. It depends, but to the extent that we have a cease-and-desist order process, it could go anywhere from 1 to 3 months when we get the information. All of it has to relate to the information that we get from the exam.

Senator CASEY. What I am trying to get a sense of is: Is there a requirement under your procedures that you exhaust any kind of informal process before you initiate a formal procedure which could result in a penalty?

Ms. THOMPSON. There is not a requirement, but we do try to work with institution management and boards of directors so that they can correct problems when they get to the formal action.

Senator CASEY. OK. And I want to get a sense also—and this is—I want to review it, but if there is a—in other words, when you get to the end of the road, say you are in the formal process, you can issue a cease-and-desist order. Are there other tools that you can use, or are there things that you believe that Congress or even through a rulemaking process, other tools that we could give you or you could be provided to have additional penalties or additional enforcement vehicles?

Ms. THOMPSON. We believe we have the supervisory tools available. We can issue civil money penalties, and we can issue orders against specific board members and bank management so that they are curtailed in banking practices.

Senator CASEY. I would ask anyone else on the panel, in terms of enforcement, in terms of getting to a solution—we are spending a lot of time today, and it is great, on what happened and why and that is important. But I want to get to the point where we start talking about how we can correct this, at least on the enforcement level. Mr. Smith?

Mr. SMITH. There are 50 State authorities who do do a lot of enforcement. Ameriquest, which was the largest consumer settlement in the mortgage—I believe in the history of the mortgage industry, which regulating of predatory lending was done by the States. Household Finance Settlement was led by the States, although I must say in fairness, HSBC has been a terrific supporter of our mortgage project, national mortgage project. But there was a time when they were not.

You have 50 State Attorneys General. You have 50 State mortgage—49 State mortgage regulators. In North Carolina, we have an active program of enforcement. Our problem, to be candid, sir, is to pick the targets that will yield us the best returns the quickest. So there is a lot of enforcement activity going on outside the Beltway.

Senator CASEY. And you are saying that you think the States, by and large, have the right—they have enough——

Mr. SMITH. And, in fairness, it is our responsibility for the non-regulated mortgage brokers and bankers. I mean, that is our job. But a lot of that we are doing—we are working as hard as we can, and it is frustrating, and it takes—to answer your other question, how long does it take for a major investigation—and, again, I was a bank lawyer before I took this job. I did not know about investigations. But the preparation and prosecution of a matter, an administrative matter, under the Mortgage Lending Act takes time. It just takes time and money. But we are working on it.

Senator CASEY. And I am running out of time. Thank you for that answer.

Let me ask you, because you spoke earlier as someone who not only knows a lot about this problem and the solutions, but you are dealing with it at a local and statewide level. You pointed in particular in your testimony to mortgage brokers and the need for regulation.

Mr. SMITH. Right.

Senator CASEY. What do we have to do on that issue in terms of cracking down on mortgage brokers who seem to be at the root of a lot of these problems?

Mr. SMITH. Well, I think there are several alternatives. First, I will say my good friend David Blanken from Pennsylvania is doing outstanding work under your law in policing the mortgage market in Pennsylvania.

Senator CASEY. I wish I could take credit for that. I cannot.

Mr. SMITH. All right. Somebody should. Maybe Mrs. Blanken, his mom. But, anyway, I think we do have a system of national mortgage regulation, coordinated regulation that can work in the relatively near future. Two things would be helpful.

We would not mind a little money. We are raising money, but to complete this will cost less than the Federal Government spills in an hour.

The second thing is I think Congress could, if it wished, in terms of the system, give us a sort of Gramm-Leach-Bliley style deadline to get our system up. You remember calling the Gramm-Leach-Bliley and I believe some of the privacy provisions, the States had to act, over insurance, I can't—I believe it was privacy. They had to act within a certain time or the Feds would do it for us.

There are those of us who have real skin in this game. I am getting rid of a million dollar system that works pretty well. You can ask David. We have invested $250,000 more of our own money to make this thing work. Some States help us. Some States do not. It would be nice to encourage them to help get with the program. I do think a State-organized system is the quickest and best result to policing in the way you are talking about. So that is another thing.

I have also had the temerity to suggest a few normative things you may want to consider in terms of the market in the future, but that would probably beyond my—I do not want to be—get above my rearing. I will stop there.

Senator CASEY. Thank you, sir. I appreciate it.

Chairman DODD. Thank you, Senator Casey.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Chairman DODD. Let me inform my colleagues, by the way, we are going to have to take a break in a few minutes. There are going to be some votes on the floor and so we are going to take a recess. But we will go as long as we can here to get as much covered by our colleagues. We may have to come back for those who want to complete some questioning for this panel.

Senator CRAPO. Thank you, and I realize we do have those votes coming up. So I will just ask a couple of my questions and then submit others for the record if that is all right.

For anyone on the panel, my first question is at the last hearing we held in February a number of reasons were tossed out as to why it is that we are seeing this dynamic now, in terms of the subprime loans, the number of mortgage delinquencies and home foreclosures that we are seeing in the subprime market.

Would any or each of you jump in and try to help explain to us what are the causes? What is causing this high rate of delinquency and the dramatic increase in mortgage foreclosures? Mr. Smith?

Mr. SMITH. I was going to say from where I sit, I agree with you, Senator, about market discipline. What, from my perspective, has been stunning to me is where is the market discipline, in terms of underwriting, in terms of the rating agencies?

We do our best to please the marketplace. We are not perfect but we try. But we did assume, naively, that up the line that lenders and securitizers were doing diligence on the people they did business with. I do not know that that is the truth. We assumed that there was going to be underwriting by the lenders of the kind that would assure that got repaid.

Forget even fairness to the borrower. It is just why would you make a loan, no money down, teaser rate loan to somebody with bad credit?

Senator CRAPO. That raises a very important question because the same point was made at the last hearing. The argument was made that why would anybody, at any stage in the level, make a loan that they knew was going to go delinquent?

But there was an argument brought up by at least one of the witnesses there that there is a financial gain to some parts of the industry from having that loan made, whether it goes delinquent or not.

Mr. SMITH. In the food chain what happens is the broker makes the loan, gets a fee, goes upstream, the securitizer puts them together, sells it, gets markup, either a gain on sale or a fee of some kind. It goes out into a trust which goes to investors. And then the derivatives markets gets involved. And I would love to tell you about that but I do not understand it. People make money that way.

And so the result is that you have a fee-driven, volume-driven machine that was proceeding for reasons—well I have said in an article recently in the American Banker—they did not have anything else to publish so they put one of mine in, but it was funny—the animal spirits overcame what remained of the control environment in the capital markets.

But I just, for the life of me——

Senator CRAPO. And at some point at that food chain, somebody pays the piper.

Mr. SMITH. Absolutely, and we do not know yet who that—I do not know yet.

Senator CRAPO. I was just going to ask you why, at that stage, there is not some market-driven control? Anybody else want to jump in on this?

Mr. POLAKOFF. Senator, I would offer that I have the perspective that market capitalization is a key ingredient to this problem. As Mr. Smith just described, there are willing investors out there for almost any type of product.

The securitization process typically takes this pool of loans and breaks it into a AAA rating. And there are many ways to structure it to get the AAA rating. That AAA rating, indeed, may not be wrong.

Then there is a mezzanine part of the securitization. And then there is that last part, the residual part, which can really be nasty.

But the market and the volume of investors in moving the money—and the market has already reacted to subprime via the pricing. It has pretty much shut off the liquidity for the subprime market right now.

Senator CRAPO. Mr. Cole.

Mr. COLE. I would also offer that the low interest rate risk—interest rate environment that preceded the run-up in 2004 did encourage a lot of entrants into the market. Then with the securitization, that certainly provided a very robust financing vehicle. So that encouraged significant increase in home prices.

Frankly, it was that perception, that prices were just going up and up, that made a lot of these deals seem viable that otherwise would not be.

Senator CRAPO. I think that one way to put it, and I have heard it said by several members here today, we are not necessarily saying that many of the people who are finding themselves in trouble now should not get any credit. It is that they were extended credit for far too great a purchase or put into a product that they did not understand that extended their cash—that overextended their cash-flow.

I would like to explore this topic for a long time with you but I do not have time. I have just one other question I would like to toss out.

I am reading a report to Congress from CRS, the Congressional Research Service, on the subprime mortgage issue. Interestingly in here it indicates, I will just quote from it, it says that "Government policies designed to aid lower income consumers to achieve home ownership may have contributed to the expansion of subprime lending."

And then it goes on to talk about the Community Reinvestment Act that encourages lenders to provide loans in poorer areas of the market where subprime borrowers are in a higher percentage. And also HUD's affordable housing goals that encourage the GSEs to focus their resources in this area of the marketplace, as well as some aspects of the FHA operations.

So the question I have to you is have we driven part of this from the policy level in Washington by the directives that we have given to our housing programs in this country to go into these markets and start servicing them better?

Mr. POLAKOFF. Senator I would offer the answer is now, that there are just absolutely outstanding loans made to low and moderate income communities, even if they are loans to individuals who have tainted credit, i.e. maybe subprime in nature, they can still be underwritten in an appropriate fashion.

Ms. THOMPSON. I would agree with that. And the Community Reinvestment Act encourages safe and sound loans, loans that are made with prudent underwriting standards.

Senator CRAPO. I am glad to hear that answer because that is the answer I had hoped that I would get. And it also reaffirms the issue that I raised earlier of the availability of credit, which is such an important part of helping people to get into their homes or to move up the chain in the American dream is something that we do not want to dampen here beyond reasonableness.

What you are telling me that is we can achieve some of these objectives with good solid loans. And that there is a different problem other than our effort to try to get as deep as we can into these markets to help people get access to home ownership. Is that correct?

I see everybody on the panel shaking their head yes.

Mr. Chairman, thank you for this hearing.

Chairman DODD. Thank you very much.

I would just point out that is a very good question you have asked, Senator. It has been pointed out to me that there are 10 million households in this country that have never stepped into a bank, a thrift, or a credit union, and do not have access to mainstream financial services in this country.

One of the goals of this Committees is going to be the whole issue of access to capital. And that home ownership, what a difference it makes in a neighborhood and a community.

I know that Senator Shelby feels as I do here. I do not want anyone in this room to believe for a single second that we believe that subprime lending is the equivalent of predatory lending. It is not at all. And good solid subprime lending has made a huge difference for people in this country.

And so our goal here is to try to sort this out. My concerns have been, as I said at the outset here, that we could have taken some steps early on that I think would have made a difference. And I regret that has not been done by the regulators and I am going to give you a chance to respond in the coming days.

Let me turn to my—I do not know which one of you arrived first. I apologize. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

I want to jump off on where Mr. Smith made a comment, that the animal instincts got control over the market. The reality is this is something that I had hoped that the industry itself would have taken attention to. Several of us called their attention to it. Now we find ourselves in the circumstances that we do.

And I want to put a human face on these abusive practices. In my home State of New Jersey I have heard from many individuals who are facing this situation. One of them, Ms. Gilbert finds herself—she lost her job, she fell behind on her monthly mortgage payments. She was facing foreclosure. And she was contacted by a mortgage company promising to bring her out of the foreclosure and actually lower her payments.

She was given an adjustable rate mortgage of $3,000 per month. When she told the lender that that was far too much because she only earned $30,000 a year, which is about $2,500 a month, $500 less than her mortgage, her response to her was well, as long as you use the cash to pay during the first year, we will be able to get you an affordable—refinance you into affordable loan after 1 year.

We all know where the story is going. The reality is she was not able to make the payments after the year and that mortgage company instituted a foreclosure action against her, which is pending today.

So it seems to me, based particularly on the answers that Senator Shelby got from Ms. Thompson, that what we are looking at is a tsunami of foreclosures that is on the horizon. And we get desensitized by the numbers, $160 billion and then moving on to next year and whatnot.

But that means thousands of families that we are going to transform the dream of home ownership and we are going to make it a nightmare for them. And we are going to affect their credit in the long-term.

That is a huge consequence. Mr. Chairman, one of the things that enormously bothers me about this issue is when I look at minority home buyers. 52 percent of African Americans seem to be finding themselves in this context. 47 percent of Latinos are finding themselves in this context. Their percentage is far beyond the rest of the population.

So it seems to me that this practice is particularly amongst those who are already struggling to try to make this dream a reality. And so it is, in my mind, particularly heinous in that respect.

I really believe that we have got to look at some national standards that define and penalize predatory lenders, that we have to certainly create access to financial literacy programs and counseling service so that prospective home buyers make informed decisions. We need to ensure that borrowers are qualified and can afford the loans they are given.

But as we look toward that, I want to ask you, Mr. Cole, I understand and I want to pick up where the Chairman asked some of the questions. I understand that the Federal Reserve has broad authority to regulate any unfair lending practices under the Home Ownership and Equity Protection Act. Is that not a fair statement?

Mr. COLE. That is correct.

Senator MENENDEZ. And in that respect, it is my understanding that the Federal Reserve has taken no significant action against any subprime lender, nor have you issued any warnings to hybrid ARMs; is that right? What actions have you taken against subprime lenders?

Mr. COLE. We have, as indicated in the time line we provide this morning, taken three formal actions and three informal actions in the last 5 years.

Senator MENENDEZ. Against those who have conducted actions that are, in fact, inviolative of the law?

Mr. COLE. Yes. But I think more importantly——

Senator MENENDEZ. Out of how many? What's the universe? You took three actions out of what is the universe?

Mr. COLE. What I was—we supervise all bank holding companies.

Senator MENENDEZ. When we are looking at this rate of default that is being talked about, 14 percent, $160 billion, another one million homes next year that are resetting its rates, and 800,000 after that. And then we look at the specifics of the growing numbers of cases that we get that are focused on predatory lending, it just seems to me that you all are asleep at the switch.

Mr. COLE. Let me respond. First of all, we do have an alternative enforcement mechanism under the Federal Trade Commission Act. We are using that very effectively working with the other agencies. Also, we do have a process through the examinations to put a lot of pressure on institutions without going to an informal or a formal enforcement. So there is a lot of activity in that regard.

I also have to say——

Senator MENENDEZ. Are you telling me this would even be greater, but for your actions?

Mr. COLE. No, as we do examinations and find problems we address them in the process.

Senator MENENDEZ. But the size of this problem leads me not to understand. Maybe I cannot comprehend. The size of this problem that we have heard defined here already leads me to question, regardless of everything that you are telling me, how could it be this big and you have done your job?

Mr. COLE. I will say that given what we know now, yes, we could have done more sooner.

Senator MENENDEZ. And why did you not do more sooner?

Mr. COLE. We were doing a good deal. And what we have observed in terms of the risk layering that has really created the problems that are coming to light now is something that we have observed in the extreme in the last year. In 2006 is when the risk layering really started to compound in terms of the various dimensions of these contracts that made these loans unviable.

I would also offer that we have done a lot in terms of education and outreach, that we have a program that was created by Congress called NeighborWorks America. And we have, through that, the ability to have outreach to communities across the country along with the other agencies in providing counseling to borrowers to understand the mortgage refinance options.

Chairman DODD. Mr. Cole, I am going to—with all due respect, I apologize. I want to give Senator Martinez a chance here to get some comment in before we take a break for the vote. I apologize.

Bob, those are great questions. The question is, in a sense, setting the standard ahead of time—enforcement actions, the cow is out of the barn. Getting the standard set early the prohibits certain things from happening is really what we are driving at here.

Senator Martinez.

Senator MARTINEZ. Mr. Chairman, thank you very much for fitting me in. And I want to associate myself with so many of the comments from my dear colleague from New Jersey.

There is a sense of outrage about those of us who have worked so hard to get people into home ownership, particularly people in the minority communities where there are so underrepresented among homeowners. And to now see what is coming, what we are seeing and what is coming, which is a backtracking, which is that horrible disappointment of seeing your dream of home ownership now turn into a nightmare of a lifetime of debt.

What I wonder is, as we look at what we can do in the future to prevent this from occurring again, how can we really, as bank regulators, have allowed so many loans to be made which are obviously not designed to be performing loans in 60 days, a year, or two with not having qualifying standards for the higher rate that is inevitably coming, but only looking at the current qualification standards under the current rate?

I do not know if it is Ms. Thompson or Mr. Cole who could provide perhaps just a quick top-of-the-line answer. We have to go to the vote and I do not have long to pursue the question.

But I wonder if the sense of outrage that I feel is not something that is counterintuitive to what bankers should be doing, which is making only loans that will perform. It seems like they have been making loans, it is counterintuitive. They are making loans they know are not going to perform.

So I guess the securitizing is what gives that freedom?

Mr. COLE. I can only say that in terms of underwriting standards, making loans that are unsustainable from the very day of inception, that is an unsafe and unsound practice.

Senator MARTINEZ. But therefore how can it occur in what we believe to be a sound banking system that we have in our country? Because you know, I mean, I am surprised. I agree with your conclusion. But I know that the consumer at the end of the food chain does not really understand all of this. They are just lucky they are going to get a loan and they are happy to go into their home.

But how do we, who are more responsible, how are we who should be looking out for them and avoid the nightmare they are now facing, how have we failed those families?

Mr. COLE. Part of our challenge is balancing the needs of the consumer and innovative markets against standard setting, rule writing.

And frankly, in terms of the HOEPA issue, one of our real concerns is that yes, we could write very detailed rules that applies to all mortgages throughout the country. And the problem then would be well, if they are going to be detailed, to really hone in on the problem areas are we going to be able to avoid——

Chairman DODD. Mr. Cole, I apologize to you. We are going to miss the vote here if we do not get out of the room.

Listen, thank you all very much. I am going to let you go.

Senator Carper wanted to raise some issues here. He will submit them in writing to you.

We will take a recess here until the conclusion of these votes and come back with our second panel.

I want to thank all of you here. To the regulators, we want this back soon now, this guidance. I do not want this to go on any longer. What has happened already has got to stop.

The Committee stands in recess.

[Recess.]

Chairman DODD. The Committee will come to order.

Again, my apologies to our witnesses for the delay. We had hoped by this hour the Committee would have been concluding its hearing this morning but with five votes we just had it has caused some delay.

I want to thank our second panel for their patience. We have kind of jammed you in and crowded you in here at this table, so I regret that. We will try and move this along.

It will help if we can ask you to keep your opening comments somewhat limited. I am going to put the 5 minute clock number on there. And again, what I said to the first panel, I will say to you. I will not hold you to that number rigidly. But keep it in mind so we can try to get down to the list and then turn to my colleagues as they come in and show up here.

Let me, and I will say this slowly to give him a chance, my colleague from Rhode Island may want to make an opening comment or two here. Is that all right, Jack? Do you want to just go ahead?

Senator REED. Go right ahead.

Chairman DODD. I said earlier the Committee had asked New Century to send its CEO to testify this morning. That is one of the five largest subprime lenders in 2006.

Unfortunately, they refused to come before the Committee, before obviously the American public through the vehicle this Committee hearing provides.

There are many, many questions that have been raised about the way they have done business, particularly with regard to treating their borrowers. And I regret they made the decision not to be here.

I want to also simultaneously thank those who have come here to be a part of this. I am very grateful to you. It did not take browbeating at all to get you to show up and be a part of this discussion, which obviously is very important to all of us.

So I thank those companies that are here. They all have varying degrees of percentages of your business that are involved in this. I understand that. In some cases, it is not the largest volume of your business. But nonetheless you are an important player in the country in terms of the largest businesses that engage in subprime lending.

I want to say again to this panel, as I have to others, home ownership and access to the wonderful dream of almost every American is to have their own home, to raise their family in their own home. That has been one of the great achievements we have been able to do.

So subprime lending, as you have heard other witnesses testify, has provided an opportunity for those that never otherwise could imagine having that dream fulfilled, to come a reality for them. And the distinction between that and those who would lure people into these arrangements with the full knowledge and awareness that they are probably never going to be able to keep that dream is what really drives this Committee hearing and the concerns that people have.

A staggering number of our fellow citizens may find themselves not only not having the dream of a home, but as others have said, Senator Menendez and Senator Martinez, the nightmare of losing that home and a lot of earnings and savings that they may have put together to make that home a possibility.

So while some may argue in the total volume of mortgages and everything else that this is a large number, but that the institutions themselves are not threatened. And I gather that is the case. That is a story that has very little comfort to those out there who may fall into that category of the potentially 2 million homeowners that will lose that dream of theirs. To them this is a nightmare for them.

So I am determined, one, that would put the brakes on so that these numbers can be stopped. And second, we look at means by which we can offer those who have lost their homes some opportunity to stay in that house.

I am going to be very interested, if not in this setting certainly as we go forward, to hear some ideas on how we might do that.

As Senator Shelby pointed out earlier, we still have other elements to come forward to this Committee and talk about their ideas and interest in the subject matter, as well, beyond the Federal regulators and those who have been directly involved in the business and those who represent or work with them.

So let me begin by introducing Mr. Al Ynigues. Is that the correct pronunciation?

Mr. YNIGUES. Al Ynigues.

Chairman DODD. Thank you.

Al is a borrower from Apple Valley, Minnesota. We thank you for joining us.

Jennie Haliburton, Jennie we thank for being here this morning from Philadelphia, Pennsylvania.

Mr. Laurent Bossard. Is that a correct pronunciation?

Mr. BOSSARD. Yes, it is.

Chairman DODD. Serves as the Chief Executive Officer of WMC Mortgage. I want to note that WMC is fully embracing the proposed subprime guidance. And I want to congratulate you on that, taking that position. It is very helpful to have endorse and support the concepts here that will give us some real hope of coming—at least stopping this process from getting worse.

Mr. Sandy Samuels is the Executive Managing Director of Countrywide Financial Corporation. We thank you very much, Mr. Samuels, for being here.

I understand again, this part of your business is about 10 percent I think someone has mentioned me of your overall business, a sizable part of the national market but nonetheless about 10 percent of Countrywide's business.

Mr. SAMUELS. It is about 7 percent, sir.

Chairman DODD. 7 percent.

Mr. Brendan McDonagh serves as the Chief Executive Officer of HSBC Financial Corporation. We thank you, Mr. McDonagh, for joining us.

Janis Bowdler; is that correct?

Ms. BOWDLER. Yes.

Chairman DODD. Is a Senior Policy Analyst at the National Council of La Raza, and we thank you.

Mr. Andrew Pollock serves as the President of First Franklin Financial Corporation.

And Mr. Irv Ackelsberg is a well-known consumer attorney from Philadelphia. And we thank you very much for being a part of this, as well.

We will begin with you, Ms. Haliburton. Is that OK with you, if we start with you? You have to pull that microphone over close to you so we can hear you.

And thank you for coming this morning. We are deeply grateful to you and to Mr. Ynigues. This is not comfortable to have to come forward in a very public setting and to talk about some personal circumstances.

But it is important you understand you are representing an awful lot of people who will never get a chance to be heard but who know exactly what you have been through and are very interested in your circumstances as a way of making the case, that when we stop the present practices and figure out some way to be helpful to people like you.

So I thank you very, very much for coming forward. The floor is yours.

STATEMENT OF JENNIE HALIBURTON, CONSUMER, PHILADELPHIA, PENNSYLVANIA

Ms. HALIBURTON. Well, I am here because I am one of those who have mortgage problems.

Chairman DODD. You have to speak right into that microphone if you can for me.

Ms. HALIBURTON. That has mortgage problems. My husband had passed and he had left me with a lot of debt.

I was sitting down watching TV one day and they were saying that I could get this loan to pay off my bills and have extra money to, you know, fix my home or fix it up, whatever, you know. And I called them up.

They came to the house and they explained to me I can get this, they will pay off all the other bills, and I could have some left to fix the house or whatever I would like.

So I agreed to that. They came out to the house and they told me I would not pay very much mortgage. I says well, I am paying $700 now and I could go eight. He said oh, we will take about eight. I asked him repeatedly, three times, is that all I have to pay is eight because I have to pay gas, electric, phone, taxes on my home, and I have to buy groceries and I have to buy medication. Oh he said oh, we will not take much.

The next thing I know I am paying $1,100 a month and I am back on gas, electric and I have not paid my taxes yesterday, on the 21st of March, because I have no money.

I was in the hospital for 2 months, April to June. I had back surgery, I had a metal plate taken out, a metal plate put back in. Now they are affecting my knees. They say it is coming from so many back surgeries, because I have had three and it is taking effect on my knees. I cannot bend them. I have to keep them out. If I bend them to get up, it hurts.

But anyway I cannot afford—when I called them on the phone to pay my mortgage, I call them on the phone to pay it. They give me about 15 members and I have to pay them $22 for calling them on the phone to pay my mortgage. They take that out of my bank. And they just took what they want.

So September, I had changed my route number so they could not take any more money. So this way I have to call them on the phone to tell them I am paying my mortgage. If I pay on the third and the fifth of the month, my grace period is the 15th of the month. How can I be late? And they charge me for late fees when I know I am not.

So they start taking a lot of my money so I just decided to get a lawyer and a consultant to talk to me about it first, and then I had to get a lawyer.

I would like to see what he has to offer, if it is OK. Thank you.

Chairman DODD. Just quickly, I do not need to know specifically, but your income? Are you on a fixed income?

Ms. HALIBURTON. Yes, I only get Social Security.

Chairman DODD. So you are retired. I am presuming that your fixed income, the monthly amounts you get each month are equal or less than the mortgage payment or a little bit more? How does that work out?

Ms. HALIBURTON. It is about seven more but it is not enough to pay the hospital bill. It is not enough—my medication is $125 a month and I am taking four medications. And the phone bill, that is up, the gas and electric is up. The water bill is about $125.

Chairman DODD. Food.

Ms. HALIBURTON. And then, how am I going to pay my taxes on the house? And that is every year March the 21st.

Chairman DODD. So this has put you in a very difficult financial position?

Ms. HALIBURTON. Yes, it did, because they are taking too much.

Chairman DODD. We thank you very much for being here.

Ms. HALIBURTON. And I thank you, Your Honor.

Chairman DODD. Thank you for listening to us.

Mr. Ynigues.

STATEMENT OF AL YNIGUES, BORROWER, APPLE VALLEY, MINNESOTA

Mr. YNIGUES. Thank you, Mr. Chairman, and thank you for having me make this presentation.

What I am speaking is not only for myself but also for the voice of the other people. I am also here on behalf of ACORN, a really good organization.

So I just want to give you a little background on myself. I am a senior of 65 years old. I belong to the Latino community.

I did get this loan through a person who was taking music lessons from me. He and his kids were taking lessons from me and so I had this relationship with this mortgagor, just at a music lessons level, for about 5 years. Then he pressed me and said why do not you start—instead of renting start doing a mortgage? And I can help you with that, he said.

So we started going through all this searching and researching and I specifically asked him for a 30 year fixed and that is what I thought I was going to get. And then I also asked him, because Dakota County in Apple Valley, Minnesota, does have a program for first-time buyers. And he completely discouraged me from that.

So as we were going along, now it has come time for signing the papers. And I find out that he could not get me a fixed so instead he got me an ARM which turned out to be an arm and a leg.

And then he said well, don't worry about it because sometimes the mortgage rates go down. If they go down, you will pay less. So upon that, because I am so trusting and gullible, I went along with it. I knew that I was getting an ARM but I also had to have a second mortgage on it because I did not have a down payment on it.

So I started off with something that I could afford, it started off at approximately $1,645 for the first mortgage, about $440 for the second mortgage. I could pay my other bills, as well.

All of a sudden the taxes started going up, the mortgages have jumped up, and now I paying pretty close to $2,300 a month and it is still going to be going up, not only for—and that is pretty much what I am taking in on my music lessons right now. All of my other credit cards, my utilities, I am completely behind on, and I have no way of getting out of it.

I am looking for some answers, some relief not only for myself, but also for all the other people that have found themselves in this same predicament.

One of the things that the mortgagor did that I am starting to find out as I am talking to other people, he actually deliberately lied about the amount of money that I made per month. He said that I made $10,000 a month, knowing exactly how much money I made because he has been with me as a student for about 5 years. That was a total surprise and I did not find this out until about 2 weeks ago.

I also found out that he padded all of the closing costs specifically on the annual yield spread. So he actually got a kickback from the mortgage company for about $5,000 just to get me into a higher interest rate.

And I am starting to find that this is common practice and it is legal. I am hoping that this Committee will find someplace to not only make it illegal but just cease-and-desist this type of practice.

I am also aware that the law cannot go in retrospect, go back. But if it could, there would be a lot of people who would be reimbursed for all the stress that they have been going through.

I really did not realize all of the hidden costs that were involved in the closing of it. But now I am really aware. And even thought it was explained, it was explained very briefly at the closing at the title company. And they basically rushed me through saying that is OK, just sign at the bottom, initial at the bottom, and then we will be done in less than an hour.

So me being the gullible, trusting person that I am, I just went ahead and signed.

I am now involved in an almost interest-only loan. So very little of that goes to the principal. So I am looking for some relief where I can actually refinance that. But at this time, because where I am in my credit report, there is not any financer or mortgagor that is going to touch me right now.

The bottom line is right now I cannot even finance a bag of cat food with my credit report, because of this mortgage.

So I want to thank this Committee for listening to me and I hope that things will get done in an expeditious manner and not to let things go like things have been going on for the past three or 4 years.

Chairman DODD. Did you have a good credit rating before?

Mr. YNIGUES. I had a fair rating.

And I welcome any questions that this Committee might have for me.

Chairman DODD. We will get back to you on some questions.

Mr. YNIGUES. Thank you very much.

Chairman DODD. Thank you very much for being with us.

Mr. Bossard.

STATEMENT OF LAURENT BOSSARD, CHIEF EXECUTIVE OFFICER, WMC MORTGAGE

Mr. BOSSARD. Good afternoon, Chairman Dodd, other members of the Committee.

Thank you for the opportunity to address you today on this important issue. My name is Laurent Bossard. I am the CEO of WMC Mortgage.

I am pleased to be here today to participate in the Committee's effort to gain a better understanding of the economic and industry conditions affecting the market and to learn from them.

Like members of this Committee, we believe that a vibrant and responsible industry plays an important role in consumers' ability to access credit for home ownership.

As you may know, WMC is a wholly owned subsidiary of GE Money, the consumer lending division of the General Electric Company. WMC was a company that originated non-prime mortgages and sold them in the capital markets to a variety of institutions including investment and commercial banks. WMC was acquired by GE Money in June 2004.

Along with the members of this Committee, we are concerned about the impact of recent market developments. These changes affect both consumers and lenders.

WMC has been responding to these changes in a number of ways. First, we have made changes to our own business. I joined WMC in November 2006 as President and was named CEO in January. We are reconstructing WMC in order to adapt its operations to the evolving market environment. In addition, GE Money made the decision post-acquisition to play WMC's mortgage operations under Federal regulations. This was accomplished by bringing the mortgage business under GE Money's Federal Savings Bank. This process was completed on January 1st, 2007.

Over the last 12 months we have made improvements to our underwriting process. WMC adheres to the Federal Interagency Guidance on Nontraditional Mortgage Products. In addition, we support the Federal bank regulators' proposed statement on subprime mortgage lending and are implementing the recommendations.

For example, borrowers will be qualified using the fully indexed rate.

Second, on new loans prepayment penalties will expire 60 days prior to the first interest rate reset date. This provides borrowers with enhanced flexibility to avoid prepayment fees.

Third, WMC will not make loans based on stated income except in the case of borrowers who are self-employed and then only with the appropriate verification.

Beyond what has been proposed in the guidance, WMC will continue its historic policy to not offer any option ARMs or products with negative amortization. And going forward, we will begin to hold a portion of this loan portfolio on our own books. This will allow us to better work with borrowers and other industry participants to help keep homeowners in their homes.

These changes help us meet our goal of providing consumers with access to fair and competitively priced mortgage products with clear and understandable terms and to keep them in the homes they purchase.

We are here today to contribute to a discussion that leads to a better understanding of the current market conditions. We also want to emphasize our desire to work with you and with our regulators on solutions. To this end we would support standards to govern the conduct of all participants in the mortgage process.

In closing, I would like to thank the Committee for the opportunity to share our views with you today. We look forward to working with you and our regulators. We want to play a responsible role in providing consumers with products that meet their needs, allow them to live in their own homes, and invest in their futures.

Thank you very much.

Chairman DODD. Thank you very much, Mr. Bossard.

Mr. Samuels.

STATEMENT OF SANDOR SAMUELS, EXECUTIVE MANAGING DIRECTOR, COUNTRYWIDE FINANCIAL CORPORATION

Mr. SAMUELS. Thank you, Senator Dodd, and Senator Reed.

Countrywide is primarily a prime lender, as I mentioned. 93 percent of our originations are to prime borrowers. We are the largest originator in the country and we are the leading lender in the country to minority and low and moderate income borrowers. We are very proud of that fact. We offer the widest arrays of products available in the marketplace and we believe that this gives us a unique perspective on what has happened in the subprime market.

It is not one thing. It is a convergence of several factors that explain the growth of the subprime market and the current circumstances of high delinquencies. Home prices appreciated at rates far exceeding income growth, causing housing affordability issues. Industry expanded underwriting guidelines to allow borrowers to qualify for loans on more expensive homes.

Interest rates began to rise from 50 year lows. The refinance boom slowed, resulting in significant overcapacity in the market. The housing market slowed in 2005 and 2006 causing more expansion of underwriting guidelines in order for lenders to maintain their volumes and to try to increase their market share. And throughout, liquidity in the global markets was searching for mortgage assets.

In 2006, home prices started to flatten or decline and delinquencies increased. We saw high LTV ratios combined with lower FICO scores, and this was particularly exacerbated in areas suffering economic weakness. When people got behind in their payments, they found it more difficult to recover.

Our analysis indicates, however, that these delinquencies were not caused by hybrid ARM payment adjustments.

The market now has begun to self-correct by materially tightening credit guidelines. So where does the subprime market go from here? Well, we need to preserve access to credit for those who cannot qualify for prime loans. Hybrid ARMs, the 2/28s and 3/27s, reduce the cost of home ownership. In the fourth quarter of 2006, 50 percent of Countrywide's hybrid ARMs went to purchase homes and 54 percent of those went to first-time home buyers.

They are a good bridge for people who can improve their credit or who can expect increased income in the future. Let me give you some data on that.

From 2000 through 2005 for Countrywide customers who refinanced their hybrid ARMs with Countrywide, almost 50 percent received a prime loan. 60 percent received a fixed-rate loan, prime and subprime. So 75 percent of all of those refinances fell into those top two categories, people who improved their situations. The other 25 percent refinanced into other subprime ARMs. They took cash out and they generally had lower loan-to-value ratios, about 75 percent.

So as I said, hybrid ARMs are a valuable tool for customers to afford a first home or as a bridge to overcome temporary financial setbacks.

Cumulatively, over the past 10 years, Countrywide originated almost 540,000 hybrid ARM loans and less than 20,000, less than 3.5 percent of those hybrid loans, have gone through foreclosure. So that means over 96 percent of our borrowers were successful.

So what I am here to ask today is that balance must be struck between maintaining affordability in the marketplace and lessening payment shock. Wherever you draw the line someone will be shut out of the market. Every attempt to raise the start rate, lengthen the fixed-rate period, reduce caps, and lengthen reset periods will raise the price of the loan product to the consumer.

Now the market has already begun to tighten so the pendulum has clearly started swinging back. What I am asking is that this Committee and our regulators be careful about an over correction because we want to make sure that we keep home ownership a viable opportunity for those Americans who can qualify for it.

I want to speak a minute about home ownership preservation because it is something that we care deeply about. We are concerned very much about delinquencies and foreclosures and we can help customers preserve their homes so long as the borrower wants to remain in the home and continues to have a source of income. Our biggest challenge is to have the borrower respond to us.

We are also involved in an organization called the Housing Preservation Foundation which is a third-party independent counseling service. I happen to serve on that board. We help borrowers find solutions to their problems.

We are committed to working with the rest of the industry to make sure that people like Ms. Haliburton and Mr. Ynigues can stay in their homes.

We are very supportive of most of the agency's guidance, use of impound accounts, restrictions on use of prepayment penalties, improved disclosures, and choice. We think we ought to give people a choice between an ARM and a fixed-rate loan for which they can qualify.

Thank you, Mr. Chairman, for the opportunity to share Countrywide's perspective on the mortgage market and I would be happy to answer any questions.

Chairman DODD. Thank you very, very much, Mr. Samuels. We appreciate you being here.

Mr. McDonagh.

STATEMENT OF BRENDAN McDONAGH, CHIEF EXECUTIVE OFFICER, HSBC FINANCE CORPORATION

Mr. MCDONAGH. Chairman Dodd, Senator Reed, my name is Brendan McDonagh and I am the Chief Executive Officer of HSBC Finance Corporation. I am also the Chief Operating Officer for HSBC North America. I have been with HSBC for 27 years but I was only appointed to these positions at the beginning of this month.

Thank you for inviting me to testify today on behalf of HSBC.

As you well know, HSBC Finance is a large player in the subprime mortgage market. We originate and service loans throughout our 1,400 retail branches in 46 states and through our wholesale broker channels. HSBC Finance has the second-largest subprime servicing portfolio in the subprime industry. Our portfolio is primarily fixed-rate loans with documented income. Indeed, adjustable rate loans are only 32 percent of our portfolio compared to 70 percent for the industry. As a result of our origination and underwriting practices, HSBC Finance's delinquency levels are almost half of the industry levels during the past 2 years.

In the interest of time, I will skip my statement's section addressing how we got to this subprime market problem, because it has been covered in both earlier statements.

What I would like to do now is talk about how HSBC Finance is addressing these issues both in the area of originations and servicing.

First, I would like to take the opportunity to thank Joe Smith of the Conference of State Bank Supervisors for recognizing the efforts of HSBC in supporting their various initiatives.

We have been servicing customers for over 125 years. We take the current situation very seriously. We are taking strong steps to minimize the impact.

In our retail branch network, we have had policies in place for more than 5 years that largely parallel the new interagency guidance on nontraditional mortgage products. We believe this guidance brings appropriate strengthening to the industry's underwriting standards. We note these rules currently apply only to federally regulated banks and bank holding companies. To create the fullest consumer protection they should apply to all lenders.

Regarding the notion of suitability, HSBC Finance implemented a comprehensive net tangible benefits test in its retail subprime lending business in 2001. We have also largely eliminated the purchase of loans originated by other lenders and sold into the secondary market, giving us greater control over quality, building on our strength in our customer facing channels.

We recognize the long-term answer to this current marketing condition is not just tightening credit but also introducing products that help subprime customers improve their circumstances. Our Pay Right Rewards product, which rewards customers for timely payments with interest rate reductions is one example.

Finally, we select and work only with responsible brokers who comply with all State and Federal laws.

Regarding our servicing and what we are addressing in that area, we have reviewed most at risk ARM customers and we have implemented a proactive program which offers payment shock relief, rate modification, et cetera. To date we have assisted more than 2,000 customers and expect to reach more than 5,000 this year.

We truly believe that foreclosure is the worst alternative for all partners concerned and we go to great lengths to avoid foreclosure. In fact, we have a foreclosure avoidance program which was actually established in 2003 and to date has provided over $100 million in financial relief to 9,000 customers.

In addition to the direct assistance to our own customers we help consumers at risk of foreclosures with other lenders.

In closing, I would like to state that clearly the mortgage industry is experiencing significant contraction. With that in mind, we believe any additional regulation needs to be carefully weighed against the implications of credit availability. Certainly, we believe that uniform legislation could benefit the industry and consumers. There are numerous versions of Federal anti-predatory lending legislation that contain many of the best practices we employ. HSBC supports the guidelines that put everybody in the industry on a level playing field.

I hope my testimony today reflects for you HSBC Finance's commitment to responsible and fair lending and servicing. And we are continually looking at our current and prospective products and services in this light.

Once again, thank you for inviting HSBC to today's important discussion and I am happy to answer any questions that you may have.

Chairman DODD. Thank you very, very much.

Ms. Bowdler.

STATEMENT OF JANIS BOWDLER, SENIOR POLICY ANALYST, HOUSING, NATIONAL COUNCIL OF LA RAZA

Ms. BOWDLER. Good afternoon. My name is Janice Bowdler. As a Senior Policy Analyst for the National Council of La Raza, I conduct research and analysis on home ownership issues facing the Latino community.

In my time at NCLR, I have published on issues related to fair housing and Latino home ownership. I have also served as an expert witness before the House Financial Services Committee and the Federal Reserve.

I would like to begin by thanking Chairman Dodd and ranking member Shelby for inviting NCLR to weigh in on this important issue.

And also, Senator Dodd, I would like to extend a personal greeting from our President and CEO, Janet Murguia, who wants to thank you for all of the work you have done on behalf of our community.

I have to tell you that the mortgage market is not working well for Latinos today. Home ownership among Latinos is at an all-time high of 50 percent, but so is Latino foreclosure. One in 12 Latino homeowners is projected to lose their home in coming years. This is a huge strike against the wealth low-income and minority communities have fought so hard to obtain.

Our office has been flooded with reports of Latino families who have been misled in various mortgage transactions. Our home ownership counselors went from one call a week from families fearing foreclosure to five a day. That is a near 100 percent increase in call volume.

This lapse in market performance, though, is not a surprise to us. Last year we helped 3,000 families become homeowners through the NCLR Home Ownership Network. We understand what it takes to get low income immigrant and Latino families into homes. And our families have unique credit needs.

But lenders in the prime market have shied away from making the loans that accommodate Latino borrowers. Those loans just do not earn the banks enough profit to make it worth their effort.

With prime lenders taking a back seat many subprime lenders have rushed in to serve our families with ill-fitting products. The result, families have been matched to loans they cannot afford. Many are on a path of endless refinance. This strains the wealth that home ownership is supposed to build.

Let me share with you a story. Mrs. Ruiz is a mother of six in California. She and her family dreamt of becoming homeowners but thought it was out of reach for them. Her husband works two jobs and earns most of the income for the family, while she worked as a housekeeper so she could stay home with their kids.

Neither of them had ever owned a credit card but they had always paid their rent and utilities on time. So a friend told them about a mortgage broker that would be able to help them out.

After their mortgage payment jumped unexpectedly, they called one of our counselors. Their payment was eating up most of their monthly income. Upon further investigation, our counselor discovered the Ruiz family had a stated income ARM. Even though the Ruiz's could document their salaries, their income was quoted at thousands over what they made combined.

Worse, the family did not get an inspection. Their mortgage broker told them it was a waste of money. They ended up having to replace their own roof and they spent the winter without heat.

Two weeks ago, Mrs. Ruiz saw no alternative for her family. She filed bankruptcy and they moved back into an apartment.

Across the country Latino families turn to mortgage brokers to serve as a trusted advisor. They see them as professionals that can be trusted to explain complex and dynamic transactions, much like we trust our doctors and our lawyers. But in reality, brokers are not legally liable and many are long gone by the time a borrower gets in trouble.

With little incentive to direct Mrs. Ruiz to a more appropriate loan, the broker sold her the one that was the easiest to process and earned the highest return.

The point is that brokers are an important part of the mortgage system and no solution is complete without considering their role.

Subprime loans are an important tool for families with damaged credit but clearly the system is broken. Families are getting matched to risky and expensive products regardless of their credit risk. More than one in five Latino families does not have a credit score. Many have multiple sources of income, multiple wage earners, and cash savings. But this does not mean that they are a riskier borrowers. Families should not be steered to subprime products simply because they are considered hard to serve. A mortgage system that works well connects borrowers to fitting products, regardless of how they enter the market, whether it is the prime or subprime arenas. This is especially important for Latino shoppers who are bombarded with ads in Spanish newspapers for risky products. Turn to English newspapers and you will find neat charts that make product comparison easy. Borrowers ought to be matched to safe products that reflect their true risk.

Let me close by just making a couple of recommendations on how I think we can make this happen. Briefly, consumers should be able to count on the advice and information provided by their lender and broker. We must level the playing field between borrowers and lenders. Lenders must be required to make loans families can afford to repay and brokers must be held accountable to the borrowers they serve.

We need a national solution to the rising foreclosure rates. We need a foreclosure rescue fund for families in financial crisis and those caught in bad loans. And we need to support the work of home ownership counselors across the country that are on the front lines of trying to save so many homes.

Thank you, and I'd be happy to answer any questions.

Chairman DODD. Thank you very, very much for that testimony. Mr. Pollock, welcome.

STATEMENT OF L. ANDREW POLLOCK, PRESIDENT AND CEO, FIRST FRANKLIN FINANCIAL CORPORATION

Mr. POLLOCK. Thank you. Mr. Chairman, Senator Reed, my name is Andy Pollock and I am the President and CEO of First Franklin Financial Corporation. I appreciate the opportunity to testify today on the state of the subprime mortgage industry.

Over the last few weeks the mortgage industry has been at the center of the financial news, with the current market conditions presenting significant challenges for some firms in the industry. I want to take this opportunity to share with you my thoughts on the subprime market and where First Franklin fits into that market.

First Franklin has been in the residential mortgage business for 25 years, successfully managing the business through various economic and credit cycles. We are proud of our long history of providing expanded and fair access to credit to all credit worthy individuals. We have a proven history as a responsible lender and a critical component to our success has been the discipline underwriting we embrace as a company.

We have enabled hundreds of thousands of hard-working families and individuals to realize the American dream of home ownership over the quarter century that we have been in business.

Three months ago we were acquired by Merrill Lynch and we operate as a stand-alone operating subsidiary of Merrill Lynch Bank and Trust Company Federal Savings Bank. First Franklin is an acknowledged leader in the subprime market place, originating loans with higher credit scores, lower delinquency rates, and generally higher performing mortgages than other subprime lenders.

As I will demonstrate, we are committed to responsible lending standards which help protect consumers. By strategic design, First Franklin has strengths that many other lenders in the subprime market do not. Specifically, we employ underwriting standards that assure the quality of the loans we originate. These underwriting standards are designed to ensure that borrowers can afford to repay the mortgages we originate as well as those we have originated in recent years.

First Franklin has one of the lowest delinquency rates in the industry, a testament to our underwriting standards and to the quality of the loans we originate. It is our goal not only to allow more Americans to be able to buy homes but to assure they have the capacity to keep them.

To further our goal, as a matter of policy, we do not originate high-cost loans as defined by Federal or State law. Prior to making owner-occupied refinance mortgage loans, we require a net tangible benefit to the borrower. We do not make loans based solely on collateral value. Specifically, all loans are underwritten based on the applicant's credit history and ability to repay the debt. We do not originate negative amortization subprime loans. We do not engage in packing fees; specifically we limit the amount of origination fees and costs which can be financed.

We also comply fully with the Interagency Guidelines on Nontraditional Mortgage Product Risks. These agencies have also recently proposed a statement on subprime lending of which we endorse the key principles.

The shake-out in the mortgage market has taken place quickly for those originators that did not maintain a commitment to quality or a culture of discipline. First Franklin's 25 years of industry experience and our commitment to responsible lending standards has allowed us to weather the current difficult situation and will enable us to continue to succeed in the future.

First Franklin intends to remain a leader in the residential mortgage market by adhering to prudent industry practices that will help consumers achieve and maintain home ownership. Wealth creation and financial security often begin with home ownership. We have a commitment to lending practices that help make homeowners make economically sound decisions and to maintain their homes.

First Franklin appreciates the opportunity to appear before you today and I would be happy answer any questions that you may have.

Chairman DODD. Thank you very, very much.

Mr. Ackelsberg.

STATEMENT OF IRV ACKELSBERG, ESQUIRE, CONSUMER ATTORNEY, PHILADELPHIA, PENNSYLVANIA

Mr. ACKELSBERG. Chairman Dodd and Senator Reed, my name is Irv Ackelsberg. I am a Philadelphia consumer lawyer specializing in defending mortgage foreclosures. I am a member of the National Association of Consumer Advocates and I am on the board of the newly launched Organization of Americans for Fairness in Lending.

I retired last year after 30 years of service with Community Legal Services of Philadelphia, the Nation's leading civil aid program. I want to just say, parenthetically, that CLS was, until 1996, funded by the Federal Legal Services Corporation. We had to give up that funding in order to avoid the restrictions imposed by Congress in 1996. Those restrictions would have prohibited much of my anti-predatory lending work. And I encourage the Senators to consider, as part of the effort to increase enforcement in this area, to unshackle the legal aid lawyers of this Nation.

I and my former colleagues at CLS have probably reviewed more abusive subprime transactions than any law firm in the country. We are familiar with the practices of the companies that once dominated the subprime mortgage market and those that are now the leaders. The subprime mortgage market has, for the last decade we know, grown astronomically. This growth has been fueled, in large part, by a complete collapse in underwriting practices and responsible lending principles, by a sales pressured get rich quick environment that has infected the market with blatant fraud and abuse, and a regulatory apparatus that has abdicated its traditional role to protect the American consumer from exploitive lending practices.

In my view and in the view of most consumer housing specialists, this fraud infested market has been producing very little in the way of social benefit. While the particular abuses most prevalent are somewhat different than those we saw in the late 1990s, the effects on the American consumer, the American homeowner, have been steadily growing and are cumulative: unprecedented levels of foreclosures and equity theft, all happening in full view of banking regulators.

At the ground level, from the standpoint of America's neighborhoods, this growth in subprime lending has been the equivalent of a gold rush where the gold being prospected is the home-equity wealth of America's homeowners. This gold rush has erupted because of the collapse of underwriting integrity. To put it bluntly, mortgage origination practices have been run over by the pursuit of profits at any cost.

I want to describe for you some of these gold rush induced underwriting practices. But first I want to dispel two myths about subprime mortgage loans that the industry has been promoting.

First, it is simply not true that the typical subprime borrower is a low-income first-time home buying purchaser. You heard numbers from Countrywide. The national numbers, I believe, are only 11 percent of the subprime loans being originated are for first-time home buyers. The majority of the loans are to existing homeowners who are being convinced to refinance their debt inappropriately. Sometimes the occasion for the transaction is a home improvement. Sometimes it is runaway credit card balances driving the deal. And sometimes, frankly, the reasons for the loan are difficult to discern.

The bottom line is that if we want to look at these transactions as opportunity loans, the opportunity lies with the broker or lender profiting on the deal not with the homeowner.

The second myth is that the mortgages are credit repair products. If that were true, most borrowers with subprime loans would be transitioning into prime products and the industry would be essentially lending itself out of existence. In fact, we know the opposite is true. The subprime portion of the market has been steadily rising and, in fact, we have some data in Philadelphia that confirms that there is very little scant evidence of credit repair using subprime.

You have heard about some of the abuses. Two of the witnesses here give examples of some of the abuses. There really are four central abuses that I think you should focus on. First, the exploding adjustable mortgages with initial teaser rates that are underwritten to the teaser rate not to the inevitable adjustment. This means that at the time the loan is being made, there is virtually no evidence of borrower repayment ability.

What you have to—I believe, frankly, that the only purpose served for that initial teaser rate in this so-called hybrid ARM is deception. That is its role. That is what it is doing. And it needs to be banned.

The second is the widespread use of no doc stated income loans. You heard Mr. Ynigues refer to that. We have seen this for years. The so-called stated—where that act of stating the income occurs, it is on the application. And that application is generally presented to the borrower at the closing to make it seem like the loan that they are getting is actually a loan that the borrower asked for in the first place. That is why, as Mr. Ynigues said, he was surprised to see that there was income that he did not have appearing, because it is buried in the documents that are signed at the closing.

The absence of escrow for tax and insurance. This was an element of Ms. Haliburton's loan with Countrywide, which was one of these hybrid ARMs. No tax and insurance escrow. And what happens is inevitably, as happened with her case as described in her written testimony, then they pay the taxes the next year and then they increase their payment. This all happens before the ARM kicks in.

Last, you have a prepayment penalty which locks people in and penalizes them if they discover how they have been scammed and try to get out of it.

In the testimony I gave to the Federal Reserve Board last year, I called their attention to a simple securitization of New Century from the first quarter of 2006. Of the $1.4 billion of mortgage loans in that particular pool, only 10 percent were traditional 30 year fixed rates and an amazing 45 percent of those mostly adjustable rate loans in the pool were no docs, stated loans.

The coming foreclosure crisis should not be a surprise to anyone, except perhaps for the magnitude. What we are seeing, I believe, is a runaway train that is only starting to gather speed. These recent foreclosures reflect large numbers of early payment defaults, that is homeowners defaulting before the fixed-rate period on their loan expire and the adjustments kick in. We have yet to see the full effect of those adjustments. It is not unreasonable to predict as many as 5 million foreclosures over the course of the next several years, a number that represents one out of 15 homeowners in this country.

The inevitable question then is what can be done to reverse this course? We need to focus on constructing relief for those in trouble now and on imposing appropriate limits on the future lending practices on the industry. I have just several suggestions.

In terms of addressing the foreclosure tsunami, to use Senator Menendez's phrase, we first have to recognize who is doing the foreclosures and why. We hear from many lenders oh, we do not want to take your house. But we have to understand, it is not the lenders who will be foreclosing. These loans are all made to order for Wall Street investors who purchase them almost immediately after they are created. Foreclosure decisions are made by massive servicing organizations that work for those investors. In the ordinary course of their business, the servicers never have to justify a foreclosure. They do, however, have to answer their investors for any forbearance being offered to the borrowers.

I believe that Congress will need to mandate moratoriums and debt restructuring in order to avoid a national disaster and to ensure that the investors are absorbing some of the losses that otherwise would fall solely on America's homeowners.

In the long run, however, the interests of financial markets and of homeowners are not in conflict. The downward spiral in property values that will be caused by massive foreclosures is something that only real estate speculators should wish to see.

Finally, as for civilizing this origination market gone amok, there are many sensible proposals that consumer advocates have been offering for years, such as imposing a suitability standard on mortgage writing like what exists in the sale of securities. And imposing assignee liability on those who purchase these loans and fuel the market.

On the latter approach, Congress already has used this tool effectively in the HOEPA legislation to successfully drive down the excessive points and fees that represented the earlier generation of predatory lending.

Congress can and should take similarly dramatic action to curb these so-called exotic mortgages which I submit should probably be named poisonous mortgages or irresponsible mortgages.

Actually the Federal Reserve, as we heard this morning, has the authority to do it on its own using the unfair and deceptive practices authority that Congress granted it.

And finally, at the very least, Congress should let the States continue to make progress in this area and put to rest the specter of industry sponsored Federal preemption.

Thank you.

Chairman DODD. Very good. Thank you very much. Thank you for that.

I appreciate the testimony of all of you here and since there are only two of us here, we will try and go a few minutes and just engage back and forth here, Senator Reed and I.

I will invite members to respond. If I ask someone a question and some of the other want a comment about it, please feel free to share some thoughts.

Mr. Pollock, let me begin with you. You had, I thought, a very important statement in your prepared remarks in that you endorse or First Franklin endorses the key principles of the statement on subprime lending.

I see the key principles as been the following: that subprime hybrid ARMs will have to be underwritten to the fully indexed rate; that the full payment of principal, interest, taxes and insurance should be taken into account in looking at debt-to-income ratios and analyzing a borrower's ability to repay; and that a no doc—no document or low doc—loans must be limited to situations in which there are mitigating factors that support the underwriting decision.

Do you agree, are those the key principles which First Franklin agrees to?

Mr. POLLOCK. We do believe in the key principles of the draft. We are still reviewing it to prepare our final comments back to the agencies.

The fully indexed underwriting, I think we need to be cautious. To fully underwrite to the index, which most likely will never occur, 90 percent of the time it could in fact force homeowners into take a fixed-rate product even though they prefer an ARM program to use as interim financing.

Not every homeowner is going to be in their home for 30 years and use the same mortgage instrument over 360 payments. The consumer of today is mobile, does relocate regularly, and buys different homes as they relocate, and likes the luxury of being able to have access to the ARM product. I think that is something that we should be cautious as we go down this path.

Chairman DODD. But what about the other ones here? The other principles?

Mr. POLLOCK. We do incorporate our debt-to-income ratios on the mortgage and the taxes and insurance, so we do endorse that.

Chairman DODD. What about the no doc and low doc?

Mr. POLLOCK. We do not do any no doc products. And the now income verification program, the low doc, the no income verification, stated income product, is a very small part of our business. Over the last 5 years it has represented about 10 percent of our volume and it is getting smaller everyday as we make additional guideline and changes to our product line.

Chairman DODD. So when you look at the ability of a consumer to pay, you do look at the taxes and insurance costs as part of that calculation?

Mr. POLLOCK. Of their debt-to-income ratio, that is correct.

Chairman DODD. You do. When it comes to underwriting, do you base that on the teaser rate or the index rate?

Mr. POLLOCK. The start rate. We do base it on the——

Chairman DODD. The teaser rate?

Mr. POLLOCK. Correct.

Chairman DODD. So a little bit short of the key principles. That is a pretty important one.

Mr. POLLOCK. As we stand today, yes, Mr. Chairman.

Chairman DODD. At the time of the underwriting, if the borrower cannot afford the higher payment, on what basis do you conclude that he cannot afford the loan?

Mr. POLLOCK. When we underwrite a loan we take into consideration a number of different factors, Mr. Chairman. No. 1, we look at the borrower's capacity, their income. We calculate our debt-to-income ratios to make sure they are reasonable and customary within our guidelines so that the person can afford that product.

We also look at their credit history. We look at their FICO scores, the depth and breadth of that FICO, and the years that credit has been maintained.

Last but not least, we do look at the collateral. We do perform appraisals on the properties that we lend on to ensure that the values there are accurate values.

Chairman DODD. Let me ask all of you here, the lenders anyway, one of the arguments we frequently hear against underwriting at the fully indexed rate is that the borrowers do not qualify because the debt-to-income ratios would be too high. I wonder if you could each give me a ballpark figure of what the debt-to-income ratios would look like if the hybrid ARM borrowers—for hybrid ARM borrowers if they were underwriting at the fully indexed rate? Mr. Samuels?

Mr. SAMUELS. I do not know what that number is, Mr. Chairman. I will tell you that about 60 percent of the people who do qualify for the hybrid ARMs would not be able to qualify at the fully indexed rate.

Now there might be other products for which they might qualify, but there is a not insubstantial number who would have difficulty qualifying in any event. That is the concern and I think that is what Mr. Pollock was referring to, that we have to be concerned in adopting any kind of regulation or legislation that we do not make it harder for families to qualify for a home purchase or refinance when they can qualify to do it and when we are sure that they can—or we have a good idea—that they can be successful in that loan.

Chairman DODD. Mr. Bossard or Mr. McDonagh.

Mr. BOSSARD. We do not have that number either here. We will provide it.

Chairman DODD. I cannot hear that. I am sorry.

Mr. BOSSARD. We do not have the number you are asking either here, but we will provide it.

We have the same estimation as Mr. Samuels said, about 40 percent of the borrowers would not qualify at the fully indexed rate.

Chairman DODD. We were told by the regulators, I asked—we asked the regulator this question—that some debt-to-income ratios could be as high as 70 percent. Do we have any disagreement with that? Mr. McDonagh?

Mr. MCDONAGH. I would agree with the regulators that under some circumstances prior to the issuance of the interagency guidance the debt-to-income ratios could be as high as 70 percent. As I stated at the hearing, however, HSBC supports the interagency guidelines issued by the banking regulators and, as of April 30, 2007, in its Consumer Lending, Decision One and Mortgage Services divisions, HSBC is in compliance with that guidance. In HSBC's prime/Alt A mortgage lending division, Mortgage Corporation, we are waiting for further guidance from Fannie and Freddie on changes to their underwriting systems to ensure compliance with the guidance.

Chairman DODD. And indexed rate, you are going to be doing that yourselves?

Mr. MCDONAGH. Yes. As of April 30, 2007, Consumer Lending, Decision One and Mortgage Services began manually underwriting to the fully indexed rate or ceased origination of interest only mortgages until those divisions can systematically underwrite to the fully indexed rate.

Chairman DODD. How about you, Mr. Samuels? I know you disagree with that a little bit, but given the fact this is only a small percentage of the—7 percent of the business.

Mr. SAMUELS. That is right. If this is the rule that goes into effect, Countrywide will be fine. There is no issue there. The concern that we have is the impact on the housing market and the impact on borrowers who are in the subprime market.

And so we hope the regulations can find a balance that will allow consumers to benefit from lower housing payments while protecting them from unaffordable payment increases.

Mr. ACKELSBERG. Senator Dodd, I think if you look at the Haliburton numbers, when her payment fully indexes in 2008, next year, her payment will be 70 percent of her Social Security income.

Chairman DODD. We were asked, by the way, staff looked over some of the subprime pricing sheets from July of 2006. And looking at the sheets, it is pretty clear to us that borrowers would pay a lower rate to get a 30 year fixed-rate loan than they would for a more risky 2/28 ARM if they are willing to document their income.

In fact, on a New Century rate sheet from July 2006, a borrower with a 615 credit score would qualify for 30 year fixed rate loan at 8.75 percent. A 2/28 stated income loan would cost 9.5 percent. Obviously it is not true that the 2/28s are the only mortgages that credit impaired borrowers can get.

So I wonder if these loans are, in fact, more costly? How do you explain that? Mr. Pollock.

Mr. POLLOCK. I cannot speak on behalf of New Century. It seems irrational to me.

Mr. ACKELSBERG. I think, Senator, the answers is that these decisions are being made for consumers by those arranging the transaction, not by the consumer. Obviously, much of these transactions, if you look at them, they make no sense whatsoever from the standpoint of the consumer. So then how does that happen? And I believe that is the issue before the Committee.

Chairman DODD. Let me turn to Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and this is a very important topic. It affects thousands of people across this country. And we see particularly two individuals here who, I thank you for your testimony. It is very compelling.

We have been told that in Rhode Island there are lenders who will not accept payment if a borrower is 30 days in arrears and will begin foreclosure. Is that your policy, Mr. Samuels?

Mr. SAMUELS. I am sorry, I did not understand that, sir.

Senator REED. We have heard from Rhode Islanders that after they are 30 days delinquent, the lender will not accept payment and begin foreclosure proceedings.

Mr. SAMUELS. No, that is not our policy.

Senator REED. Not at all?

Mr. SAMUELS. No.

Senator REED. Is it your policy, Mr. McDonagh?

Mr. MCDONAGH. We work with our borrowers to try to keep them in their homes from the time we learn of their financial difficulty until the last possible moment of an unavoidable foreclosure. We want to avoid foreclosures as much as possible because we lose money on every foreclosure. The entire foreclosure process consists of many steps, usually takes from 6 to 8 months and we are ready and willing to work out a solution with our customer that is mutually beneficial until the very last day of that process.

Senator REED. Mr. Pollock?

Mr. POLLOCK. No, we do not follow that policy.

Senator REED. So that is not the policy of any of these companies here today. Mr. Bossard?

Mr. BOSSARD. No, it is not our policy.

Senator REED. Given the fact that many of the loans that you issue are then securitized, is that the policy of any of these security instruments, that they will not accept payments after 30 days of delinquency?

Mr. SAMUELS. Not that I am aware of.

Mr. MCDONAGH. We actually hold all our mortgages on our balance sheet. We have over $90 billion currently on our balance sheet.

Senator REED. Mr. Pollock?

Mr. POLLOCK. I have not heard of that.

Senator REED. Mr. Bossard?

Mr. BOSSARD. I am not aware of it.

Senator REED. One of the problems, I think, that has been illustrated by the testimony is that there does not seem to be significant accountability at every stage of the process. Your brokers, and Ms. Haliburton and Mr. Ynigues has described brokers who seem to be deliberately deceptive or certainly misleading or less than candid. I think Mr. Ackelsberg, it is his indication is that happens too often.

They work for you lenders. Once—except for the case of Mr. McDonagh, who holds the paper, the incentives you have are just to put the paper in a securitization process and get it out. And then it goes off to somebody else, to Wall Street.

And I think that is one of the biggest problems in the whole system. No one is really accountable.

Let me ask, Mr. McDonagh, you said that you work with outstanding brokers. Do you have statistics correlating between the brokers and the number of foreclosures on the paper they have issued?

Mr. MCDONAGH. I do not have them today but I will check and submit them. We have a pretty robust process of monitoring our brokers. They must comply with State and Federal laws. We look. We monitor the loan terms and fees. We have capped the back-end premium spreads. We make sure that we are at least equal to or much better than the industry standards.

Senator REED. The problem we are talking about today is people who are going into foreclosure with these subprime loans. Do you have statistics that would correlate a broker and the number of his clients that fall into this category?

Mr. MCDONAGH. We do not have that statistic. Because so many loans are sold into the secondary market and/or securitized, it is very difficult to follow the loan from the broker through the entire securitization process, the payment process, delinquency and foreclosure. We do, however, track “early payment defaults (EPDs).” We are required to repurchase loans under circumstances where the borrower fails to make timely payments to the investor soon after the loan is sold. The EPDs have been analyzed from a variety of perspectives, including, more recently on a broker basis. Brokers that submit loans that have unacceptable frequencies of EPDs are terminated.

Historically, our delinquency and foreclosure analysis was product based, resulting in the elimination of products that had higher frequency of delinquency and foreclosure. Seller score cards were developed, however, that evaluated delinquency and foreclosure rates on an originator or lender level basis for those loans retained in portfolio. We found that vigorously enforcing repurchase of EPD or fraudulent loans by the originating lenders drove better behavior on the underwriting side.

Although we do not have the statistics you refer to, we do track our brokers. The tracking of brokers that we do shows that from March 2005 to March 2007 we had 24,201 approved brokers, although only 8,400 of them were active. During that time, 1,679 were added to our "Ineligible List" and 1,774 were added to our "Watch List." In March of 2007, we started to deactivate brokers due to their borrower's credit quality. For the month of March, the only figures we have at this point, 61 brokers were deactivated.

For your information, I have also attached our "Responsible Lending Guidelines and Best Practices" document which is distributed to any and all brokers approved by HSBC.[1]

Senator REED. Could you provide that for us?

Mr. MCDONAGH. Yes, I can provide that.

Senator REED. What would happen if you found a certain, a high correlation.

Mr. MCDONAGH. We would stop doing business with that broker.

Senator REED. How many brokers have you stopped doing business with?

Mr. MCDONAGH. Again, I will have to submit that information later on.

Senator REED. Mr. Samuels, what about your concern?

Mr. SAMUELS. Yes, the same thing. We do have a number of processes to work with our brokers and monitor their activity. We have a broker scorecard. I think it goes exactly to what you are referring to. And if we find that there are too many loans that are involved with fraud or something like that, we would cut them off immediately.

Senator REED. Mr. Pollock, do you have a comment?

Mr. POLLOCK. Absolutely. Broker management is an important key to this business. Chairman Dodd. Someone has not paid the electric bill.

[Laughter.]

We do track the broker performance. And if we see acts of fraud by a broker, we reject the broker from our approved list. And if there have been damages, we go after them.

Senator REED. Thank you.

Mr. Ackelsberg, the light——

Mr. MCDONAGH. Senator Reed, if I could just also add, another way which we are able to monitor and protect the situation is we originate the majority or 50 or 60 percent of our mortgages through our own branch network. And so we look at those and then look at the ones that are coming in from the broker community. And that way we have our own internal way to self-check.

[1] The document can be found starting on page 267 of this hearing.

Senator REED. Mr. Ackelsberg, from what the two borrowers have said, that they seem to have failed to link up with these excellent brokers, which you suggest that there is a lot of broker misbehavior going on. And yet, the lenders seem to suggest that they have controls and they worry about this and they are concerned about it.

Mr. ACKELSBERG. There absolutely is broker abuse. It starts with the fact that in many States the brokers have taken the position, and the States have allowed them to take the position, that they have no fiduciary responsibility to anybody, neither to the lender nor to the borrower. They basically say they represent themselves. So if they are representing themselves, no surprise, we have all of these kind of transactions out there.

But I think it would be a really bad mistake for this Committee to think that the problem can be solved by reining in the brokers. We have to understand that they are selling the products that the lenders want them to sell. And the lenders themselves are selling the products that Wall Street has ordered.

The ultimate consumer here is not the homeowner. There is no real market demand for being ripped off. The real market demand is on Wall Street for bond securities. And the broker and the lender and everybody else in between is part of a factory that is producing bond securities for Wall Street. That is the real market and that is the real culprit.

Senator REED. Mr. Chairman, I have to go on to Appropriations.

Chairman DODD. I just want to pick up on the question. I had asked this before and I would just remind the lenders here, we looked on the website of the National Association of Mortgage Brokers under frequently asked questions. The very first question is why choose a mortgage broker?

The answer given on a Mortgage Brokers Association website is as follows "The consumer receives an expert mentor through the complex mortgage lending process."

I looked up the word mentor. I think it means a wise and trusted counselor under Webster's definition.

So they are holding themselves out as the mentor, in the sense. Exactly what happened in two cases here, one I presume, Ms. Haliburton, you had never met this individual before they came to your home or you called them?

Ms. HALIBURTON. No, I had not.

Chairman DODD. In the case of you, Mr. Ynigues, this was someone actually you had had a long-standing relationship with?

Mr. YNIGUES. Yes.

Chairman DODD. So a different set of circumstances. But clearly in the case of you, Ms. Haliburton, was it your feeling that this individual you were talking to was actually helping you through this process and giving you advice and counsel as someone who was really sort of on your side, watching out for you? Was that the impression you had?

Ms. HALIBURTON. Yes, I did.

Chairman DODD. How about you, Mr. Ynigues? Was that similar?

Mr. YNIGUES. Same thing.

Chairman DODD. Even though you knew this individual?

Mr. YNIGUES. Yes, I did know and I had fiduciary trusting relationship with him prior.

Chairman DODD. Are you still giving music lessons to that——

Ms. HALIBURTON. Not any longer, no.

Chairman DODD. My imagination thinking about some sort of music lessons you might like to give is almost endless here.

Mr. YNIGUES. Yes.

Chairman DODD. I just point that out to those lenders. You might want to take a look at these websites in a sense here, because that answered the question. I mean, it seems to me that at least the assumption is here is your new broker here. You hold yourself out as the mentor is a really very troubling instruction, in a sense here if, in fact, there is not that fiduciary relationship between the borrower and that broker.

And in most cases the broker is pretty much out of the deal within 10 to 12 weeks anyway, I presume, because once you securitize these mortgages they have been paid their fees and whatever and move on.

I remember in the case of one of the individuals who appeared before us in February, this woman, a widow, said that she had tried to get back in touch and has never heard from again the mortgage broker to find out what was going on and what happened. They disappeared on them, obviously, not to be found again.

Listen, there are very many good mortgage brokers. I do not want this to be an indictment of people out there doing the business every day. But when the association of the brokers lists this kind of information on their website, I mean do any of you have any difficulty with that kind of piece of information, that you are holding yourself out as a mentor? Is that what you tell your brokers?

Mr. Samuels.

Mr. SAMUELS. I am sorry.

Chairman DODD. The national brokers, they are giving answers. "The consumer receives an expert mentor through a complex mortgage lending process."

Mr. SAMUELS. That is the broker who does that. Yes, I mean we, as the mortgage company, do not hold ourselves out as a fiduciary to the borrower.

Chairman DODD. In terms of the brokers that you use and so forth holding themselves out as a mentor, was that a proper description of their role?

Mr. SAMUELS. Some do and some do not. Some do hold themselves out as a fiduciary, and others are very clear that they are offering a rate just like anybody else, any other bank or any other lender.

Chairman DODD. But what should that role be in the broker, with regard to the consumer coming in? What would your advice be to someone like Mrs. Haliburton here who is dealing with an individual? How should that broker have conducted himself in dealing with her?

Mr. SAMUELS. In any case, everybody needs to make sure that the disclosure of what the person is getting into is correct, that there is no fraud.

From our perspective, from Countrywide's perspective, we win when we have an educated borrower. That is very important to us because we want the borrower to know exactly what they are getting into so that we can make sure that they can stay in their home, that they know what their goals are and we can help them achieve those goals. That is very important.

Chairman DODD. In the case of Mrs. Haliburton, we had what, $1,600? What is your monthly——

Ms. HALIBURTON. $1,700 a month. I am 77 and I never saw a broker. Two people came to my home and a very young guy, and he was like a car salesman. He could really sell you. And I believed in what he said. But there was no broker.

And who was he working for? I do not know. But he says Countrywide.

Mr. SAMUELS. Mr. Chairman, if I may, I commit to you and to Mrs. Haliburton that I am going to make sure that we look at all the facts involving her situation and that we do everything that we can to make sure that she stays in her home. We do that for all of our borrowers. We want to do that here.

Chairman DODD. I appreciate that. Thank you very much for that.

Ms. Haliburton.

Ms. HALIBURTON. I feel like they took advantage of me because I am 77 and they figure oh well, she is old and she will die soon and we will take over. But there are so many elderly people like me are suffering and they are losing their homes.

My husband was a policeman for 25 years. He worked hard in the cold, walking, standing. And I deserve to take my last days of my life and live at peace and ease. My kids have grown and gone. They are not all in Philadelphia. I need to relax for what I have done through the years. And that is over 58 years.

Chairman DODD. Anybody who ever called you shy made a huge mistake.

[Laughter.]

Mr. YNIGUES. Mr. Chairman, I would like to make a——

Ms. HALIBURTON. Oh no, I am not shy.

[Laughter.]

I have been around too long.

Chairman DODD. Thank you very much, Ms. Haliburton.

And the point being made obviously, too, Ms. Haliburton, is we are talking about—and I appreciate very much the offer to be of help to Ms. Haliburton.

But obviously, we could not have a table of, a roomful of just witnesses coming in who have through this, and a lot of people are. And the point is we need to figure out something to do here to make sure that the numbers that we are talking about, that could happen here with people put in that situation that we can find some way here to minimize the ability that these people can lose their homes and maximize the opportunity for them to stay in their homes during this difficult period. We are going to be very interested in how we can achieve that and do that.

Again, the point I have made in the past, and I will keep on saying it again here, it is very, very valuable in my mind that we maintain and have instruments available for people to be able to move into their home ownership.

There was a statement again, Mr. Samuels made, that these teaser rates—and I am quoting you here—"Are a critical bridge for our customers, reducing costs for homeowners experiencing temporary financial challenges."

That may be in some cases, but most of the people we are talking about here, a lot of them are on—it is not temporary to the circumstances. There are people who are lower income, do not have historically good credit ratings. In the case of fixed incomes and older people here on Social Security or some retirement program that does not allow for a lot of flexibility in terms of what they can handle.

And again, looking at some of the numbers here, it seems to me that an awful lot of people we are talking about, the range of their financial circumstances are not terribly elastic. They are not going to expand considerably. That is a pretty fair statement to make unless they have some good fortune at the lottery or something else.

So the idea that it is a bridge to get through a temporary set of circumstances just does not seem to hold up, in my view, unless you can convince me otherwise.

Mr. SAMUELS. This is our experience, Mr. Chairman, that many who get into these 2/28s or 3/27s are able to repair their credit within that 2 year or 3 year period. And so if they are able to do that, and the statistic that I gave is that 50 percent of those who re-refinance from a subprime 2/28, we were able to refinance into a prime loan.

So that if someone is able to make their payments on time, keep their credit good for that period of time, their FICO score is going to go up and we are going to be able to make them a prime loan. That is the purpose of these kinds of products.

Chairman DODD. What is the point of the teaser rate, the sense? It seems to me——

Mr. SAMUELS. It makes the loan affordable.

Chairman DODD. But if it is only for a year or so, and the circumstances are not going to change——

Mr. SAMUELS. It is 2 years.

Chairman DODD. Two years.

Mr. SAMUELS. But it is for 2 years——

Chairman DODD. How does someone that is 70 years old with a teaser rate, and she is 72, what is the circumstances?

Mr. SAMUELS. If she makes the payment on time for the period of those 2 years, her FICO score will go up and we will be able to refinance her into a——

Chairman DODD. Then she is going to pay more, though?

Mr. SAMUELS. No, into a prime loan. She will pay less because she will have gone from a subprime loan into a prime loan.

Chairman DODD. Anybody want to make any comments on this at all, on this particular——

Ms. BOWDLER. Yes, I would like to.

I think it is a great thing for the borrowers that that happens. But I think what we have seen is that certainly is not the universal experience. And to the extent that these products are putting families in a position where they are going to be going through endless cycles of refinancing, I mean no family should be in a position where they have to refinance to keep their home. And that is what we are seeing with our borrowers that are coming in to their counselors.

I am not going to say that an investor out there cannot use a sophisticated product to do whatever they need to do with that. But what we are seeing are average every day people who did not make the decision for themselves that they wanted a 2-year teaser rate and now are in a position where they are just going refinance after refinance, and no equity left to show for it.

Chairman DODD. Would any of the lenders on here besides Mr. Samuels, you do not restrict these hybrid ARMs to borrowers who are experiencing temporary financial difficulties? Is that true?

Mr. MCDONAGH. In our case, in the last few months, we have actually withdrawn a number of products which we believe are not appropriate to the consumer, in reaction to what is going on.

As I mentioned too, our organization is perhaps a bit unique in the sense that we have 1,400 of our own branches. In that case, we are very much able to provide the loan on a know your customer—I think what you would call knowledgeable counsel, sort of the thing that was on the website of the brokers.

Our way of controlling, as I said about the brokers, is we look at the statistics, the correlation that Senator Reed mentioned. If we find that a broker is not maintaining the standards that would be associated with our brand, then we will cut them off.

There is no silver bullet here, Mr. Chairman. I think there are a number of things people can do. We need to improve financial literacy. The average consumer out there certainly does not have to know about complex products. But we need to bring up their level of education by a certain amount.

At the same time, and then equally, I think the lenders have to make sure that the range of products are properly controlled for the segment that they are dealing with.

I think quite a few—I can only speak to my own organization but I am sure a number of my industry colleagues here have financial literacy programs. I mentioned our foreclosure avoidance program. I think the industry, broadly, has to be encouraged to work with the community groups to have similar programs. That is one way of starting to solve the problem. Then you look at the products, as well.

And then, as we talked about it, we support the guidelines. There is a certain amount of regulation that is required. There is a certain amount that is not because we do not wish to dry up the credit that is available. There are people out there who need loans.

I think if we initiated a collection of all those suggestions you will begin to see an overall improvement in the marketplace.

Chairman DODD. I hope so. We are going to look at all of that. And I do not disagree about financial literacy.

But you are looking here, even well-educated people, sophisticated people, this can be a pretty daunting experience even through a normal closure that occurs that people go through in terms of buying a home through a prime lender, prime lending practice. So it is a pretty overwhelming experience for people.

And there is an excitement and enthusiasm, and you are hoping that this is going to work out. So your inclination is to want to say yes to everything at the time.

The advantage between the lender and the borrower in these cases are such that that borrower is so determined and so anxious to achieve that dream. And the thought that you might get turned down or that you might not get accepted has a profound effect on the quality of the bargaining position, so to speak, in those critical moments where people are not aware of choices and options available to them.

So you get kind of drawn into a situation that can be difficult. So there is responsibility on the consumer side, clearly. But I would say respectfully, Mr. McDonagh, I think there is a higher degree of responsibility on the part of the lender, who is a sophisticated operator here, much more sophisticated than that borrower in 98 percent of the cases are going to be, even with educated consumers, about these issues.

My hope is, and I am encouraged by what I have heard here today on the part of the lenders who are here, that are going to either accept either the changes that will be made by the regulators or on your own are going to do so. And I strongly encourage that, if I could, because really this situation that my colleagues here, some of them, have predicted dire consequences of what may happen in the coming weeks and months. I do not know with any certainty what is going to hope—I hope they are wrong about that.

I hope this can be relatively contained and that we do not have the kind of shock in the marketplace here that could really be of great harm to our economy.

But we need to talk to some other people, as well, and we need to be prepared to make sure that those who could be put in the position of losing their homes can avoid that catastrophe, and in the meantime to put the brakes on this stuff as quickly as possible.

For those of you who made the statements here that you are going to change your policies, I would urge you to do so immediately. There is not a better message that could come out of this hearing than the other people who could be disadvantaged, you are going to make every effort to see that does not happen.

And I appreciate that very, very much and your willingness to be here and to participate. And we thank all of you for coming.

There will be a lot of questions, I am sure we will submit to ask written answers to in a timely fashion, if we could.

We have kept you a long time and I apologize for doing that. You are patient and I appreciate that very much.

Ms. Haliburton, Mr. Ynigues, we thank you both very, very much for being here.

The Committee will stand adjourned.

[Whereupon, at 2:07 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

STATEMENT OF

SANDRA L. THOMPSON
DIRECTOR
DIVISION OF SUPERVISION AND CONSUMER PROTECTION
FEDERAL DEPOSIT INSURANCE CORPORATION

on

MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

March 22, 2007
Room 538, Dirksen Senate Office Building

Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the residential housing mortgage market.

My testimony will discuss developments in the mortgage market that concern the FDIC, including the impact that the nontraditional and subprime hybrid adjustable rate mortgages (ARMs) are having on consumers and on FDIC-supervised institutions. I also will discuss supervisory standards the federal banking agencies have imposed and enforcement actions the FDIC has taken to address issues in the nontraditional and subprime mortgage markets, as well as action the FDIC takes to combat predatory lending. We also have provided responses to the Committee's specific data requests based on the best information available to us, and this material is attached to my statement.

The Evolution of Today's Mortgage Market

The current U.S. mortgage market reflects the confluence of trends that came together in 2004 and 2005 to substantially change the marketing and funding of mortgage lending. These factors included rising home prices, declining affordability, historically low interest rates, intense lender competition, innovations in the structure and marketing of mortgages, and an abundance of capital from lenders and mortgage securities investors.

In 2003, U.S. home price appreciation began to intensify, far outpacing the growth of disposable personal income. While disposable incomes have grown slightly faster than average home prices during most years, home prices had begun to grow faster than incomes beginning in 2001, much the same as they had during previous boom periods in 1978-79 and 1986-87. The difference in the recent housing boom was the very rapid acceleration of home price growth to double-digit rates by 2004 and 2005. Average U.S. home prices grew more than three times faster than disposable incomes in 2005.

From 2001 to mid-2004, prime borrowers with a preference for fixed-rate mortgages refinanced in record numbers as long-term interest rates fell to the lowest rates in a generation. As interest rates began to rise in 2004 and the pool of potential prime borrowers looking to refinance shrank, lenders struggled to maintain or grow market share in a declining origination environment, and did so by extending loans to subprime borrowers with troubled credit histories. Between 2003 and 2005, the prevalence of subprime loans among all mortgage originations more than doubled from 9 percent to 19 percent.[1]

In addition, new homebuyers with both prime and subprime credit profiles migrated toward the lower monthly payments associated with ARMs to cope with rapidly rising home prices and declining affordability. Over 30 percent of all conventional mortgages made in 2004 and 2005 were ARMs.[2] The percentage of ARMs among

[1] See "Mortgage Originations by Product," *Inside Mortgage Finance*, February 25, 2005.
[2] Federal Housing Finance Board.

subprime borrowers was even higher -- nearly 80 percent of securitized subprime loans were ARMs by early 2006.[3]

Lenders accommodated these borrowers by diversifying mortgage offerings and easing lending standards as they competed to attract borrowers and meet prospective homebuyers' financing needs. Because of the affordability aspect already noted, borrowers increasingly turned to products such as payment option and interest-only (IO) loan structures in 2004 and 2005. These "nontraditional" mortgages are specifically designed to minimize initial mortgage payments by eliminating or relaxing the requirement to repay principal during the early years of the loan. Although it is difficult to measure the use of these mortgage structures across all mortgage originations, payment option and interest-only loans appear to have made up as much as 40 to 50 percent of all subprime and Alt-A loans securitized by private issuers of mortgage-backed securities during 2004 and 2005, up from 10 percent in 2003.[4] The majority of subprime originations over the past several years were "2/28 and 3/27" hybrid loan structures. These hybrid loans provide an initial fixed-rate period of two or three years, after which the loan converts to an adjustable rate mortgage and the interest rate adjusts to the designated loan index rate for the remaining 28 or 27 years of the loan.[5] The 2/28 and

[3] See "ARMs Power the Subprime MBS Market in Early 2006," *Inside B&C Lending*, July 21, 2006.
[4] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-Agency securitized mortgage originations. Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.
[5] For example, the underlying adjustable loan index rate could be 6 month LIBOR plus some spread. The spread between the initial fixed rate of interest and the fully-indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

3/27 loan products accounted for almost three-quarters of subprime securitized mortgages in 2004 and 2005.[6]

The mortgage market was further fueled by significant mortgage backed securities (MBS) liquidity, with investors increasingly seeking yield through higher risk. Securitizations allow financial institutions to access the capital markets to fund mortgage operations, while simultaneously transferring credit risk away from the institutions and to securitization investors. The share of U.S. mortgage debt held outside the government-sponsored enterprises by private mortgage-backed securitizations doubled between 2003 and 2005, helping to fuel the growth of subprime and nontraditional mortgages. The ability to include these mortgage products in securitization pools facilitated their availability to borrowers through both FDIC-insured and non-bank lenders. Many of these lenders would not have found these products to be attractive absent the funding and credit risk transfer features available through securitization.

Detecting Problems in the Mortgage Market

The FDIC routinely monitors the mortgage markets on a systemic basis, and compiles information on subprime lending activity in insured institutions using examination data. As part of this process, the FDIC published research that discussed the changing role of subprime lending in the mortgage market in recent years. In 2004, the FDIC noted the prevalence of ARMs among subprime borrowers. In 2005, the FDIC

[6] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-Agency securitized mortgage originations.

raised the possibility that increased use of subprime and nontraditional mortgages was contributing to the expanding U.S. housing boom.[7]

Although our research showed that subprime loan volume began increasing in 2004, clear indications of problems in the subprime market did not begin to surface until the latter part of 2005. Delinquency rates for subprime loans 60 days or more past due began falling in 2002 and continued to fall until the third quarter of 2005. It was not until the fourth quarter of 2005 that severe delinquencies and foreclosures in the subprime market began to rise noticeably (this data did not become available for review until the end of the first quarter of 2006). Total subprime delinquencies rose from 10.33 percent in the fourth quarter of 2004 to 13.33 percent in the fourth quarter of 2006.[8] In the same period, foreclosures rose from 1.47 percent to 2.00 percent. For subprime ARMs, the total loan past due rose from 9.83 percent to 14.44 percent, and foreclosures rose from 1.50 percent to 2.70 percent.[9]

Supervisory Response

The federal banking agencies strive to maintain consistent regulatory policies by developing any significant policy changes on an interagency basis. The interagency policymaking process is both collaborative and deliberative, and often involves the public. Although the interagency collaboration and public comment process invariably

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[7] *FDIC Outlook*, Spring 2004 and "FYI Revisited – U.S. Home Prices, Does Bust Always Follow Boom?," *FDIC FYI*, May 2, 2005.
[8] Mortgage Bankers Association National Delinquency Survey
[9] Source: Mortgage Bankers Association / Haver Analytics

slow response time, these comments help to identify the diversity of viewpoints about the issue at hand, as well as any potential unintended consequences that a proposed supervisory action may pose to market activities or to the availability of credit. It also raises awareness among the industry and the public about the concerns of the federal banking agencies, which often triggers the beginnings of corrective action in the financial marketplace even before the final rules or guidance are enacted.

Because the policymaking process is so intensive, the federal banking agencies work to make supervisory guidance principles-based, not product specific. Our experience has shown that product-specific guidance quickly becomes obsolete, while principles-based guidance can remain relevant for many years.

With respect to mortgage lending, over the past two years the federal banking agencies have published a number of examiner and industry guidance documents warning about deteriorating underwriting standards. As early as May 2005, the agencies issued *Credit Risk Management Guidance for Home Equity Lending*[10] in response to the strong growth in home equity lending. This guidance described specific product, risk management, and underwriting standards that warranted supervisory attention, including interest-only features; limited or no documentation of borrower's assets, employment and income; higher loan-to-value and debt-to-income ratios; lower credit scores; and increased use of third-party or brokered transactions.

[10] FIL-45-2005 (May 24, 2005).

In December 2005, the federal banking agencies followed up with proposed *Interagency Guidance on Nontraditional Mortgage Product Risks* (NTM Guidance).[11] The proposed *NTM Guidance* sent a clear message to the marketplace that bank regulators were concerned about these products. The agencies' concerns with nontraditional mortgage products were similar to the ones identified with home equity lending, but were compounded by the lack of principal repayment and the potential for negative amortization, as well as risk-layering features such as simultaneous second-lien loans and reduced documentation. The *NTM Guidance* was finalized in October 2006 following careful consideration of comments from the industry, consumer groups, and others. The *NTM Guidance* not only reminded bankers to carefully manage the risks associated with these products, it also emphasized that consumers should be provided with clear and accurate information about these products at the point in time at which they are choosing a loan or deciding which payment option to select. To help the industry provide necessary information to borrowers, the federal banking agencies also proposed model illustrations that institutions may use to assist consumers as they select products or choose payment options.[12]

The FDIC also published borrower-focused articles in 2005 ("Mortgages: More Choices, New Risks for Borrowers") and 2006 ("Avoid Costly Banking Mistakes: No Trivial Pursuit") in our *FDIC Consumer News*, a quarterly publication with more than 35,000 mail and electronic subscribers and an average of about 28,000 Internet visits each month. The articles emphasized the importance of obtaining and carefully

[11] FIL-90-2006 (October 5, 2006).
[12] See Proposed Illustrations for Nontraditional Mortgage Products, 71 FR 58672 (October 4, 2006).

reviewing complete information about loans when choosing among the increased varieties of mortgages available.

As the federal banking agencies reviewed comments and prepared the final *NTM Guidance* during 2006, it became apparent that the loosened underwriting and risk layering in the NTM market had extended to the subprime market. However, the *NTM Guidance* initially was focused on the risks of products that defer the repayment of principal and sometimes interest which were not primarily marketed to prime, rather than subprime, borrowers. With respect to subprime lending, the final *NTM Guidance* cross-referenced the 2001 *Subprime Lending Guidance,* which clearly outlined regulatory expectations for subprime lending programs.

In addition to its general research, the FDIC identified significant underwriting and consumer protection issues via the examination process, which also elevated our concerns. It was clear that some in the industry had collectively reached beyond the level of time-tested prudent underwriting principles. The federal banking agencies recognized the need to provide expanded guidance to the industry.

Earlier this month, the federal banking agencies and the NCUA issued a proposed *Statement on Subprime Mortgage Lending* (*Subprime Statement*).[13] The *Subprime Statement,* which is currently out for public comment, makes it clear that lenders should follow two fundamental principles when underwriting and marketing mortgages: (1) approve borrowers based on their ability to repay the loan according to its terms (not just

[13] FIL-26-2007 (March 9, 2007).

at the introductory rate); and (2) provide borrowers with clear information to help them understand the transaction at a time when they are deciding if the loan is appropriate for their needs. Collectively, the standards articulated in the *Subprime Statement* build on fundamental and longstanding consumer protection and risk management principles.[14]

Enforcement

The FDIC enforces mortgage lending standards through examinations and supervisory actions. When examiners encounter unsafe and unsound lending practices, we take whatever supervisory actions are necessary to effect correction. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including the FTC Act prohibition against unfair or deceptive practices, we take action to ensure that illegal practices cease and that harm to consumers is remedied.

Our examination process has led to the issuance of more than a dozen formal and informal enforcement actions that are currently outstanding against FDIC-supervised institutions that failed to meet prudential mortgage lending standards. In addition, the FDIC uses these standards in screening applicants for new banks and establishing prudential conditions for the granting of deposit insurance charters.

The extensive standards for subprime lending and unfair and deceptive practices give the FDIC strong tools with which to fight unsafe, unsound, and abusive lending

[14] For example, the *Interagency Guidelines for Real Estate Lending*, issued by the federal banking agencies in 1992, addresses basic underwriting standards for real estate loans. *See* 12 C.F.R. Part 365, Appendix A.

practices. As an example, earlier this month the FDIC issued a significant cease and desist order against an FDIC-supervised institution for operating without effective risk management policies and procedures in place in relation to its subprime mortgage and commercial real estate lending operations. The FDIC determined, among other things, that the institution was operating without adequate subprime mortgage loan underwriting criteria, and that it was marketing and extending subprime mortgage loans in a way that substantially increased the likelihood of borrower default or other loss to the institution. The order, which became public on March 7, 2007,[15] sets forth a variety of specific corrective actions to be undertaken.

Options for Troubled Borrowers

While the federal bank regulators have issued guidance to address the issues raised by nontraditional and subprime ARMs, as well as taking appropriate enforcement action, there remain a large number of borrowers who obtained these loans and face potential economic hardship as the loans reset under current economic conditions. A number of borrowers with loans due to reset may be able to take advantage of the current interest rate environment and refinance into a fixed-rate mortgage. However, this will not be an option for everyone.

In many cases, the loans have been securitized, which makes it more challenging to apply the flexibility necessary to develop solutions for borrowers. The terms of the securitizations can limit the options available for restructuring these loans. The FDIC has

[15] See FDIC Press Release dated March 7, 2007, http://www.fdic.gov/news/news/press/2007/pr07022.html

already begun discussions with lenders, servicers and other participants in the subprime securitization market to find ways to address the needs of borrowers facing economic hardship.

With regard to subprime loans held in insured depository institutions, the FDIC is working to reassure financial institutions that they do not face additional regulatory penalties if they pursue reasonable workout arrangements with borrowers who have encountered financial difficulties. Many lenders and loan servicers are today working directly with stressed borrowers to restructure their loans or find other ways to allow them to keep their home and make more affordable payments. Working constructively with borrowers is typically in the long-term best interests of both financial institutions and the borrowers

In addition, programs that transition borrowers from higher cost loans to lower cost loans may receive favorable consideration as a lender's Community Reinvestment Act performance is assessed.[16] The FDIC strongly supports such transition programs. Further, some non-profit organizations have developed programs that counsel struggling borrowers and work with local leaders to create foreclosure intervention programs. For example, the Center for Foreclosure Solutions is sponsored by NeighborWorks America, an organization created by Congress to provide financial support, technical assistance,

[16] See Interagency Questions and Answers on the Community Reinvestment Act, 66 Fed. Reg. 36619, 36631, Sec. 345.22(a)-1 (July 12, 2001), http://www.fdic.gov/news/news/financial/2001/fil0164.html.

and training for community based revitalization efforts and chaired by FDIC Director Thomas J. Curry.[17]

Predatory Lending

In January the FDIC issued its *Supervisory Policy on Predatory Lending*[18] that describes certain characteristics of predatory lending and reaffirms that such activities are inconsistent with safe and sound lending and undermine individual, family, and community economic well-being. The policy also describes the FDIC's supervisory response to predatory lending, including a list of policies and procedures that relate to consumer lending standards.

The federal banking agencies have been concerned about abusive practices for some time. Six years ago, the agencies issued guidance for financial institutions that outlined the specific characteristics most often associated with predatory lending:[19]

- Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and

[17] See NeighborWorks America website at: http://www.nw.org/network/neighborworksprogs/foreclosuresolutions/default.asp
[18] See FDIC Financial Institution Letter 6-2007, dated January 22, 2007.
[19] *Expanded Guidance for Evaluating Subprime Lending Programs*, FIL-9-2001, January 31, 2001, http://www.fdic.gov/news/news/financial/2001/fil0109.html.

- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

The federal banking agencies warned lenders that loans with these characteristics would be closely reviewed from both a consumer protection and a safety and soundness perspective. Moreover, they explained that examiners would criticize loans made to borrowers who have not demonstrated the capacity to repay from sources other than the collateral pledged.[20] While these principles were first stated in the context of subprime lending, the FDIC treats them as valid guidance for loans made to all borrowers. As mentioned earlier – and it bears repeating -- when FDIC examiners encounter any loans with predatory characteristics, they take whatever supervisory actions are necessary to effect correction. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including the FTC Act prohibition against unfair or deceptive practices, we take action to ensure that illegal practices cease and that harm to consumers is remedied.

Because many predatory practices can be characterized as either unfair or deceptive, the FDIC communicated to its state nonmember banks in 2002 that the FTC Act prohibition against such practices applies to their activities.[21] Together with the Board of Governors of the Federal Reserve (FRB), the FDIC issued more detailed FTC Act guidance applicable to all state chartered banks in 2004.[22] This guidance explained the standards used to assess whether an act or practice is unfair or deceptive, as well as

[20] Id. at p. 10.
[21] See FIL-57-2002, issued on May 30, 2002.
[22] See FIL -26-2004, issued on March 11, 2004.

the interplay between the FTC Act and other consumer protection statutes. It also offered suggestions for managing risks related to unfair and deceptive practices. Two years ago, the FDIC issued procedural guidance to its examiners to ensure that they have the tools that they need to assess whether unfairness or deception has occurred.[23]

Concern about predatory lending prompted us to amend the Community Reinvestment Act (CRA) rules in 2005 to clarify that credit practices that are discriminatory, unfair or deceptive, involve unearned fees or kickbacks, or fail to meet other significant regulatory standards weigh against an institution when its CRA performance is assessed.[24]

The FDIC also has worked to integrate Home Mortgage Disclosure Act (HMDA) pricing data into its fair lending compliance examination program. Compliance examiners are now required to evaluate racial and gender-related patterns in the HMDA pricing data when conducting compliance examinations of all institutions subject to HMDA reporting requirements. The FDIC also uses the new HMDA pricing data to identify outlier institutions that warrant special scrutiny because of larger pricing disparities for minorities or females in one or more loan product areas than are evident for other FDIC-supervised institutions. Institutions identified as outliers are asked to provide the FDIC with information that explains the channels through which people obtain mortgage loans and the factors the bank considers in making its pricing decisions for the loan product under review. As necessary, comparative analysis is conducted to

[23] See "Abusive Practices" section of FDIC Compliance Examination Handbook, published on January 30, 2007 through FIL 10-2007. .
[24] See, e.g., 12. C.F.R. §345.28(c) (CRA rules applicable to FDIC supervised institutions).

determine whether those factors were fairly and neutrally applied. In addition, the FDIC considers whether minorities or women have been disproportionately steered to high cost products.

Examinations at a handful of the outlier institutions suggest the possibility of discriminatory pricing on the basis of race. In these situations, loan officers typically enjoyed broad, unmonitored pricing discretion. Although the FDIC review is on-going, two of these matters have been referred to the Department of Justice for enforcement action.

Conclusion

The FDIC is very concerned about recent practices in the mortgage markets, especially with regard to subprime lending. Although we have been monitoring this type of lending for a decade and have issued guidance and taken supervisory actions when necessary, we also recognize the need to keep pace with this evolving market. Accordingly, we look forward to the public comments on the recent draft Subprime Statement. In addition, the FDIC will continue to aggressively enforce all laws, rules and guidance regarding subprime lending. Working with our federal and state regulatory counterparts and the Congress, we also are eager to find solutions for borrowers with mortgages they cannot afford.

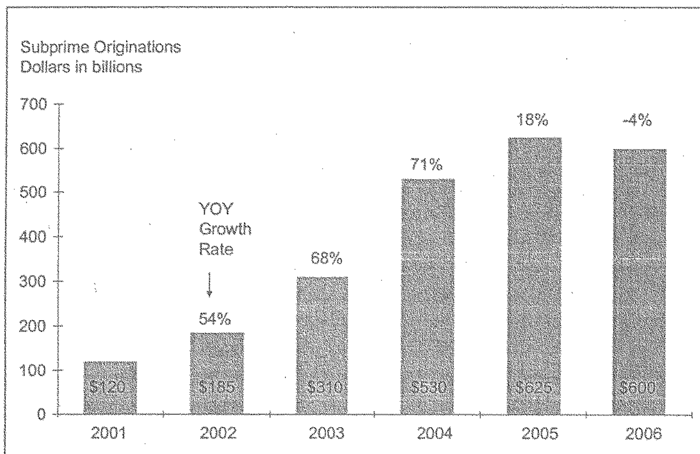
This concludes my statement. I will be happy to answer any questions the Committee might have.

Attachment

Responses to Data Requests from the

Senate Committee on Banking Housing and Urban Affairs

Inside Mortgage Finance reported on mortgage market trends and provided historical data on subprime mortgage originations.



Source: Inside Mortgage Finance.

An analysis of private-label securitization data provides a sampling of subprime loan characteristics from 2001 forward.

Subprime MBS composition

Origination Year	Total subprime MBS ($ in billions)	ARM share	Fixed Share
2001	$72.76	60.8%	39.2%
2002	$118.99	67.7%	32.3%
2003	$215.34	65.2%	34.7%
2004	$357.25	75.7%	24.2%
2005	$429.66	79.7%	20.3%
2006	$197.34	74.0%	26.0%

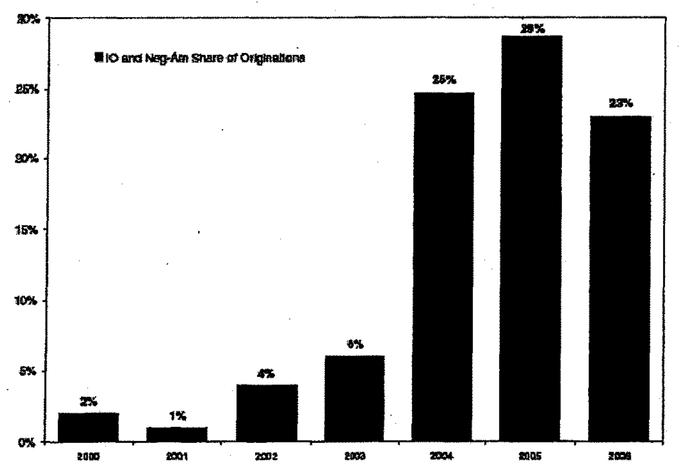
	IO share*	Negative amortization share	2- and 3- year hybrid adjustable rate	5- 7- and 10-year hybrid adjustable rate
2001	0.0%	0.0%	59.5%	0.8%
2002	1.2%	0.0%	65.4%	1.4%
2003	4.1%	0.0%	63.1%	1.4%
2004	16.2%	0.0%	73.5%	1.5%
2005	27.2%	0.0%	72.2%	1.5%
2006	17.0%	0.0%	50.3%	2.0%

	Investor share	Second home share	Owner occupied share	Purchase share	Refinance share
2001	5.0%	0.8%	93.5%	31.2%	67.2%
2002	5.2%	0.7%	93.8%	31.4%	67.7%
2003	5.7%	0.8%	93.4%	31.6%	67.9%
2004	5.5%	0.9%	93.6%	37.6%	62.4%
2005	5.4%	1.4%	93.2%	42.7%	57.3%
2006	5.2%	1.5%	93.3%	44.1%	55.9%

Source: LoanPerformance, non-agency securitized mortgage originations.
*IO = interest only

Nontraditional mortgages (including interest-only and negative amortization loans) grew substantially as a share of purchase originations in 2004 and accounted for almost a quarter of originations in 2006.

Exhibit 29: Interest-Only and Negative Amortization Share of Total Purchase Mortgage Originations, 2000–06



Note: Based off of origination dollars.
Source: Loan Performance, Credit Suisse analysis.

Detailed data for nontraditional originations is available from 2004 forward.

Inside Mortgage Finance (January 2007)
Mortgage Originations (dollars in billions)

	Interest-Only						
Origination year	Total	ARM	FRM	Option ARM	40 year ARM	Total Originations	Interest only and option ARM share of total originations
2004	$60	$55	$5	$145	$0	$2,920	7.02%
2005	$481	$418	$63	$280	$10	$3,120	24.39%
9M06	$405	$300	$105	$208	$58	$2,260	27.12%

Note: 40-year balloons have initial amortization schedule of 40-50 years with balloon payment due at 30 years.
Source: Inside Mortgage Finance, January 2007.

Analyzing LoanPerformance non-agency MBS data provides a more detailed analysis of securitized nontraditional loans:

Interest-only and negative amortization shares of non-agency MBS

Origination Year	IO share	Negative amortization share
2001	4.2%	0.9%
2002	12.1%	1.1%
2003	16.7%	0.6%
2004	32.2%	6.6%
2005	35.6%	14.3%
2006	31.5%	18.3%

Subsequent shares are calculated as a percent of nontraditional* non-agency MBS

Origination Year	Total nontraditional originations ($ in billions)	ARM share	Fixed Share	2- and 3- year hybrid adjustable	5- 7- and 10-year hybrid adjustable
2001	$12.06	98.8%	1.2%	1.4%	61.7%
2002	$45.03	99.2%	0.8%	4.9%	56.9%
2003	$90.17	97.3%	2.6%	15.0%	51.8%
2004	$296.05	97.0%	3.0%	32.7%	34.2%
2005	$452.81	88.8%	11.2%	28.8%	27.8%
2006	$236.86	84.3%	15.7%	14.4%	32.5%

	Investor share	Second home share	Owner occupied share	Purchase share	Refinance share
2001	1.8%	6.9%	91.3%	31.6%	68.4%
2002	2.0%	5.8%	91.7%	31.0%	69.0%
2003	4.5%	5.8%	89.7%	41.8%	58.1%
2004	7.0%	4.4%	88.5%	54.4%	45.4%
2005	8.7%	4.3%	87.0%	52.0%	48.0%
2006	8.9%	4.7%	86.5%	47.3%	52.7%

Source: LoanPerformance, non-agency securitized mortgage originations.
*Nontraditional refers to interest-only and negative amortization originations

For Release Upon Delivery
10:00 a.m., March 22, 2007

TESTIMONY OF

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Before the

COMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Of the

UNITED STATES SENATE

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Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chairman Dodd, Ranking Member Shelby, and members of the Committee, my name is Wayne Rushton, Senior Deputy Comptroller and Chief National Bank Examiner for the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to appear before you today to discuss developments in mortgage underwriting and marketing practices, particularly in the subprime market, that have been the focus of attention by the OCC and the other federal banking agencies. Before discussing subprime mortgage lending and the OCC's supervision of national banks, I think it is important at the outset to make the following observations:

First, it is clear that some subprime lenders have engaged in abusive practices and we share the Committee's strong concerns about them. But, it would be wrong to equate all subprime lending with predatory lending. Subprime loans have helped to provide mortgage financing for millions of first-time homebuyers with few credit options, and this segment of the population is important to the economy. No one wants to see these consumers shut out of the credit markets, and so we need to work together to ensure that they are treated fairly and responsibly without cutting off their access to credit.

Second, the vast majority of subprime loans are not originated in the national banking system or supervised by the OCC. While some national banks and their subsidiaries help to serve the credit needs of the subprime market, their subprime lending last year amounted to less than 10% of the total of subprime mortgage originations by all lenders. Subprime lending is a specialized business that must be carefully managed to maintain safety and soundness, to mitigate risks, and to ensure fair treatment of borrowers. National banks and their subsidiaries that engage in subprime lending are subject to extensive oversight by OCC examiners and must operate in close compliance with the OCC's rigorous safety and soundness and consumer protection standards. Unsound underwriting standards and abusive lending practices have no place in the national banking system. Some have said, perhaps not surprisingly, that there is a direct connection between the rigor of the OCC's supervision of subprime mortgage lending and the low level of this activity in national banks. Indeed, there have been recent instances in which banks have decided against converting to a national charter for this very reason.

Third, we are now confronting adverse conditions in the subprime mortgage market, including disturbing but not unpredictable increases in the rates of mortgage delinquencies and foreclosures. These conditions can be attributed to a variety of factors, including changes in local economies that affect borrowers' creditworthiness and home values; the willingness of investors -- and borrowers -- to assume greater levels of risk; fraud in the application process; intense competition; and a relaxation of lending standards. With regard to matters that are within the purview of the bank regulatory agencies, let me assure you that we will work together, in the institutions we supervise, to obtain appropriate corrections to underwriting practices that cause us concern. Given the importance of the housing sector to our economy and to our national policy goals, however, it is imperative that we all use the right degree of pressure when "applying the brakes" to avoid putting in jeopardy the segments of the market that are working well and that have helped to raise homeownership rates to historic levels.

Finally, as we seek to address the concerns that have been raised about subprime mortgage lending, we need to recognize the predominant role played by nonbank companies in providing financing to subprime borrowers. Almost half of all subprime loans originated in 2006 were made by nonbank lenders, and this is due to several factors. First, insured depository institutions, whether nationally- or state-chartered, are the most heavily regulated of all financial institutions, and they also tend to have the most conservative underwriting standards. This may account for the fact that banks have the smallest share of the subprime market. Nonbank affiliates of bank and thrift holding companies have a larger share of subprime originations than do banks. However, as noted above, state-regulated nonbank lenders and brokers that originate these loans have captured the largest share of the subprime market recently -- primarily because hedge funds and private equity investors provided extraordinary liquidity to fuel this growth by purchasing loans originated by nonbanks, as well as securities backed by these loans, in the secondary market. Given the complexity of subprime mortgage finance, and the variety of companies engaged in the activity, adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

My testimony today will describe these developments in the mortgage market, as well as recent interagency guidelines on mortgage lending. I will also discuss the OCC's supervisory process to describe how we seek to prevent national banks and their subsidiaries from engaging in unfair and deceptive, predatory, or unsafe and unsound mortgage lending practices. In this regard, I will describe supervisory and regulatory standards that the OCC has issued relating to mortgage lending by national banks and their mortgage lending subsidiaries, how we examine these institutions for compliance with these standards, and relevant enforcement actions.

Developments in the Subprime Mortgage Market

Throughout most of the 1990s, mortgage origination volumes remained steady at around $1 trillion per year. Beginning in 2001, however, interest rate reductions by the Federal

Reserve Board had a substantial impact on the mortgage market. As interest rates declined, many borrowers refinanced existing loans, often lowering their interest rates and extracting cash at the same time. The result was a three-year rapid expansion of the mortgage market that peaked in 2003 with just under $4 trillion in new originations. When the Federal Reserve began raising interest rates in 2004, the impact on mortgage markets was almost immediate. By the end of 2004, originations volume declined to just under $3 trillion, a 26% drop from 2003.

As one might expect, the 2001-2003 surge in demand prompted mortgage lenders to expand their operations to boost capacity. These conditions also attracted new market participants, often lenders with little business experience or financial strength. When loan demand slowed in 2004, the market was left with overcapacity. To maintain production levels, and satisfy continued strong investor appetite, mortgage originators shifted to "innovative" products, often designed to help borrowers cope with rising home prices or continue to tap idle home equity. Some of these "innovations" included relaxed underwriting standards and temporary payment reductions that increased risk for both borrowers and lenders.

In recent years, 15- and 30-year fully amortizing conventional loan products have declined from 62% of total originations in 2003, to just 33% by the end of 2006, while originations of loans to subprime borrowers, and originations of interest only (IO) and payment option adjustable-rate mortgage (ARM) loans to prime or near-prime borrowers, have increased. For example, loans to subprime borrowers increased from just 8% of total originations in 2003, to 20% in 2005. Subprime originations peaked in 2005 at a total of $625 billion in originations, and declined to about $600 billion in 2006, with a 20% market share in both years. Originations of loans to the so-called Alt-A market, including nontraditional products such as IOs and payment option ARMs, grew from only 2% in 2003 to 13% by the end of 2006.

In contrast to their share of the mortgage market generally, and their share of commercial banking assets, national banks have not been significant players in the subprime loan market. Roughly two-thirds of commercial bank assets are held by national banks. In addition, almost one-third of the approximately $3 trillion in total mortgages that were originated in 2006 were originated by national banks or their subsidiaries. However, as I noted earlier, subprime lending by national banks and their subsidiaries in 2006 amounted to less than 10% of the total $600 billion in subprime mortgage originations by all lenders. Moreover, it bears noting that subprime loans originated by national banks have been relatively higher quality, and are performing better, than subprime loans in the general market.

However, loan performance in the subprime sector generally, as we have been seeing, is deteriorating. Recent statistics reported in a nationwide survey by the Mortgage Bankers Association (MBA) showed that 14.44% of subprime borrowers with ARM loans were at least 60 days delinquent in their payments in the fourth quarter of 2006.[1] This was an increase of 122 basis points from the third quarter delinquency rate for such mortgages of 13.22%. According to the MBA survey, foreclosure start rates for subprime loans increased 18 basis points (from 1.82% to 2%) during the fourth quarter of 2006.

The OCC has carefully monitored these changes in the mortgage market over time, with particular focus on developments affecting the national banking system, and taken preventive steps as appropriate to address safety and soundness and consumer protection

[1] National Delinquency Survey, Mortgage Bankers Association, March 2007.

concerns as they have been identified. The OCC has addressed the liberalization of mortgage underwriting and the need for caution in four consecutive Annual Surveys of Credit Underwriting Practices, beginning in 2003. In 2004, we began to take particular steps to assess the risks associated with this activity. These steps included a survey of national bank originations of IO and payment option ARM loans, including underwriting and marketing practices. Based on our preliminary findings, in 2005, we initiated an interagency process to develop guidelines to address emerging risks affecting both safety and soundness and consumer protection. This process culminated in the special guidance on nontraditional mortgages, described below, that was issued in 2006.

Close in time to the interagency work on nontraditional mortgage guidance was our review of subprime mortgage loans, including the so-called "2/28" and "3/27" hybrid ARM products. We determined that these loan products, although not technically covered by the nontraditional mortgage guidance, raised underwriting and consumer protection concerns that are similar in several respects to those raised by IO and payment option ARM products. In particular, the agencies, as well as members of Congress and the public, became concerned that lenders are not appropriately underwriting these loans and have loosened their borrower qualification standards too far in response to increasing competition for loan volume. For example, with respect to more recent vintages of subprime hybrid ARMs, the agencies are particularly concerned about the potential for increased levels of delinquencies and potential defaults and foreclosures after the payments reset.[2] Based on our assessment of these trends, we developed the proposed interagency statement on subprime lending, which also is described below.

[2] According to a Special Report by Moody's (March 3, 2007), serious delinquencies increased dramatically for subprime loans originated in 2006, in contrast to delinquency patterns for subprime loans originated in the years 2002 to 2005.

OCC Supervisory Guidance Relating to Mortgage Lending

In addition to on-site examinations and extensive public outreach, an important component of the OCC's oversight of national banks is our provision of written supervisory guidance. We use the guidance process to alert national banks to practices that may raise legal, compliance, safety and soundness, and consumer protection risks and concerns, and to try to prevent such risks from taking hold in the national banking system. Our examiners then apply the principles articulated in guidance in their ongoing bank supervision activities. Over the past several years, the OCC has issued supervisory guidance to national banks on a wide range of matters involving potentially abusive, unsafe and unsound lending practices, providing both general guidelines and more targeted directives where appropriate.[3]

Guidance on Nontraditional Mortgages

In October 2006, the OCC and other federal banking agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) issued final guidelines addressing a variety of supervisory issues raised by nontraditional mortgages (NTM guidance), such as IO mortgages and payment option ARMs.[4] Nontraditional mortgage products have frequently been marketed as "affordability" products, and they have been structured to reduce monthly payments in the

[3] *See* Attachment A.

[4] 71 Fed. Reg. 58,609 (October 4, 2006). We published proposed guidance addressing these concerns in December 2005, and asked for public comment on the proposal. After evaluating the public comment we received on the proposal following the end of the 90-day comment period, the agencies issued the final NTM guidance in October 2006. Most lenders strongly objected to what were deemed to be "overly prescriptive" borrower qualification and consumer protection standards in the proposed guidance. However, the agencies adopted this guidance, essentially as proposed, including the strong borrower qualification and consumer protection standards, in order to address the concerns we had about these practices.

early years of the loan to make the loan more attractive to borrowers. The agencies were concerned that underwriting standards had eroded to the point that some lenders were paying too little attention to the borrower's ability to make the higher payments that would be required later in the loan term. The agencies also were concerned that such "back-loaded" repayment structures may cause borrowers to commit to substantial increases in required monthly payments that they may not understand or be able to afford. This potential for payment shock, which can be severe given the non- or partially-amortizing nature of these products, is the most significant consumer protection concern related to nontraditional mortgage products.

The NTM guidance directs financial institutions to address and mitigate the risks inherent in nontraditional mortgage products. This includes ensuring that loan terms and underwriting standards are consistent with prudent lending practices, which require a credible analysis of a borrower's repayment capacity. In this regard, the NTM guidance provides that such loans should be underwritten based on a borrower's ability to make fully-amortizing payments at the fully-indexed interest rate. For products like payment option ARMs that permit negative amortization, the guidance provides that a lender's underwriting analysis should be based on the initial loan amount plus any balance increase that may accrue over time based on the maximum potential amount of negative amortization that the loan permits.

The NTM guidance also addresses the increasingly common practice of institutions to rely on reduced documentation, particularly unverified income, when they qualify borrowers for nontraditional mortgage loans. This practice essentially substitutes assumptions and alternative information for verified data in analyzing a borrower's repayment capacity and general creditworthiness. Because this practice can present significant risks, including the risk of fraud, it should be used with caution. Accordingly, the NTM guidance provides that the use of reduced documentation, such as unverified, stated income, should be accepted only if there are other mitigating factors that minimize the need for direct verification of repayment capacity. Further, the NTM guidance notes that institutions generally should be able to readily document income for many borrowers using recent W-2 statements, pay stubs, or tax returns.

Finally, the NTM guidance addresses the need for financial institutions to provide timely, clear, and balanced consumer information about nontraditional mortgage products, including information about the potential adverse consequences of these loans, such as payment shock and negative amortization. This information should be provided to consumers when they are shopping for a loan. In addition, the guidance provides that information that will allow consumers to make informed choices concerning payment options should be provided with any monthly statement on a payment option ARM.

The NTM guidance took effect immediately upon its publication on October 4, 2006, and it 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. We are now in the process of ensuring that national banks that offer nontraditional mortgage products perform a self-assessment to determine whether their operations comply with the guidance and, if not, to bring their operations into conformity. And, of course, we will confirm this information, and monitor compliance, through our on-site examination process.

At the same time the agencies issued guidance on nontraditional mortgage product risks, we published for comment proposed illustrations of the consumer information contemplated in the guidance. Commenters, including community banks, generally favored the issuance of these illustrations as a simple "compliance aid" in implementing the disclosure recommendations contained in the NTM guidelines. The agencies have carefully considered the comments we received and we expect to be able to finalize the illustrations in the next several weeks.

Proposed Statement on Subprime Mortgage Lending

A number of questions also have been raised concerning the underwriting and marketing of certain hybrid ARMs that are being made to subprime borrowers, commonly known as 2/28 and 3/27 ARMs, and sometimes referred to as "credit repair" loans. These products make up a significant portion of the subprime mortgages being originated today.[5]

Hybrid ARM products feature fixed initial payments of principal and interest that reset in two or three years based on a variable interest rate plus margin formula. The reset margins on subprime hybrid ARM products are typically much higher, and interest adjustments more frequent, than on comparable prime loans. These circumstances, especially when they are combined with high periodic caps on how much the interest rate may increase and lower than normal initial payments, mean that a subprime borrower's payment may increase significantly and quickly, causing payment shock. The agencies are concerned that some lenders are not prudently evaluating the repayment capacity of borrowers by failing to consider the borrower's ability to service the debt when payments increase and to make housing-related tax and insurance payments. With some subprime mortgages, the terms of a prepayment penalty also can be onerous, which can make it very difficult or expensive for the borrower to refinance the loan in order to avoid unaffordable increases in monthly payments. These products present

[5] The 2/28 and 3/27 hybrid ARM products represented more than 60% of all subprime mortgages originated in 2006.

serious concerns that they are being offered to borrowers who may not understand the associated risks and who do not have the capacity to repay the loan as structured.

As noted above, the consequences of these loan structures can include an inability of the borrower to make payments after the initial rate adjustment, adding to the risk of default. Thus, these loan products raise some of the same concerns about appropriate underwriting, consumer protection, and the risks of payment shock that the agencies addressed with respect to nontraditional loan products in the NTM guidance. However, because hybrid ARM products generally provide for fully amortizing payment schedules, they were not specifically covered by the NTM guidance. [6]

The agencies determined that guidance was needed to address the specific concerns that had been raised with respect to certain subprime mortgage loans such as hybrid ARMs.[7] The proposed "Statement on Subprime Mortgage Lending" published by the agencies earlier this month addresses appropriate underwriting standards, measures to prevent predatory lending, and consumer disclosure practices for subprime ARM products that raise the concerns summarized above.

Like the NTM guidance, the proposed subprime mortgage lending statement specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal explains that an institution's analysis of repayment capacity should include an assessment of the borrower's ability to repay total monthly housing expenses including real estate taxes and property insurance, in addition

[6] Depending upon the terms of a particular loan, the degree of payment shock for a payment option ARM can be greater than for a hybrid ARM, because payment option ARMs permit negative amortization.
[7] Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (March 8, 2007).

to principal and interest payments on the loan. The statement also provides that, in making its assessment of the borrower's income and ability to repay the loan, a lender generally should not rely on reduced documentation or stated income procedures. It further notes that most institutions should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

The proposed statement also describes the consumer protection principles that are fundamental to the underwriting and marketing of hybrid ARMs to subprime borrowers. These principles include 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. Therefore, the guidance provides that consumers should receive clear and balanced information about the relative benefits and risks of the products, including information on:

- Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires;
- The existence of any prepayment penalty, how it will be calculated, and when it may be imposed;
- The existence of any balloon payment;
- Whether there is a cost premium attached to a reduced documentation or stated income program; and
- The requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

The proposed statement strongly encourages institutions that impose prepayment penalties to provide borrowers with sufficient time immediately prior to the reset date to refinance without penalty. And, it provides that institutions should not directly, or indirectly, through broker compensation systems, steer consumers to subprime mortgage products to the exclusion of other products offered by the institution for which the consumer may qualify.

The agencies have issued the Statement on Subprime Mortgage Lending as proposed guidance, and we are seeking public comment during the 60-day comment period that ends on May 7, 2007. We recognize that the market for providing mortgage loans to borrowers with impaired credit records has evolved rapidly in recent years, as have subprime mortgage products, in response to expanding home ownership opportunities, higher home prices in certain areas, competition by lenders for loan volume, developments in the secondary mortgage market, and investor and borrower risk tolerances. Not all of these product developments have been benign, and thus there is a need for the agencies to address the concerns we have noted above. We believe that the underwriting and consumer protection principles contained in the proposed statement are responsive to the legitimate concerns that have been raised.

However, it is also important to note that we do not issue prescriptive underwriting standards lightly. In such cases, the government is effectively substituting its judgment on how institutions may assess credit risk for the judgment of market participants and the borrowers themselves. Moreover, in formulating underwriting standards, it can be very difficult to draw lines that will restrict "bad" credit without unintentionally restricting the availability of "good" credit. The subprime market presents unique issues and particular challenges in this regard, as has been noted in a number of recent news articles about deteriorating conditions in the subprime market.

Given the level of concern about the subprime market, questions have been raised about whether or not the agencies have responded with appropriate speed and diligence. We have also been asked why we did not apply the NTM guidance to subprime loans, since a characteristic common to both nontraditional mortgages and subprime hybrid ARMs is the risk of payment shock. I would like to address those questions now. The agencies ultimately decided to propose guidance on subprime hybrid ARM products as separate guidance, to focus public comment on the particular issues raised by this type of lending. In doing so, we hope to be able to evaluate how the application of borrower qualification standards like those contained in the NTM guidance will affect subprime borrowers in particular, and whether other standards should be considered that may be more appropriate or effective in some circumstances. As noted earlier, loan performance data for subprime loans originated in 2006 show a sharp increase in delinquencies, as compared to subprime loans originated in the preceding four years. With respect to whether or not the agencies are reacting with appropriate speed to address underwriting deficiencies suggested by the performance of recent vintage hybrid ARMs, it is true that our course of action to issue separate guidance following a public comment process has the disadvantage of not immediately responding with final guidelines affecting new originations. However, it will permit us to proceed in a better informed manner in addressing issues that may be unique to subprime borrowers and their access to credit.

For example, in recent years, lending institutions have been encouraged to reach out to the subprime market to provide greater access to credit, in connection with their obligations under the Community Reinvestment Act, and in a manner consistent with safe and sound lending principles. As noted earlier, these efforts have been instrumental, and highly effective, in expanding homeownership for these borrowers and in fueling economic growth. In this regard, it is important to note that the borrower qualification standards contained in the proposal are likely to result in fewer subprime borrowers qualifying for home loans, and there is no guarantee that such borrowers will be able to qualify for other loans in the same amount if the standards are adopted. Thus, as compared to the standards for prime and near-prime loans contained in the NTM guidance, imposing strict borrower qualification standards on subprime loans has the inherent risk that borrowers could be denied access to types of credit that represent their only way to finance a home purchase. The application of these standards to existing subprime borrowers with hybrid ARMs, who want to refinance their loans in order to avoid unaffordable payment increases, can raise particular challenges and questions of fairness if they are unable to do so.

We also recognize that some products have been introduced that are intended to serve as temporary credit accommodations, rather than long-term financing vehicles. At origination, these loans may involve terms that exceed the borrower's present ability to service the debt. The motivations for these arrangements vary, but sometimes they include providing a home purchase loan to a borrower who intends to use the property only temporarily, for whom there is expected future earnings growth, or for whom there is a need for affordable payments in the short term, in order to improve the borrower's credit history. Indeed, a recent survey involving an admittedly small sample of these loans found that a number of the products have been used for credit repair, enabling at least some borrowers to refinance their subprime hybrid ARMs to either prime loansor subprime fixed-rate products. Thus, these loans can operate as de facto balloon payment loans that may be appropriate in certain circumstances.

In light of these considerations, we are particularly interested in public comment on whether the proposed statement appropriately balances the need for changes in underwriting standards with the need to prevent an undue constriction in credit availability for creditworthy borrowers. Therefore, we have asked for comment on whether the loans described in the statement always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances they may be appropriate. In addition, as noted above, we are concerned about the impact of the proposed standards on borrowers who currently hold such loans, and we seek comment on whether the standards, if adopted, will unduly restrict the ability of these existing borrowers to refinance their loans and avoid payment shock.

We are also concerned about the possibility of an "unlevel regulatory playing field" if already highly-regulated, federally-regulated institutions are subject to stricter standards on subprime mortgage lending, but state-licensed nonbank lenders are not. This is a particular concern because, as noted earlier, state-licensed nonbank lenders and brokers play a predominant role in the subprime market. In this regard, we appreciate the recent announcement by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) of their intention to seek adoption by state regulatory agencies of comparable subprime lending standards when the federal agency guidance is finalized. This approach is consistent with the undertakings by the CSBS and AARMR in connection with state-by-state adoption of the federal agency NTM guidance. Although many states have not yet applied the NTM guidelines to state-licensed lenders and brokers -- including several states with major real estate markets -- we are encouraged that agencies in a number of states *have* adopted them.[8] Similarly, we think that it is important that the basic principles embodied in our subprime lending guidance are also adopted by secondary market participants who purchase such loans. We note that Freddie Mac recently issued

[8] *See* www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

guidance comparable to the proposed Statement on Subprime Mortgage Lending concerning the eligibility of hybrid ARM products for purchase,[9] although to date, there have not been similar moves by other major securitizers. As mentioned at the outset, we believe that adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

There is evidence that some lenders are already revising their underwriting practices in response to deteriorating market conditions and increasing risks, delinquencies, and foreclosures involving subprime mortgage loans. In light of these developments, it is imperative that the agencies develop final guidelines on subprime mortgage lending that are carefully calibrated to try to ensure that consumers are protected against undue risks while avoiding unintended adverse consequences both to credit availability *and* to mortgage markets.

Finally, the agencies have been asked about the steps that can be taken to address loan delinquencies and to prevent foreclosures. The OCC believes that it is in the best interests of both lenders and borrowers to work together to bring a loan current and to avoid foreclosure whenever possible. Reasonable workout arrangements are an appropriate way to assist borrowers who have encountered financial difficulties. Let me assure you that national banks are encouraged to engage in responsible loan workout and recovery activities in order to avoid a foreclosure and they will not face regulatory criticism for such activities. Moreover, the

[9] *See* News Release, Freddie Mac, "Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default; Company Also to Develop Model Subprime Mortgages" (Feb. 27, 2007), *available at* www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html; *see also* Letters from J.B. Lockhart, III, Director, Office of Federal Housing Enterprise Oversight to R.F. Syron, Chairman and CEO, Freddie Mac, and D.H. Mudd, President and CEO, Fannie Mae (Dec. 8, 2006) (requesting a report on the steps taken in response to interagency guidance on nontraditional mortgage products), *available at* www.ofheo.gov/media/pdf/ NontraditionalMortgage121306.pdf. Another important improvement in the secondary market would be enhanced investor disclosures that state whether or not mortgages in the pools backing the securities are in compliance with federal banking agency guidelines on nontraditional mortgage products and subprime lending, as applicable.

OCC recognizes the need for all lenders to engage in foreclosure prevention efforts and we have been very proactive in communicating our views to national banks on this issue and on "best practices" for foreclosure prevention.[10] Among the best practices for effective foreclosure prevention is having a full-cycle approach to borrower financial counseling -- before, during, and after taking out a mortgage, and at the first sign of repayment problems. In this regard, the OCC issued guidance to national banks on strategies for effective delinquency intervention activities in affordable mortgage portfolios held by national banks.[11] The OCC, along with the U.S. Department of Housing and Urban Development (HUD) and the other bank regulators, serves on the board of NeighborWorks America, a national non-profit organization. The NeighborWorks Center for Foreclosure Solutions, its national foreclosure center, has developed very effective foreclosure prevention strategies and foreclosure intervention programs in communities across the country. The OCC has encouraged national banks to work to reduce foreclosures through partnerships with nonprofit organizations, like the NeighborWorks Center. We have also advised national banks that when they participate in foreclosure avoidance counseling programs targeted to low- and moderate-income borrowers in their assessment areas, they will receive Community Reinvestment Act credit.

OCC Regulations and Federal Laws Relating to Predatory Lending Practices

OCC Regulations

There is scant evidence that national banks or their subsidiaries are engaging in predatory lending practices. Nevertheless, the OCC has taken a number of significant steps directed at ensuring that national banks do not become involved in unfair, deceptive, or

[10] *See* "Homeownership: Preserving the American Dream," by John C. Dugan, Comptroller of the Currency, *Community Developments*, Spring 2006.
[11] *See* OCC Advisory Letter 97-7, Affordable Mortgage Portfolios.

predatory practices. Through the issuance of supervisory guidelines and regulations, and through enforcement actions, we have acted to deter abusive lending practices and ensure fair treatment of national bank customers.

The OCC was the first federal banking agency to issue comprehensive anti-predatory lending guidance and anti-predatory lending regulations specifically applicable to the institutions we supervise -- national banks and their operating subsidiaries. Early in 2004, the OCC adopted regulations that address a fundamental characteristic of predatory lending – equity stripping. Under OCC rules, national banks are prohibited from making mortgage loans based predominantly on the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms.[12] In addition, while the OCC does not have the authority to issue regulations defining the specific acts and practices that are unfair or deceptive, and therefore unlawful under the Federal Trade Commission Act (FTC Act),[13] OCC regulations do prohibit national banks from engaging in any lending practice that would be unfair or deceptive within the meaning of the FTC Act.[14]

In 2005, the OCC issued additional regulatory standards for national banks to avoid potentially predatory lending practices in direct loan originations, loan purchases, and brokered transactions. These standards are entitled "Guidelines Establishing Standards for Residential Mortgage Lending Practices" (Part 30 guidelines).[15] The Part 30 guidelines were drawn from principles contained in advisory letters on the same subjects that the OCC issued in 2003,[16] but

[12] 12 C.F.R. §§ 7.4008(b) and 34.3(b).
[13] The Federal Reserve Board has exclusive authority to issue regulations that define the practices that are unfair or deceptive for banks under the FTC Act. 15 U.S.C. 57a(f)(1).
[14] 12 C.F.R. §§ 7.4008(c) and 34.3(c).
[15] 12 C.F.R. Part 30, App. C.
[16] Because of the importance of mortgage lending to the nation's economy and to individual consumers, as well as the devastating consequences of predatory mortgage lending, the OCC issued two detailed advisory letters – one focused upon mortgage origination standards and the other addressing the special problems presented by brokered or purchased loans – that were designed to help national banks avoid ever engaging in predatory practices in their

unlike the advisory letters, are enforceable under section 39 of the Federal Deposit Insurance Act.[17] In issuing the Part 30 guidelines, we recognized that "[f]air treatment of customers is fundamental to sound banking practices."[18] The Part 30 guidelines were designed to protect against involvement by national banks, either directly or through loans that they purchase or make through intermediaries, in lending practices that can injure national bank customers and expose the bank to credit, legal, compliance, reputation, and other risks.

Significantly, the Part 30 guidelines identify particular practices in which national banks should *not* become involved, either directly or through brokered or purchased loans:

- equity stripping and fee packing;
- loan flipping;
- encouragement of default on an existing loan; and
- refinancing of special subsidized mortgages with loans that do not provide a tangible economic benefit to borrowers relative to the refinanced loans.[19]

The guidelines also address a second category of loan terms and features that the OCC recognized may in some circumstances be susceptible to predatory, unfair or deceptive lending risks, and yet may be appropriate risk mitigation measures in other circumstances. These practices or features are:

- financing single premium credit insurance;

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mortgage lending activities. OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003) and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003). These advisory letters expanded upon earlier advisories relating to abusive lending practices and the legal standards the OCC would use in determining whether practices are unfair or deceptive. *See* Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000); Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002).

[17] 12 U.S.C. § 1831p-1; *see also* 12 C.F.R. §§ 30.3 - .6.

[18] 70 Fed. Reg. 6329 (Feb. 7, 2005).

[19] 12 C.F.R. Part 30, App. C at III (A)(1) – (4).

- negative amortization;
- balloon payments in short-term transactions;
- prepayment penalties not limited to the early years of a loan;
- interest rate increases on default at a level not commensurate with risk mitigation;
- provisions allowing the bank to accelerate payment of the loan in circumstances other than the borrower's default or to mitigate loss;
- the absence of an appropriate assessment and documentation of the consumer's ability to repay the loan in accordance with its terms;
- mandatory arbitration clauses;
- pricing terms that trigger HOEPA;
- extending a loan in which the principal balance exceeds the appraised value of the property;
- payment schedules that consolidate more than two periodic payments and pay them in advance from the proceeds; and
- payments to a home improvement contractor from proceeds of a mortgage loan other than to the consumer, the consumer and contractor jointly, or to a third-party escrow agent. [20]

Pursuant to these mortgage lending guidelines, national banks must prudently consider the circumstances, including the characteristics of the targeted market and applicable consumer protection and safety and soundness safeguards, under which the bank will make residential mortgage loans with the terms and features outlined above. A national bank is expected to exercise enhanced care and to apply heightened internal controls and monitoring when making

[20] *Id.* at III(B)(1) – (12).

loans with these features to borrowers who are not financially sophisticated or whose credit choices are limited.[21]

As noted above, the Part 30 guidelines apply to mortgages that national banks and their subsidiaries originate directly, as well as mortgages that they purchase or make through a broker or other intermediary. The guidelines thus address concerns that have been raised about the link between predatory practices and non-regulated lending intermediaries, as well as concerns that a national bank could inadvertently facilitate predatory lending through the purchase of loans and mortgage-backed securities and in connection with mortgage broker transactions.

The Part 30 guidelines provide that indirect lending activities by national banks should reflect standards and practices consistent with those applied by the bank in its direct lending activities.[22] Thus, these guidelines specify measures that banks should undertake, such as establishing criteria for entering into and continuing third-party relationships, underwriting and appraisal requirements, compensation standards, appropriate third-party agreements, and criteria for taking appropriate corrective action in the event the bank's policies are not followed.[23] They also provide that national banks should take appropriate steps to ensure that compensation policies for brokers do not provide incentives for originating loans with potentially predatory terms and conditions. In addition, the guidelines provide that a national bank should engage in appropriate monitoring and oversight of its third-party originations to ensure that the bank's residential mortgage lending activities comply with applicable law and

[21] *Id.* at III(C). Consistent with the OCC's general emphasis on strong consumer disclosure practices and the avoidance of unfair or deceptive practices, the Part 30 guidelines also establish high expectations for the provision of relevant information to consumers. In particular, the Part 30 guidelines provide that national banks should give "timely, sufficient, and accurate information to a consumer concerning the costs, risks, and benefits of the loan," including information "sufficient to draw their attention to these key terms." *Id.* at III(D).
[22] *Id.* at III(E).
[23] *Id.* at III(E)(1) – (6).

the bank's internal standards.[24] This rigorous and detailed OCC guidance will remain applicable to all mortgage lending in national banks and their subsidiaries in addition to the interagency issuances in this area.

Applicable Laws

In addition to OCC regulations, several federal laws apply to the mortgage lending operations of national banks and can be enforced as necessary to address instances of unfair, deceptive, or predatory mortgage lending practices. These laws, and the agencies responsible for issuing and interpreting related regulations, include:

- The Truth in Lending Act (TILA),[25] which requires creditors to provide disclosures about terms and costs of credit (Federal Reserve Board);
- The Home Ownership and Equity Protection Act of 1994 (HOEPA)),[26] which provides enhanced consumer protections with respect to certain high-cost mortgages and directs the Federal Reserve Board to issue such additional regulations as necessary to address unfair, deceptive, or abusive mortgage lending practices (Federal Reserve Board);
- The Equal Credit Opportunity Act (ECOA),[27] which prohibits discrimination against applicants based on race, color, religion, national origin, sex, marital status, age, the receipt of public assistance income, or the exercise of rights under the Consumer Credit Protection Act in any aspect of a credit transaction (Federal Reserve Board);

[24] *Id.* at III(F).
[25] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.
[26] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.
[27] 15 U.S.C. § 1691 *et seq.*; *see also* 12 C.F.R. Part 202.

- The Fair Housing Act,[28] which prohibits discrimination based on race, color, religion, sex, handicap, familial status, or national origin in making a residential real estate-related transaction available (HUD);
- The Real Estate Settlement Procedures Act (RESPA),[29] which requires advance disclosure of settlement costs in residential real estate transactions and prohibits kickbacks or unearned fees for settlement services (HUD); and
- Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices and directs the Federal Reserve Board to define by regulation such practices that are unlawful for banks (Federal Reserve Board for banks; Office of Thrift Supervision (OTS) for thrifts).[30]

OCC Supervisory Process

The OCC conducts comprehensive examinations of national banks to ensure that they operate in a safe and sound manner and in accordance with the applicable laws, regulations, and supervisory directives described above. Through a network of approximately 1,800 examiners located throughout the United States and in London, we monitor conditions and trends, both in individual banks and in the banking system as a whole. Our supervisory activities focus on the risks as identified by our supervisory monitoring tools and subject matter experts. At the largest banks, on-site examination teams continuously monitor all aspects of the banks' operations.

[28] 42 U.S.C. § 3601 *et seq.*; *see also* 24 C.F.R. Part 100.
[29] 12 U.S.C. § 2601 *et seq.*; *see also* 24 C.F.R. Part 3500.
[30] 15 U.S.C. § 45. The OCC's ability to enforce this prohibition against national banks and their operating subsidiaries has been upheld in the courts. *See* Roberts v. Fleet Bank, 342 F.3d 260, 270 (3d Cir. 2003); Chavers v. Fleet Bank, 844 A.2d 666, 674-676 (R.I. 2004).

The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries.

National banks are regularly examined for safety and soundness and for compliance with applicable consumer protection laws and regulations. The OCC reviews the adequacy of the bank's policies, systems, and controls relative to the character and complexity of the bank's business, and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners sample individual transactions to validate their assessment of the bank's systems, controls, and legal compliance.

Depending on the bank's risk profile and other supervisory information, including consumer complaints, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the institution is engaging in significant new or expanded mortgage lending activities, examiners ordinarily would pay particular attention to those loans during their review. If the sampling process indicates potential issues, examiners will expand their review as appropriate. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis.

As indicated above, consumer complaints filed with our Customer Assistance Group (CAG) may raise red flags concerning potential predatory lending. CAG staff are responsible for assisting customers of national banks and their subsidiaries by answering questions and resolving individual complaints. When CAG receives a written, signed complaint, it requests a response from the bank involved, and may request additional information from the consumer or the bank. Additionally, CAG personnel may, and often do, consult with OCC's bank supervision and Law Department personnel to help ensure that complaints are resolved appropriately and, where applicable, any identified violations of law are fully addressed.[31] After evaluating the information before it, CAG sends the consumer a letter containing its findings. Over the last five years, from 2002 to 2006, national bank customers received more than $3,500,000 in financial relief in connection with resolution of individual mortgage-related complaints filed with CAG.

CAG also provides data to examiners to help flag banks, activities, and products that require further investigation, and to OCC management and others to assist in identifying trends and emerging problems. If predatory or abusive lending issues surface in the course of these examinations or are otherwise brought to examiners' attention through consumer complaints or other sources, examiners and OCC attorneys determine whether the practices in question violate any applicable laws and regulations, including the FTC Act, HOEPA, or the OCC's Part 30, or are otherwise inconsistent with OCC guidelines and mortgage lending standards. In cases where such a determination is made and depending upon the circumstances, the OCC will either obtain appropriate corrective action informally through the supervisory process or formally through an enforcement action, as described below.

The OCC's bank supervision process can result in significant reforms to bank practices and keep banks on a proper course even in the absence of litigation, formal enforcement actions, or other publicized events. The OCC's examiners exert extraordinary authority and influence over the activities of national banks through the supervisory process. When examiners identify an issue, they expect it to be fixed promptly, without having to resort to a

[31] Complaints that allege or raise issues of predatory lending or unfair or deceptive practices are generally reviewed by CAG personnel in close consultation with the OCC's Law Department.

formal enforcement action, and the agency can use a wide range of measures short of formal, public enforcement actions to obtain the desired result. Such measures include communications of "matters requiring attention" in confidential examination reports to bank management and boards of directors and informal enforcement actions such as nonpublic memoranda of understanding.

The vast majority of supervisory problems are promptly corrected through informal means. In some cases, however, a formal enforcement action may be necessary based on the nature or gravity of an issue or the nature of the remedies sought to address instances of unfair, deceptive, or predatory lending practices. In such cases, as described below, we do not hesitate to bring an enforcement action when appropriate.

Enforcement Actions

Congress has provided the OCC with a wide range of methods to address unsafe or unsound practices or violations of laws, rules, or regulations. Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to compel compliance with any law, rule, regulation, written agreement or condition imposed in writing. The OCC may initiate cease and desist proceedings, seek civil money penalties, and, as appropriate, seek restitution or reimbursement for affected customers if the OCC determines that a national bank or its operating subsidiary has violated any applicable federal law or regulation or any applicable state law or regulation. [32]

The OCC was the first federal banking agency to take enforcement action against an institution it supervises for violations of Section 5 of the FTC Act. In a groundbreaking case,

[32] 12 U.S.C. § 1818. This statute also permits the OCC to pursue remedies based on unsafe or unsound banking practices.

the OCC asserted section 5 of the FTC Act as a basis for seeking a cease and desist order, as well as affirmative remedies, against a national bank in 2000. Since that time, the OCC has taken several more formal enforcement actions against national banks found to be engaging in unfair or deceptive practices within the meaning of the FTC Act. These cases have involved issues ranging from misleading and deceptive advertising of credit cards and ancillary products to unfair mortgage practices.[33]

To date, the OCC has charged FTC Act violations in two cases to obtain reimbursement for mortgage loan borrowers who were harmed by predatory or unfair practices. In a consent order entered into in 2003, we required a bank to provide restitution to borrowers who were affected by unfair practices in connection with tax lien loans. We found that fees for these loans were imposed for services that were not performed, and that the bank also violated federal legal requirements in TILA, HOEPA, RESPA, and the FTC Act. Consumers who were harmed by the bank's practices were provided restitution in the amount of all fees paid in connection with the loans – whether or not characterized as a finance charge under TILA and whether paid to the bank or to a third party, and all interest charges.

In 2005, the OCC entered into a formal agreement requiring another bank to establish a $14 million fund to reimburse consumers who were harmed by the lack of appropriate controls in the bank's mortgage lending operations and practices. Consumers entitled to restitution included consumers who: (1) paid origination fees and/or interest rates substantially different from those indicated on good faith estimates; (2) did not have their creditworthiness adequately considered; or (3) held a subsidized loan that was refinanced with a higher cost loan that did not appear to provide the consumer with a tangible economic benefit. The agreement also

[33] *See* Attachment B.

required the bank, among other things, to ensure that its advertising materials adequately disclose limitations or conditions on various products and to develop a detailed consumer compliance program to ensure compliance with the FTC Act, RESPA, the OCC's Part 30 guidelines, and the OCC's other issuances regarding abusive, predatory, unfair, or deceptive practices.

Conclusion

In conclusion, this hearing is an important opportunity to examine the issues confronting the subprime mortgage market, including the very serious concerns that have been raised about loan underwriting practices, consumer protection, and deteriorating loan performance. Even though subprime lending engaged in by national banks under the OCC's supervision accounts for a small percentage of the overall market for such loans, we nevertheless believe that it is important that the federal banking agencies and state agencies continue to work together to address these concerns to the extent they arise in the institutions we supervise. In going forward, we should all be cognizant of the need to find an approach that not only addresses these concerns without unintended adverse consequences to consumers or to credit markets, but that also is fairly applied and consistently implemented for all of the providers of subprime mortgage finance.

I appreciate the opportunity to present the OCC's views on these issues and will be pleased to answer any questions that you might have.

Attachment A

List of OCC Supervisory Guidance Documents on Abusive Lending Practices

- Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000)
- Advisory Letter 2000-10, "Payday Lending" (Nov. 27, 2000)
- Advisory Letter 2000-11, "Title Loan Programs" (Nov. 27, 2000)
- Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002)
- Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003)
- Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003)
- Advisory Letter 2004-4, "Secured Credit Cards" (April 28, 2004)
- Advisory Letter 2004-10, "Credit Card Practices" (Sept. 14, 2004)
- Joint Guidance on Overdraft Protection Programs (Feb. 18, 2005)
- Interagency Guidance on Nontraditional Mortgage Product Risks (Oct. 4, 2006)
- Interagency Statement on Subprime Mortgage Lending (Proposed March 8, 2007)

Attachment B

List of Public Enforcement Actions under the FTC Act

- Consent order – June 28, 2000. We required the bank to set aside not less than $300 million for restitution to affected consumers and to change its credit card marketing program, policies, and procedures.
- Consent order – May 3, 2001. We required the bank to provide restitution of approximately $3.2 million and to change its credit card marketing practices.
- Consent order – December 3, 2001. We required the bank to set aside at least $4 million for restitution to affected consumers and to change its marketing practices.
- Formal agreement – July 18, 2002. We required the bank to change its marketing practices.
- Consent order – January 17, 2003. We required the bank to set aside at least $6 million for restitution to affected consumers, to obtain prior OCC approval for marketing subprime credit cards to non-customers, to cease engaging in misleading and deceptive advertising, and to take other actions.
- Formal agreement – March 25, 2003. We required the bank to provide restitution in connection with private label credit card lending and to make appropriate improvements in its compliance program.
- Formal agreement – July 31, 2003. We required the bank to provide refunds of approximately $1.9 million to affected consumers in connection with credit card practices.
- Consent order – November 7, 2003. We required the bank to set aside at least $100,000 to provide restitution for borrowers who received tax lien loans, review a portfolio of mortgage loans to determine if similar violations existed, and take steps to prevent future violations.
- Consent order – May 24, 2004. In a second case involving the same bank, we required the bank to set aside at least $10 million for restitution to affected consumers and prohibited the bank from offering secured credit cards in which the security deposit is charged to the consumer's credit card account.
- Formal agreement – November 1, 2005. We required the bank to set aside at least $14 million for restitution to affected customers and to strengthen internal controls to improve compliance with applicable consumer laws and regulations and underwriting standards.

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Statement of

Roger T. Cole

Director, Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

March 22, 2007

Introduction

Chairman Dodd, Ranking Member Shelby, members of the Committee, I appreciate the opportunity to discuss mortgage lending, the recent rise in mortgage delinquency and foreclosure rates, particularly in the subprime sector, and the Federal Reserve's supervisory response.

The Federal Reserve is concerned about recent developments in mortgage markets and has been closely monitoring the effects of these developments on the financial health of mortgage borrowers and lending institutions. Regarding safety and soundness of the banking system, less than half of subprime loans have been originated by federally regulated banking institutions. To date, the deterioration in housing credit has been focused on the relatively narrow market for subprime, adjustable-rate mortgages, which represent fewer than one out of ten outstanding mortgages. Borrower performance deterioration in the subprime market has been concentrated in loans made very recently, especially those originated in late 2005 and 2006, and problems in those loans started to become apparent in the data during the latter half of 2006.

As in past credit cycles, market investors and lenders have begun to implement more appropriate underwriting standards and to change their risk profiles. Some borrowers are clearly experiencing significant financial and personal challenges, and more subprime borrowers may join these ranks in the coming months. We are mindful that any action we take should not have the unintended consequence of limiting the availability of credit to borrowers who have the capacity to repay. I will shortly offer some suggestions to address these challenges, including the potential for lenders to work with troubled borrowers.

We know from past cycles that credit problems in one segment of the economy can disturb the flow of credit to other segments, including to sound borrowers, creating the potential for spillover effects in the broader economy. Nevertheless, at this time, we are not observing spillover effects from the problems in the subprime market to traditional mortgage portfolios or, more generally, to the safety and soundness of the banking system.

Subprime lending has grown rapidly in recent years and has expanded homeownership opportunities for many individuals. It is important to ensure that these gains are not eroded by the recent increase in delinquencies and foreclosures in the subprime market. It is especially important to preserve homeownership for the many low- and moderate-income borrowers who have only recently been able to achieve the goal of owning a home.

Later in my testimony, I will discuss the recent activity in mortgage markets and the possible causes for the increases in delinquencies and foreclosures in the subprime market. I will discuss the Federal Reserve's ongoing efforts as a banking supervisor to ensure that the institutions we supervise are managing their mortgage lending activities in a safe and sound manner, including assessing the repayment capacity of borrowers. In particular, I will discuss existing guidance that has been issued over the past several years that addresses many of these issues and the general scope and findings of examinations at the lending institutions we supervise.

I will also discuss our efforts in the area of consumer protection, including guidance to ensure that lenders provide consumers with clear and balanced information about the risks and features of loan products at a time when the information is most useful, before a consumer has applied for a loan. The Federal Reserve Board has significant responsibilities as a rulewriter for several consumer protection laws, and I will discuss our efforts to date to improve the effectiveness of our regulations in this area as well as our plans to continue this work in the near and longer term.

Mortgages and the Role of the Capital Markets

The banking system has changed dramatically since I first joined the Federal Reserve Bank of Boston in the mid-1970s. Back then, banks and savings and loans used their deposit bases and other funding sources to finance, originate, and hold loans to maturity. These financial institutions were highly exposed to any problems that might emerge in residential markets, and their analysis of credit risk was generally limited to making sure that each loan was underwritten properly. Home mortgages had fixed rates and few bells and whistles.

Today, the mortgage lending business has changed dramatically. With the remarkable growth we have seen in securitization, that simple book-and-hold model has evolved to incorporate an alternative and more complex originate-to-distribute model. While commercial banks still play a significant role in the mortgage origination and distribution process, they are no longer the only originators or holders of residential mortgages. Securitization has had profound effects in financial centers, where investment bankers use a broad array of approaches to package and resell home mortgages to willing investors, and in local communities, where mortgage brokers and mortgage finance companies compete aggressively with banks to offer new products to would-be homeowners.

These innovations in housing finance have brought many benefits to lenders, investors, and borrowers. Much more so than in the past, insured depository institutions are now able to manage liquidity and control risks by adjusting credit concentrations and maturities through the use of financial instruments such as mortgage-backed securities. For capital market investors, securitization has reduced transaction costs, increased transparency, and increased liquidity. The market has become very proficient at segmenting cash flows of mortgage portfolios into risk tranches targeted at investors with differing risk appetites.

Homebuyers have also benefited in this environment of financial innovation and market liquidity. More lenders are actively competing in the mortgage market, product offerings have expanded greatly, the underwriting process has become more streamlined, borrowing spreads have decreased, and obtaining a mortgage loan has become easier. In short, securitization has helped to expand homeownership, which recently reached a record 69 percent.[1] Not surprisingly, there have also been significant gains in homeownership for low- and moderate-income individuals. The development of the subprime mortgage market has been an integral factor in creating these homeownership opportunities for previously underserved borrowers.

Recent Trends in the Subprime Market

The term "subprime" generally refers to borrowers who do not qualify for prime interest rates because they exhibit one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios. Prime borrowers represent more than 75 percent of the 43 million first-lien mortgage loans outstanding in the United States; subprime borrowers represent about 13 or 14 percent; and the remaining borrowers fall within a somewhat ill-defined category between prime and subprime known as "Alt-A," or "near-prime," which includes borrowers with good credit records who do not meet standard guidelines for documentation requirements, debt-to-income ratios, or loan-to-value ratios.[2]

While still only a relatively small part of outstanding mortgages, the subprime sector grew rapidly over the past three years and accounted for an outsized share of originations in 2006. The roots of this increase can be traced back to the low levels of market interest rates that

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[1] United States Census Bureau.
[2] Estimates based on data from LoanPerformance Corp. and the Mortgage Bankers Association.

existed in the early part of this decade which, in turn, spurred significant volumes of mortgage refinancing, as well as new originations. To meet this demand, financial institutions significantly increased their mortgage origination and securitization infrastructures. New entrants in the mortgage industry, including independent mortgage brokers and finance companies, also ramped up their origination capacity. With the rise in short-term market interest rates beginning in 2004, the cost burden of such infrastructures came under increasing pressure as both mortgage refinance and new origination volumes declined.

In this environment of high liquidity, rising home prices, and competition, some lenders that had an originate-to-distribute model responded to the capital market's demand for new products by easing their credit standards and increasing risks through "risk-layering" practices such as simultaneous second liens, no- or low-income documentation, and high loan-to-value ratios. Some borrowers were actually investors utilizing the ease in terms to purchase investment and rental properties. In the latter part of 2005 and in 2006, risk-layered loans were originated in greater numbers and, increasingly, to borrowers with lower credit scores. An additional layer of risk was embedded in the subprime market since subprime borrowers are more likely to use adjustable-rate mortgages, or ARMs, because these loans generally carry lower interest rates at origination, particularly if a promotional or "teaser" rate is offered for the loan's introductory period. While these loans contribute to more manageable payments early in the life of the mortgage loan, borrowers can be exposed to payment shock when rates adjust. ARMs account for only about one in eight prime mortgages, but they account for between one-half and two-thirds of subprime mortgages.

During the years of exceptionally strong growth in housing prices and low, stable interest rates, most borrowers did not face large payment shocks and many of those that did could later take advantage of home price appreciation to refinance. These conditions changed in 2006, when mortgage interest rates hit four-year highs, the volume of home sales declined, and the rate of house price appreciation decelerated, leaving the most recent subprime borrowers vulnerable to payment difficulties. Subprime borrowers with hybrid ARMs have experienced the largest recent increase in delinquency and foreclosure rates.[3] Meanwhile, an unusual number of subprime loans have defaulted shortly after origination; these "early payment defaults" are further evidence of laxer underwriting standards by subprime lenders, especially during 2006. Based on anecdotal evidence, it seems possible that fraud has also been a factor in the recent increase in early payment defaults.

Undiversified subprime finance companies have been hit especially hard by early payment defaults, and many have been forced under the terms of their securitization contracts to repurchase these loans. The costs associated with these repurchases have further reduced earnings, pushing some lenders into bankruptcy and forcing the sale or operational shutdown of others. This consolidation in the subprime sector of the mortgage finance industry began several months ago and has likely not yet run its course. These changes in market conditions may assist the industry as investors become more focused on risk-reward tradeoffs and as lenders become more prudent. However, over the next one to two years existing subprime borrowers, especially those with more recently originated hybrid ARMs, may continue to face challenges.

[3] Delinquency rates on subprime variable-rate mortgages rose during 2006 from 6.3 to 10.9 percent, according to data from LoanPerformance (data from the Mortgage Bankers Association show a similar pattern; delinquency rates are for loans 90 days or more past due or in foreclosure). Delinquencies in the Alt-A sector have increased at rates comparable to subprime loans, but the overall delinquency level is far lower. For example, Alt-A loans 60 days or more past due represented between two and three percent of all Alt-A loans in January 2007. Because, at most, one in ten borrowers has a subprime variable rate mortgage, and because delinquency rates on other types of loans have remained relatively low and stable, the overall delinquency rate on all loans drifted up only slightly during 2006.

Supervisory Guidance

Over the past several years, the Federal Reserve has been monitoring these developments and has adjusted our supervisory activities accordingly. Banking supervisors expect our regulated institutions to be mindful of the risks posed by new and expanding business activities. The principles of sound lending have been with us for generations and most of the guidance we issue is to remind bankers what they should already be doing.

In our routine on-site examinations over the past several years, most banking practices that we have observed have reflected sound risk management. However, at a few institutions, we have observed weaknesses in risk management and consumer protection practices. We have addressed issues involving these individual institutions through the examination process with requirements that management take appropriate corrective actions. We have also responded by issuing guidance, with the other federal regulators, on subjects such as real estate lending, subprime lending, home equity lending, nontraditional mortgages, and securitization.

Since the early 1990s, the Federal Reserve and the other banking agencies have issued a number of guidance statements on residential real estate lending that focus on sound underwriting and risk-management practices, including the evaluation of a borrower's repayment capacity and collateral valuation.

Interagency Guidelines for Real Estate Lending

The foundation for much of this guidance is the 1993 *Interagency Guidelines for Real Estate Lending*, which was issued pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA required the federal banking agencies to prescribe uniform real estate lending standards. The final rule requires every depository institution to establish and maintain comprehensive, written real estate lending policies that are consistent with safe and sound banking practices. A key point in this document is that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.

Interagency Guidance on Subprime Lending

The 1999 *Interagency Guidance on Subprime Lending*, as expanded in 2001, discusses essential components of a well-structured risk-management program for subprime lenders. This guidance emphasizes that lending standards should include well-defined underwriting parameters such as acceptable loan-to-value ratios, debt-to-income ratios, and minimum acceptable credit scores. It advises institutions actively involved in the securitization and sale of subprime loans to develop contingency plans that include alternate funding sources and measures for raising additional capital if investors lose their appetite for certain risks.

The subprime guidance, as amended in 2001, also addresses concerns about predatory or abusive lending practices. The agencies recognized three common characteristics of predatory lending, including making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced; or engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower. The guidance advises institutions that higher fees and interest rates, combined with compensation incentives, can foster predatory pricing or discriminatory practices and that institutions should take special care to avoid violating fair lending and consumer protection laws and regulations. The agencies expressed the expectation that institutions should recognize the elevated levels of credit and other risks arising from subprime lending activities and advised that these activities require more robust risk management and, often, additional capital. The guidance also states that loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than collateral are generally considered unsafe and unsound. Where risk-management practices are deemed deficient, the guidance advises examiners to criticize bank management and to require corrective actions.

Interagency Guidance on Nontraditional Mortgage Product Risks

In 2005, the Federal Reserve and the other federal agencies observed that lenders were increasingly combining nontraditional or "exotic" mortgage loans, which defer repayment of principal and sometimes interest, with the risk layering practices that I talked about earlier. In particular, the agencies were concerned about the lack of principal amortization and the potential for negative amortization in these products. Moreover, we were concerned that the easing of underwriting standards and the marketing of these products to a wider spectrum of borrowers, including investors purchasing rental properties, might create higher embedded risks. To address those concerns, the Federal Reserve and other agencies issued guidance on nontraditional mortgage products last September. The *Interagency Guidance on Nontraditional Mortgage Product Risks* highlights sound underwriting procedures, portfolio risk management, and consumer protection practices that institutions should follow to prudently originate and manage nontraditional mortgage loans. A major aspect of this guidance is the recommendation that the analysis of repayment capacity should include an evaluation of borrowers' ability to repay debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The agencies were also concerned that borrowers were obtaining these loans without understanding the risks as well as the benefits. The guidance also reminds institutions that they should clearly communicate the risks and features of these products to consumers in a timely manner, before consumers have applied for a loan.

To complement the guidance on consumer protection, the agencies issued for comment proposed illustrations that show how institutions might explain the risks and terms to consumers in a clear and timely manner. Currently, the agencies are reviewing the comment letters on that proposal.

Proposed Guidance on Subprime Mortgage Lending

Earlier this month, the agencies proposed the *Interagency Statement on Subprime Mortgage Lending* for public comment. This proposal specifies the same qualification standard as the nontraditional mortgage guidance and emphasizes the added dimension of risk when these products are combined with other features such as simultaneous second lines and little or no documentation of income or assets. However, unlike the nontraditional mortgage guidance, which targeted prime and subprime loans with the potential for negative amortization, the proposed guidance covers fully amortizing loans.

The proposed subprime guidance would apply to all depository institutions, their subsidiaries, and non-depository affiliates, but not to state-regulated independent mortgage companies. To protect borrowers in the broader subprime market that is outside our purview, and to ensure a "level playing field" for depository institutions and independent mortgage companies, we coordinated the development of the proposed guidance with the Conference of State Bank Supervisors (CSBS). CSBS has committed to making every effort to encourage the states to consider proposing this guidance for state-regulated lenders.

Supervisory Activities

Regulators became concerned in the late 1990s about certain subprime lending activities that had become the primary or sole business activity of some institutions. As regulators increased their scrutiny, it became clear that risk-management practices were deficient at some institutions. We understood that concentrations in subprime lending, if not properly managed, could result in significant safety and soundness concerns. Supervisors took actions to address identified deficiencies, including formal enforcement actions, but a few of these institutions were unable to resolve their credit problems and ultimately failed. The agencies issued the first *Interagency Statement on Subprime Lending* in 1999 to address such situations.

Between 1999 and 2003, in implementing the guidance, the Federal Reserve focused on those institutions that had concentrations in subprime lending or were operating large subprime programs to ensure that risk-management practices were appropriate and that the activity was conducted in a safe, sound, and prudent manner. As examiners identified additional issues and concerns, the agencies recognized the need for additional guidance and issued the 2001 expanded subprime guidance.

As the larger mortgage lenders under our supervision began to expand their subprime lending activities in recent years, examiners increased their scrutiny of risk-management practices, including lending policies, underwriting standards, portfolio limits and performance, and management information systems. Examiners also began to evaluate institutions' advanced risk-management techniques to make sure bank managers understood the ramifications of a possible downturn.

We also evaluated institutions' securitization activities, particularly with respect to subprime lending, to determine if residual interests were properly valued and if there were any capital implications for implicit recourse.

More recently, we have conducted a number of examinations on the subprime businesses of the banks and bank holding companies that we supervise, including subprime residential mortgage portfolios. These examinations have included the review of credit risk-management practices such as underwriting, portfolio risk management, and quality control processes concerning third-party originations. In addition, examiners have conducted reviews of stress testing, economic capital methods, and other quantitative risk-management techniques to ensure that banks are assessing the level and nature of the risks associated with subprime lending and nontraditional mortgages; residential lending appraisal practices to ensure appropriate collateral valuation processes; and new product review processes to ensure that disciplined approaches are being brought to new lending products and programs.

Where Federal Reserve examiners observe weaknesses in the practices of supervised institutions, we ensure that these institutions take appropriate corrective action. In our examination reports to individual institutions, as needed, we highlight weaknesses in real estate lending practices, including residential mortgage activities, both from a safety and soundness and from a consumer protection perspective, and direct management to take recommended actions. Our ability to describe findings at specific institutions in this forum is limited because examination reports are, by their nature, highly confidential.

For illustrative purposes, I will describe a few recent examples that involved supervised institutions. In one case, following the examination of a banking organization's mortgage banking activities, examiners identified weaknesses in its risk management and controls and recommended that the institution improve its real estate appraisal processes, mortgage servicing asset valuations, and management information systems for tracking performance in specific product portfolios. Another institution, in which examiners discovered weaknesses in policies and procedures, was required to strengthen and amend practices to avoid further supervisory action.

Regulatory Action to Protect Consumers

The Federal Reserve also has significant rule-writing responsibilities for consumer protection laws such as the Truth in Lending Act (TILA) and for laws designed to assist in consumer protection efforts such as the Home Mortgage Disclosure Act (HMDA) of 1975.

HMDA Loan Price Information

HMDA requires most mortgage lenders in metropolitan areas to collect data about their housing-related lending activity, report the data annually, and make the data publicly available. Congress authorized the Federal Reserve Board to issue regulations implementing HMDA.

During the 1990s, the early growth of the subprime mortgage market raised concerns that some consumers lacked the information they needed to negotiate the best terms, or to protect themselves from unfair or deceptive practices. There were also concerns that wide price differences in these markets may reflect unlawful discrimination rather than legitimate risk- and cost-related factors.

In 2002, to bring greater transparency to the subprime mortgage market, the Federal Reserve made two changes to the HMDA rules: adding a requirement to report loan price information for certain higher priced loans and extending reporting responsibilities to more independent state-regulated mortgage companies. These changes first took effect for HMDA data collected in 2004 and disclosed in 2005.

Based on 2004 and 2005 HMDA data, independent mortgage companies originated slightly more than half of all subprime loans. The new loan price information and the expanded coverage of nondepositories have increased our ability to detect potential problems in the subprime market and to conduct reviews of banks' fair lending practices. The changes have also facilitated the states' oversight of independent state-regulated mortgage companies.

The Board's Review of the Truth in Lending Disclosures

The Federal Reserve also has responsibility for the regulations associated with the TILA and its required disclosures. While consumer disclosures alone cannot solve the problems that lead to foreclosures, disclosures help consumers to understand the terms and features of various mortgage products before entering into a long-term financial obligation. To that end, the Federal Reserve Board has begun a comprehensive review of Regulation Z, which implements TILA. Currently, the Federal Reserve is addressing credit card disclosures and expects to address mortgage cost disclosures beginning later this year.

Rulemakings take time, however, and in the meantime the Board has taken steps to address concerns that consumers are not getting sufficient information to help them understand the risks and features of ARMs and nontraditional mortgage products.

The CHARM Booklet

The Board and the Office of Thrift Supervision recently revised the Consumer Handbook on Adjustable Rate Mortgages (CHARM booklet) to include additional information about nontraditional mortgage products, including hybrid ARMs. The CHARM booklet is an effective means of delivering to consumers information about ARMs because creditors are required to provide a copy of the booklet to each consumer when an application for an ARM is provided.

Consumer Brochure on Nontraditional Mortgage Products

The Board has taken other steps to increase consumer awareness of the risks of nontraditional mortgage loans. We published a consumer education brochure, *Interest-Only Mortgage Payments and Option-Payment ARMs—Are They for You?* The brochure is designed to assist consumers who are shopping for a mortgage loan, and is available in printed form and in electronic form on the Board's website.

Responding to the Challenge

The Federal Reserve believes that the availability of credit to subprime borrowers is beneficial and that subprime loans can be originated in a safe and sound manner. We continue to focus on institutions' sound underwriting and risk-management practices and to promote clear, balanced, and timely consumer disclosures.

The proposed *Interagency Statement on Subprime Mortgage Lending* specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In proposing the guidance, the agencies specifically asked whether the subprime guidance would unduly restrict the ability of subprime borrowers to refinance their loans in order to avoid payment shock. We are mindful of unintended consequences that may affect credit availability to otherwise sound borrowers and are prepared to make changes in response to constructive comments.

Lenders and investors should take an active role in working through the current problems in the subprime market. They should not manage subprime and nontraditional mortgage portfolios in the same way as they manage more traditional portfolios that do not contain the same level of risks. Lenders, portfolio managers, and mortgage servicers should be examining how interest rate increases, real estate price fluctuations, and future payment resets can affect delinquencies, default rates, foreclosures, and losses. Strategies should be developed to minimize the effect of deteriorating conditions on segments of the portfolio identified as at-risk. Lenders should be assessing how severely a stressed environment may affect the credit quality of their portfolios, especially with respect to the large volume of subprime adjustable-rate mortgages underwritten in the last year or so. As the supervisor of some of these institutions, the Federal Reserve will continue to closely monitor our institutions' practices and the trends in this market.

Although a rising number of borrowers are having difficulty meeting their obligations, regulated institutions do not face additional supervisory scrutiny if they pursue reasonable workout arrangements with these borrowers. Existing regulatory guidance does not require institutions to immediately foreclose on the underlying collateral when a borrower exhibits repayment difficulties. Working constructively with borrowers is typically in the long-term best interests of both financial institutions and the borrowers. Capital markets investors in securitizations have the same motivation as direct lenders in maximizing recoveries on defaulted loans. Thus, mortgage servicers will have an important role to play in working with delinquent borrowers. Established and well-rated loan servicers are usually given a range of options by investors in workout situations. These options could include modification of interest rates, payment restructuring, and extension of maturities. Working together, the federal regulatory agencies will continue to use their supervisory authority to ensure that regulated institutions have policies and procedures designed to treat borrowers fairly, both when seeking new credit and when working through financial difficulties.

In conclusion, I would like to commend you, Chairman Dodd, Ranking Member Shelby, and the Committee for holding this hearing today. The issues you have raised pertaining to the subprime mortgage markets will serve as an important reminder to both borrowers and lenders of the risks that can be inherent in complex financial products designed to make credit more widely available. As I mentioned previously, the principles of sound lending have been with us for generations. From a supervisory perspective, the Federal Reserve believes those principles need to be part of any risk-management approach to new and emerging products such as subprime lending and risk-layered loans, as well as the securitization of such loans. We also believe that consumer education efforts to explain both the benefits and risks of new financial products are important, including disclosures that borrowers who are not fully conversant with financial products can easily understand. I am prepared to answer any questions you may have.

Attachment to Roger Cole's Statement
The Board of Governors of the Federal Reserve System
Timeline of Major Events and Supervisory Responses
Related to Real Estate, Nontraditional and Subprime Lending
March 22, 2007

- **1990 and 1994** – Poor real estate appraisal practices were identified as a contributing factor to real estate lending problems at failed institutions in the late 1980s and early 1990s. Pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the agencies adopted real estate appraisal regulations to establish appropriate standards for regulated institutions' real estate appraisal practices. In 1994, the agencies amended their appraisal regulations and issued Interagency Appraisal and Evaluation Guidelines to further promote sound appraisal practices.

- **1993** – In response to poor real estate lending practices in the late 1980s and early 1990s that led to thrift and bank failures, and the FDIC Improvement Act of 1991, the agencies adopted regulations and guidelines on real estate lending standards for commercial and residential lending. These guidelines impose supervisory loan-to-value (LTV) limits and capital limitations on high LTV loans.

- **1998 through 2002** – Five institutions closed due to problems related to subprime lending, including poor underwriting, fraud, and valuation of securitization and residual interests.
  - July 1998- Bestbank
  - September 1999 - Keystone
  - November 1999 - Pacific Thrift and Loan
  - July 2001 - Superior
  - February 2002 - Nextbank

- **1999** – The agencies identified problems related to the risk management practices and valuation of securitization and residual interests at federally regulated subprime lenders. In December 1999, the agencies issued the Interagency Guidance On Asset Securitization Activities that describes the proper valuation of residual interests and highlights situations where such interest should be assigned no value.

- **1999** – Problems were observed at both regulated and nonregulated subprime lenders, resulting in the bankruptcy of several nonregulated lenders. In March 1999, the agencies issued the Interagency Guidance on Subprime Lending to address concerns with mono-line subprime lending institutions.

- **1999** – In October 1999, the agencies issued the Interagency Guidance on High Loan-to-Value (LTV) Residential Real Estate Lending to remind institutions that risks are higher in residential mortgages when the LTV ratio exceeds 90 percent and that institutions' risk management practices need to address these risks.

- **2001** – In January 2001, the agencies issued the Expanded Guidance for Subprime Lending Programs. The issuance was in large part in response to the increasing number of mono-line subprime lending institutions, particularly credit card and residential mortgage lending. The guidance addresses a number of concerns related to the subprime lending business model and inappropriate risk management practices and underwriting standards.

- **2001** – As a result of concerns with predatory lending in the subprime mortgage market, the Federal Reserve revised the rules implementing the Home Ownership and Equity Protection Act (HOEPA) to extend HOEPA's protections to more high-cost loans and to strengthen HOEPA's prohibitions and restrictions, including a requirement that lenders generally document and verify a consumer's ability to repay a high-cost mortgage loan.

- **2002** – The Federal Reserve expanded the data collection and disclosure rules under the Home Mortgage Disclosure Act (HMDA) to increase transparency in the subprime mortgage market. New data elements were added on loan pricing for certain higher priced loans, which helps to facilitate the federal banking and thrift agencies' ability to identify potential problems in the subprime market. The Federal Reserve also expanded the share of nondepository state-regulated mortgage companies that must report HMDA data, which has provided a more complete picture of the mortgage market, including the subprime mortgage market.

- **2003** – The agencies observed weaknesses in regulated institutions' appraisal practices and issued in October the Interagency Guidance on Independent Appraisal and Evaluation Functions. The statement reinforces the importance of appraiser independence from the loan origination and credit decision process to ensure that valuations are fairly and appropriately determined.

- **2003 to 2006** - The Federal Reserve issued three formal enforcement actions and three informal actions, which involve mortgage lending issues, including subprime mortgage lending. Formal enforcement actions included:
  - Citigroup Inc. and CitiFinancial Credit Company: Cease & Desist Order 5/ 27/04
  - Doral Financial Corporation - Cease & Desist Order – 3/16/06
  - R&G Financial Corporation - Cease & Desist Order – 3/16/06

- **2004** – In March 2004, the Federal Reserve and the FDIC issued Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks. This guidance describes standards that the agencies will apply to determine when acts or practices by state-chartered banks are unfair or deceptive. Such practices are illegal under section five of the Federal Trade Commission Act.

- **2005** – In February 2005, the agencies under the auspices of the Federal Financial Institutions Examination Council issued interagency guidance on the Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties to assist the banking industry in detecting, investigating, and deterring third party mortgage fraud. The term "third party" refers to the parties necessary to execute a residential mortgage other than a financial institution or a legitimate borrower. Third parties include mortgage brokers, real estate appraisers, and settlement agents.

- **2005** – As a result of the 2003 interagency appraisal independence guidance, many institutions started to review their appraisal practices and asked for additional guidance on appropriate practices. In March the agencies issued a follow-up document of questions and answers to promote sound appraisal and collateral valuation practices.

- **2005** – In response to supervisory concerns that regulated institutions' risk management practices were not keeping pace with the rapid growth and changing risk profile of their home equity loan portfolios, the agencies issued in May the Interagency Credit Risk Management Guidance for Home Equity Lending.

- **2005 to 2006** – The Federal Reserve conducted supervisory reviews of mortgage lending, including subprime lending activity, at large banking institutions with significant mortgage lending activity. The focus of these reviews was an assessment of the adequacy of the institutions' credit risk management practices, including lending policies, underwriting standards, appraisal practices, portfolio limits and performance, economic capital, credit stress testing, management information systems, and controls over third party originations.

- **2004 to 2005** – The agencies observed a rapid growth of mortgage products that allow for the deferral of principal, and sometimes interest, (interest-only loans and payment option ARMs) that contain the potential for substantial payment shock when the loans begin to fully amortize. In 2004 and 2005, the Federal Reserve and the other agencies reviewed the nontraditional mortgage lending activity and risk management practices at selected major regulated institutions. During this time, the Federal Reserve staff met with various industry and consumer groups to discuss the trends and practices in the nontraditional mortgage markets. In December 2005, the agencies issued the proposed Interagency Guidance on Nontraditional Mortgage Products in December 2005.

- **2006** – In October 2006, the agencies issued the Interagency Guidance on Nontraditional Mortgage Product Risks. The guidance addresses the need for an institution to have appropriate risk management practices and underwriting standards, including an assessment of a borrower's ability to repay the loan at the fully indexed rate, assuming a fully amortizing repayment schedule, including any balances added through negative amortization. The guidance details recommended practices for lenders' consumer disclosures so that a borrower receives clear, balanced and timely information.

- **2006** – In October 2006, the agencies issued two additional documents related to the nontraditional mortgage guidance: (1) Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products and (2) an addendum to the May 2005 Interagency Credit Risk Management Guidance for Home Equity Lending.

- **Current** – In March 2007, the agencies issued for public comment the Proposed Statement on Subprime Mortgage Lending in which the agencies discuss the risk management, underwriting standards, and consumer disclosure practices for a regulated institution's subprime mortgage lending activity.

Embargoed until
March 22, 2007, at 10:00 am

Statement of

Scott M. Polakoff, Deputy Director
Office of Thrift Supervision

concerning

Nontraditional Mortgages and
Subprime Hybrid Adjustable Rate Mortgages

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

March 22, 2007

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Department of the Treasury

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Nontraditional Mortgages and
Subprime Hybrid Adjustable Rate Mortgages
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March 22, 2007

Scott M. Polakoff, Deputy Director
Office of Thrift Supervision

I. Introduction

Good morning, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on current issues related to nontraditional mortgages and subprime hybrid adjustable rate mortgages (ARMs). You ask us to address the impact of these products on the nationwide housing market, the insured institutions that we regulate, and their customers and other consumers of these products. And you express a particular interest in better understanding the role that these products play in recently rising foreclosure rates across the country.

You also request that we address numerous related issues and questions, including the origin and evolution of nontraditional mortgage products and subprime hybrid ARMs; issues related to the proliferation of these products; and the timing, availability and nature of the data that raised regulatory concerns and the need for guidance to address emerging problems in these product markets. In addition, you ask us to discuss the role of securitization in the development and growth of mortgage markets for subprime hybrid ARMs and nontraditional mortgage products. And you seek recommendations on preventing foreclosures, and information on our handling of consumer complaints involving potentially abusive lending practices.

In my statement, today, I will attempt to address each of these issues and discuss our overall regulatory regime with respect to the oversight of these products and OTS efforts to combat predatory lending and promote consumer education and financial literacy. I will first highlight the relevant data and provide for your consideration some initial perceptions that appear to have framed the debate on these issues. Next, I will discuss the background and development of the proposed subprime guidance and provide greater detail on the proposal, including what we hope to learn in the comment process.

I will then highlight issues with subprime hybrid ARMs, including addressing the questions and issues you raise in your invitation letter, Mr. Chairman, with respect to the impact of these products in the current housing market and recently rising foreclosure rates. Finally, I will conclude my statement with a discussion of predatory lending issues and OTS efforts to combat the problem, including various consumer awareness and financial literacy initiatives.

II. Current Industry Data

Recent data suggest that nearly 69 percent of all U.S. households are homeowners. The total U.S. home mortgage debt is $10 trillion. Of this, subprime mortgages account for a total of $1.3 trillion, or roughly 13 percent of aggregate outstanding mortgage debt. In 2005, subprime originations were approximately $600 billion, representing roughly 20 percent of the $3 trillion mortgage origination market that year.

Insured depository institutions, including banks, thrifts, and credit unions, currently hold 32 percent of the outstanding mortgage debt in the U.S. And government sponsored enterprises (GSEs) and GSE Mortgage Pools hold another 41 percent (down from 52 percent 3 years ago) of aggregate U.S. mortgage debt. Finally, more than 17 percent of mortgage debt is currently held by private asset backed security issuers, including numerous foreign investors.

With respect to the subprime market, hybrid ARMS are the predominant mortgage product. In fact, 2/28 hybrid ARMs are almost exclusively underwritten to the subprime market. With respect to the most prevalent segment of this market, 2/28 hybrid ARMs, we are able to identify the following characteristics:

- 43 percent of outstanding 2/28 hybrid ARMs were purchase money loans (25 percent were made to first time buyers);
- 49 percent of these ARMs were cash out refinances; and
- 8 percent of these ARMs were no-cash out refinances.

And we also know that subprime hybrid ARMs typically have significant prepayment speeds, as demonstrated by the following trends:

- 10.5 percent of 2003 subprime hybrid ARM originations are still active;
- 27.5 percent of 2004 originations of these products are still active; and
- 65.3 percent of 2005 originations of these products are currently active.

Finally, approximately $567 billion of subprime ARMs are scheduled for reset in 2007. While this in itself is concerning, we also know that subprime hybrid ARMs are having increased problems well before the rate reset, as demonstrated below:

- Of total 2005 originations, 8.6 percent are seriously delinquent at the 11-month mark;

- Of total 2004 originations, 6.2 percent are seriously delinquent at the 11-month mark; and
- Of total 2003 originations, 5.6 percent are seriously delinquent at the 11-month mark.

As you suggest in your letter of invitation, Mr. Chairman, these are very serious issues. I submit to you, however, that while the numbers in and of themselves may be daunting, there are also some positive dynamics in our respective industries and the overall housing market that should be considered in the context of this debate. I will attempt to highlight these for you in the course of my testimony.

III. Overview and Nature of the Current Debate

At the outset, I believe it is worth stating what may seem obvious but often gets misconstrued in the context of discussions on subprime lending and predatory lending. That is, these are not the same thing. While there is significant debate about the appropriateness of lending in the subprime market, particularly with respect to rates and terms offered to many subprime borrowers, a subprime loan is not per se predatory. For that matter, predatory lending practices may be found in the prime market as well as the subprime market. Several examples are illustrative of the distinction:

- A widowed, 75 year old grandmother who has significant equity in her home but an income stream primarily limited to social security may have a reasonably high FICO score. If a broker lures her into an unacceptable mortgage under the guise that she can get cash out of her property but without full disclosure of the terms of the loan, this predatory action does not involve a subprime borrower.
- An opposite example is a construction worker who gets into an automobile accident and incurs significant medical bills. He becomes 30 – 60 days delinquent on some bills but eventually manages to bring everything current. He is fully employed and wants to purchase a home for his family. The delinquency may have hurt his FICO score, putting him into a "subprime" category, but he may be a good credit risk for proper loan underwriting. This subprime loan is not predatory.

IV. Background on Development of the Interagency Lending Guidance

A. Overview on the Nature of "Guidance"

As noted in your invitation letter, the federal banking agencies (FBAs) issued final guidance last fall on nontraditional mortgage lending products and put out for comment several weeks ago proposed guidance on subprime hybrid ARMs. While we understand your concern with respect to the time that it took for the FBAs to issue the guidance, please bear in mind that the guidance itself is intended to address particular issues with the use of these products in the recent housing market. As described more fully later in this statement, the laws and rules that address the origination, marketing and safe and sound underwriting of these products have been in place for many years at the OTS.

With respect to the proposed subprime guidance that is currently out for comment, our observations in this statement are generally limited to a description of the proposal and the basis for its issuance. Our discussion is not intended to suggest our final views on the appropriate handling of these products, or that our position has been decided or predetermined. We encourage all interested parties to provide their views to guide us in formulating final guidance.

Finally, it is also important to bear in mind the nature of agency "guidance" and its enforceability. Guidance, particularly on an interagency basis, is typically intended to present supervisory and/or regulatory views on the implementation and applicability of existing laws and regulations to a particular issue or emerging set of circumstances that warrant heightened attention or supervisory scrutiny. Guidance provides a flexible approach to highlight issues or concerns versus a more proscriptive regulatory approach that has the potential of producing unintended consequences in an area that may be highly volatile and reactive.

One of the benefits of guidance (versus a regulation) in the current context is that it provides the FBAs the ability to address ongoing issues that may arise from future market innovations not anticipated at the time the guidance is finalized. This is particularly important in the context of the subprime market where the availability of credit can be significantly influenced by government policies affecting credit providers. While we want to intercede to weed out irresponsible and predatory lenders, we do not want to shut off the availability of credit to the subprime market. Again, subprime lending is not per se predatory lending. As you are aware, the subprime market raises numerous unique challenges, not the least of which are ensuring that subprime borrowers continue to have access to credit from regulated depository institutions and not be forced to turn to other less regulated or unregulated credit providers.

B. Differences with the Interagency Nontraditional Mortgage Guidance and the Proposed Subprime Guidance

The final guidance on nontraditional mortgage products issued last fall addressed supervisory concerns with the use and proliferation of certain nontraditional mortgage (NTM) products. That guidance, *The Interagency Guidance for Nontraditional Mortgage Product Risks* (NTM Guidance), covers mortgages with interest-only and negative amortization features. And it applies to all banks, thrifts and credit unions, their subsidiaries and affiliates. While it does not specifically cover other state-licensed lenders and brokers, the Conference of State Banking Supervisors (CSBS) and the

American Association of Residential Mortgage Regulators (AARMR), have encouraged their member States to adopt similar guidance so that it applies more broadly to non-federally regulated lenders. It is our understanding that 28 States and the District of Columbia have done so.

As finalized and implemented by the FBAs, the NTM Guidance applies to mortgages with interest-only and negative amortization features. This was the exclusive focus of the NTM Guidance, which was tailored specifically to exclude coverage of fully amortizing loans. It is important to note that in tailoring the NTM Guidance, great care was taken to avoid unintended consequences, and that was the basis for the exclusion of fully amortizing loan products.

Fundamentally, the two pieces of guidance differ in their approach – the former is product-based and the latter is principles-based.

In this regard, an examination of the NTM Guidance reveals a clear and targeted focus on particular nontraditional mortgage products, i.e., so-called "interest only" and "pay option" ARMs. The intent in the issuance of this guidance was to send a strong and unambiguous signal to the industries we regulate that we expect underwriting of these products to be at the fully indexed rate and supported with a strong analysis of the appropriate risk layering practices for these products. Significantly, the OTS signaled this same message to the thrift industry more than a year earlier in a two-part series in the agency's publication, "The Quarterly Review of Interest Rate Risk."

By contrast, the proposed interagency subprime guidance provides a more principles-based review and analysis of appropriate underwriting practices and the assumption of risks by institutions operating in the subprime market. Most importantly, the subprime guidance, as proposed, is intended to send a strong signal regarding the appropriate marketing of subprime hybrid mortgage products. As described in the proposal, it is our view that such an approach will protect the interests of both lenders and borrowers in this market.

Having noted the difference between the two sets of guidance, we fully understand and appreciate that the same concerns that exist with NTM products also exist with subprime hybrid ARMs. These issues – including loans structured with features such as significant payment shock, risk layering, or inadequate customer disclosure of nonstandard features – raise unique challenges in the subprime market. As such, we believe that separate guidance is appropriate.

Regarding the additional time required to address these concerns, it remains critical to bear in mind that the NTM Guidance addresses concerns with what are generally viewed as prime credit products. Thus, the consequences of the guidance affect the prime credit markets. While a legitimate concern was the potential constriction of credit from the issuance of the NTM Guidance, it was our view that this was a far greater danger with the application of the NTM Guidance in the subprime markets. Thus, a determination was made to develop separate guidance, i.e., the current subprime proposal, rather than extend the NTM Guidance to the subprime market with the potential of a devastating effect on credit availability.

Separate guidance addressing subprime hybrid ARMs is appropriate for a number of reasons. We have significant concerns with the proliferation and marketing practices associated with subprime lending products. These concerns include, but are not limited to, the impact on subprime borrowers of payment shock and the inability to repay a debt that was not responsibly extended to them in the first place. And when a borrower attempts to escape a bad loan, prepayment penalties are often very high. In many cases, this can limit a borrower's ability to refinance a loan with more favorable rates and terms. This can be particularly problematic with loans that have low teaser rates that adjust to higher payments. High and extended prepayments penalties also make it more expensive for a borrower in financial difficulties to refinance or sell their home. Without viable options, some borrowers may not be able to avoid foreclosure.

Customer disclosures are a particularly sensitive issue in the subprime market. In many instances, lawful disclosures can be at best confusing to even the most sophisticated borrowers. Most borrowers can generally understand fixed-rate, amortizing loans, where monthly payments, over time, will amortize a mortgage. However, the rash of new mortgage products with varying and nontraditional payment options and interest rates has left many borrowers about how exactly their mortgage works. And it does not help that many brokers sell their products by stressing the low initial interest rates and payments. As a result, many borrowers focus simply on whether they can afford the payments at inception.

Further complicating the process is that the standard truth-in-lending disclosures are not sufficient to fully inform borrowers of how their loans are structured, when payments will increase, and by what amount. In both the NTM Guidance and the proposed subprime guidance, the FBAs stress the importance of disclosures that fully inform borrowers of alternative and nontraditional mortgage products. We believe this is important both from a safety and soundness standpoint for the lenders we regulate as well as the protection of the customers and consumers they serve.

While consumer information is an important part of the loan process, it is equally important for lenders to make sure that borrowers have the ability and willingness to repay their loans. While making loans affordable is a worthy goal, it does no good to make a loan affordable for two or three years and then increase the monthly payment to the point that a borrower cannot make the payments. Foreclosures hurt lenders as well as borrowers – a point that we constantly stress with our regulated institutions. Safe and sound underwriting tailored to each individual borrower is a critical step in the loan evaluation process.

There are many factors that go into loan underwriting, including credit history, employment history, and combined loan-to-value (CLTV) and debt-to-income (DTI) ratios. Both the NTM guidance and the proposed subprime guidance state that borrowers should be qualified based on payments reflecting the fully amortizing and fully indexed interest rates, and not teaser, or low initial start rates. In this regard, while a DTI ratio is just one factor that needs to be considered in whether a borrower has the ability to repay the loan, it can be especially important. For example, we look hard at any loan where a borrower's DTI ratio exceeds 45 percent.

Closely related to DTI ratio is income and employment verification. Historically, lenders would verify an applicant's employment, income, deposits, and other financial assets to evaluate repayment capacity. Over the past few years, however, many lenders have offered loans with low documentation requirements (low-doc loans), such as simply "stated income," where the loan analyses are based on the income the borrower indicates on his loan application without any verification. For some borrowers with high down payments and high credit scores the risks for these loans may have been manageable. However, these loans are now offered beyond this class of borrowers and even include some subprime borrowers. Statistics have shown that such loans have a significantly higher risk of default than loans where income and employment are documented and verified.

Affordability is also a critical issue, and remains an important consideration in the FBAs efforts in providing responsible flexibility to lenders in structuring their loan products. It is also a reason that the FBAs have proposed the subprime guidance, rather than prohibiting or significantly limiting or curtailing subprime lending. Notwithstanding concerns with subprime credit constriction, loans to low- and moderate-income people must be structured so that the borrower can afford them both at origination and throughout the life of the loan. Loans should not be structured with the idea that a borrower will eventually be required or will elect to refinance or sell their home. This is not an affordable loan, but rather a recipe for foreclosure.

Paramount to the underwriting process is maintaining safety and soundness. Lenders that responsibly protect their own self interest also protect the interests of their borrower-customers. All loans should be underwritten in a manner that provides reasonable assurance that a borrower has both the willingness and ability to repay. Where borrowers have weak credit histories, other factors – such as private mortgage insurance, low CLTVs, current sound credit histories, proper income documentation and reasonable DTIs – can serve to mitigate higher default risks for such borrowers. However, when risk factors are layered and include high LTVs, poor recent credit, high DTIs, a lack of proper documentation, and/or loan structures that create payment shock or escrow issues, default risk for both an institution and the borrower are dangerously elevated.

With all of these factors in mind, the FBAs proposed the subprime guidance on March 2, 2007. Again, it is intended to address the particular issues and challenges presented by subprime lending, both currently and in the future.

V. Description of the Proposed Subprime Guidance and Request for Comments

As stated previously, the proposed interagency subprime guidance focuses on loans involving repayment terms that exceed a borrower's ability to service the debt without refinancing or selling the property. The proposal specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal also underscores that communications with consumers should provide clear and balanced information about the relative benefits and risks of the products.

In connection with the proposed guidance, we are particularly interested in obtaining comments on a number of issues. These include:

- Whether subprime hybrid loan products always present inappropriate risks to institutions and consumers, or the extent to which they can be appropriate under some circumstances;
- Whether the proposed guidance statement would unduly restrict existing subprime borrowers' ability to refinance their loans;
- Whether other forms of credit are available that do not present a risk of payment shock;
- Whether the principles of the proposed guidance should be applied beyond the subprime ARM market; and
- Whether limiting of prepayment penalties to the initial fixed-rate period would assist consumers by providing them time to assess and act on their mortgage needs.

Again, while we do not wish to comment beyond the issues already discussed given that the guidance is out for proposal, these are issues of great concern in the current housing market. Comments are extremely important in further guiding the FBAs in this process. We are requesting comments on the proposed subprime guidance by May 7, 2007.

At this point, it also bears noting that the proposed subprime guidance applies to insured depository institutions, including banks, thrifts and credit unions. As with the NTM Guidance, it does not apply to state-licensed mortgage brokers or other state-regulated and/or unregulated mortgage bankers and lenders. While we applaud the efforts of CSBS and AARMR to enlist the support of 28 States and the District of Columbia to adopt the NTM Guidance, we believe that it is even more imperative that the States take similar action with respect to guidance or laws targeted at subprime lenders within their jurisdiction.

Approximately 80 percent of subprime loans are originated through mortgage brokers. And there are currently roughly 44,000 licensed mortgage brokers in the U.S. Typically, mortgage brokers are required to obtain a state license, but frequently there are no testing or education requirements that are part of that process. Complicating the picture is that background checks may be run only against a State's own criminal database, but not against the FBI's national criminal database. Moreover, it was recently reported in the American Banker that there are eight states that have no regulation of mortgage bankers and lenders. Not coincidentally, two of these States also happen to have the highest delinquency rates for subprime hybrid ARMs, with delinquency figures substantially above the national average.

We understand that CSBS and AARMR are currently working on a nationwide residential mortgage licensing program to address part of the problem. We have been advised that the initiative will create uniform national mortgage broker and lender licensing applications and a centralized database to house relevant information regarding mortgage brokers and lenders. We applaud this initiative and encourage all States to participate in the CSBS/AARMR program. Of particular note, this initiative will free up scarce State resources currently used for processing licensing applications and permit the States to focus greater attention on supervision and enforcement of mortgage brokers and lenders.

Again, however, this is only part of what is required to address the existing problem with the activities of state regulated mortgage brokers and lenders. We encourage CSBS and AARMR to work with their member States to review and comment on the proposed subprime guidance, and to consider appropriate action at the state level to pursue similar standards.

VI. Subprime Hybrid ARMs and Foreclosure Rates

A growing number of mortgage industry analysts are predicting significant increases in mortgage foreclosure rates. Traditional causes of foreclosure include significant medical expenses, job loss, divorce, and other unexpected challenges. Additionally, unscrupulous or predatory lending practices can also result in mortgage foreclosures.

And while there are more dual-income families servicing today's mortgages, today's mortgages (proportionate to incomes) are growing ever larger due to the high cost of housing in many markets. The financial impact of these larger mortgages grow exponentially with any upward movement in interest rates and/or loan balances, as allowed under the terms of many of today's mortgage products.

The proposed subprime guidance was issued in response to concerns that certain subprime hybrid loan products, which increased in volume significantly the past few years, are posing greater risks to lending institutions and borrowers.

A. National and Industry Foreclosure Rates

Based on the data currently available to us regarding subprime lending activities and the exposure of institutions that we regulate to this market segment, we can make a number of observations. First, external data available to us shows that the foreclosure rate on subprime mortgages nationwide, i.e., for all lenders, as of December 2006 was 3.63 percent of outstanding subprime mortgage products. This compares to a foreclosure rate of 2.48 percent one year earlier. This represents a year-over-year increase of 46 percent. While this large percentage increase is clearly a concern, it is important to keep it in context. For example, at 3.63 percent, the current foreclosure rate is where it was in September 2003, and substantially lower than the rate of 4.73 percent in December 2001. In other words, while the recent percentage increase is significant, in aggregate, the current level is not extraordinary.

Within the thrift industry, we survey our institutions semi-annually on their subprime lending activities. As of June 2006 (the latest compiled report), we had 17 (out of 854) thrifts with significant subprime lending operations. These institutions reported having approximately $47 billion in subprime mortgages, which represents about 5 percent of total mortgages held by the thrift industry. More significantly, OTS-regulated thrift industry holdings represented just 3.6 percent of the aggregate subprime market.

OTS-regulated thrift institutions engaged in subprime lending programs are generally well capitalized, and are all subject to heightened supervision and regulatory scrutiny by OTS examiners with respect to the conduct and operation of these programs. As described below, examiner oversight is tied into our agency-wide consumer complaint program. Institutions with significant consumer complaint activity regarding their mortgage lending operations are subject to heightened scrutiny. While we do not separately track the performance of subprime loan products held by thrift institutions, aggregate foreclosure rates for the industry are currently running about 0.065 percent per quarter, or about 0.26 percent on an annualized basis. While the current rate is up slightly, it is about where it was in 2004.

Comparing this data with the nationwide data available to us on subprime loan performance provides some additional analysis that is helpful to understand the portion of the subprime market currently occupied by the thrift industry. We know that subprime mortgage performance is heavily affected by local economic conditions. According to nationwide data available to us, the states with the highest foreclosure rates are Ohio, Indiana, and Iowa. California, the state where thrift industry subprime lending activity is concentrated, ranks well below the national average, with a foreclosure rate of 2.73 percent. From this, we conclude a lower aggregate industry exposure and foreclosure rate than the national averages.

With respect to thrift industry exposure to potentially increasing foreclosure rates predicted by some experts, the industry is well positioned from a capital and earnings standpoint to absorb such an increase in losses, should it occur. We encourage our regulated institutions (and, as described more fully below, particularly those with subprime lending programs) to work closely with borrowers to address potential foreclosure issues as quickly as possible in order to protect both the institution and the borrower. And we are closely monitoring those thrift institutions having significant subprime lending operations.

Another important consideration regarding thrift industry involvement in subprime lending programs going forward is the recent increase in early default put-backs among subprime securitizations. This has caused some smaller mortgage banking firms (but no thrift institutions) that specialized in subprime lending to fail. The reaction of the secondary market to this perceived increase in risk has been to lower the price on such securitizations. Lower prices, in turn, have reduced the attractiveness of engaging in such securitizations. The likely impact is to reduce the profitability of subprime lending and, thus, the attractiveness of the activity.

At this point, OTS-regulated institutions' exposure to these "early payment default" (EPD) put-backs appears to be minimal, although we expect repurchase demands to continue to rise over the course of this year. And there are several isolated instances of thrifts with heightened levels of put-backs. Of the six institutions that have reported put-backs as of December 31, 2006, the reported amount equaled approximately 2.65 percent of the respective institutions' Risk-Based Capital as of the reporting date.

We are continuing to monitor thrift institutions' exposure to this area, and are well aware of the significance of early detection of potential problems. Many of our institutions with more significant levels of exposure to the subprime market have already begun to pare down their participation in this market. In fact, initial data from a year-end survey of thrifts suggest that subprime lending by institutions involved in this market has slowed at least as much as the overall mortgage market, if not more. We expect the impact on securitizations to further reduce this activity.

B. OTS Oversight of Thrifts with Subprime Lending Programs

As noted above, thrift institutions engaged in significant subprime lending activities are subject to heightened OTS supervision and oversight with respect to the conduct and operation of these programs. During the normal course of examinations, institutions with subprime credit programs are reviewed from a safety and soundness perspective, and are also scrutinized to ensure that the institution is lending responsibly and following applicable laws and regulations.

In light of recent developments in the home mortgage market, the OTS has revised and will issue shortly its examiner guidance on home mortgage lending and servicing. The examiner guidance re-emphasizes our existing policy on foreclosures and, in doing so, explicitly recognizes that foreclosure is seldom a cost effective option, and encourages lenders to make special efforts to develop and maintain effective servicing and collection procedures for home mortgages that become delinquent. For example, the guidance suggests that lenders involved in subprime lending should have their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary.

In addition, the OTS's long-standing guidance on servicing states that a thrift's collection activities must comply with the following:

- The Fair Debt Collection Practices Act – in particular, the law defines from whom a debt collector may gather information on a consumer, the type of information that it may collect, and the acceptable forms of communication with the consumer and other parties;
- State laws that pertain to collection and foreclosure actions; and
- Bankruptcy law – an institution's collection activity is affected by any bankruptcy plan into which a debtor has entered. For instance, the filing of a bankruptcy petition acts as an automatic stay on any collection activities in process at the time. After such filings, collection efforts usually process through the bankruptcy court.

In some cases, a collection unit may enter into a short-term forbearance arrangement with a delinquent borrower before beginning a foreclosure action. For example, a servicer may permit the borrower to defer payments, follow an alternative repayment plan, or execute a deed in lieu of foreclosure (which grants the borrower full forgiveness of the debt). And the use of some loss mitigation techniques, such as waiving a due-on-sale clause to allow an assumption, may require an institution to repurchase the loan out of its mortgage-backed security pool. We expect thrift management to have information systems adequate to analyze these forbearance activities.

While we stress the need for an institution to work with its borrowers to resolve any payment delinquencies, we also stress the need for the institution to be fully aware of, report properly, and reserve adequately for its troubled loans. Transparency of operations is critical to a safe and sound banking system.

As noted elsewhere in this statement, loan forbearance and foreclosure strategies targeted as a win-win for the lender and borrower are generally significantly more cost-effective from a safety and soundness standpoint. We encourage all of our regulated institutions to consider and adopt such programs in a manner consistent with their safety and soundness and the protection of their borrower customers.

C. OTS Enforcement Activities

When an institution's lending programs are found to be potentially predatory or are lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to eliminate these risks. These include informal agreements, supervisory directives, board resolutions, and various other approaches.

For example, in one relatively recent case we addressed a series of transactions where an institution entered into an agreement with an affiliated entity to originate and fund subprime loans through the institution. The affiliate provided loan sourcing and origination services, and assisted in the disposition of the originated loans to investors.

In reviewing the parameters of the relationship between the institution and its affiliate, OTS examiners determined that the thrift was not managing the relationship appropriately, and insufficient controls were in place to fully ensure effective lending practices. And there was also an indication that some of the lending practices were abusive. In response, the agency issued supervisory directives and required board resolutions to address the problem. The thrift's relationship with the affiliated entity was terminated one month after the OTS took action to address the matter.

In another case involving an institution with a high level of customer complaints regarding potentially abusive lending practices, OTS examiners were sent to the institution to review the institution's lending practices and program. Pursuant to that review, the institution was directed to implement adequate policies to address and resolve various unacceptable lending practices. When the institution failed to address these issues in a timely manner, the OTS initiated an enforcement action against the thrift.

Pursuant to the OTS's enforcement order, the institution signed a written supervisory agreement with the OTS in which it agreed to improve its compliance with the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act and the Fair Credit Reporting Act. In addition, the institution agreed to create a "Consumer Ombudsman" responsible for "fairly and impartially reviewing and addressing [customers'] borrowing issues in a timely and effective manner." The agreement also required the development of borrower-oriented customer service plan/practices, and a consumer dispute resolution initiative plan among other things.

Approximately one year following the execution of the supervisory agreement, the OTS approved the institution's request for "voluntary dissolution".

We also recently addressed an issue with an institution engaged in what we viewed as a potentially abusive subprime credit card lending program. The nature of the program was uncovered in the normal course of an examination. In connection with the resolution of that matter, we directed the institution's board of directors to establish a systematic process to withdraw from the subprime credit card program, and immediately cease new approvals under the program.

Although this was a more informal action pursued in the course of an examination, the result was that the program's growth was immediately terminated, and the program itself was unwound within a reasonably short timeframe following the examination.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so.

VII. Predatory Lending and OTS Efforts to Combat the Problem

A. OTS Examination Efforts

The OTS regularly examines thrifts for compliance with federal compliance and consumer protection statutes including fair lending statutes such as the Equal Credit Opportunity Act, the Fair Housing Act, and section five of the FTC Act which prohibits Unfair Acts and Practices. In addition, the OTS examines for compliance with our regulations that prohibit discrimination and misrepresentations in advertising. We also examine to ensure compliance with interagency guidance on subprime lending, such as the 1999 Interagency Guidance on Subprime Lending and the 2001 Expanded Guidance for Subprime Lending Programs.

Finally, we are currently developing enhanced examination procedures that specifically address responsible lending practices for our regulated lenders that have a subprime lending program. These procedures direct examiners to focus on various issues and institution program areas, including:

- Whether institution marketing materials are well designed to present the typical consumer with adequate information to help them make informed product choices;
- Whether institution sales practices – either through loan officers or third parties – may tend to mislead a consumer about the nature and scope of a

credit transaction or may impose pressure on consumers to accept terms and conditions based on incomplete or unbalanced information;

- Whether institution employee training programs, including training provided to third party vendors that interact with institution customers, foster best practices; and
- Whether existing institution practices may have the effect of steering particular groups of consumers to less favorable credit products or higher cost credit products than their credit risk profile warrants.

We are in the process of field testing these examination procedures with formal adoption expected as soon as practicable after making any necessary adjustments upon conclusion of the field testing exercise.

B. Utilization of Consumer Complaint Data

The OTS continually tracks individual institution consumer complaints relating to various potential regulatory violations, such as the Equal Credit Opportunity Act, and with respect to product offerings, such as ARM products. Consumer complaint staff and managers prepare summaries of consumer complaints for OTS examiners to utilize in their review during on-site examinations.

Institution consumer complaint records are an integral part of an the OTS's individualized Pre-Examination Response Packages (PERK) for each institution, and play a significant role in identifying areas for examiners to focus on during their on-site examination. These records also play a critical role in assessing the adequacy of an institution's overall compliance management program and in pursuing corrective action that may be appropriate to address programmatic weaknesses or deficiencies.

C. OTS Examiner Consumer Compliance Test

OTS recently developed an examination that is used to test and train OTS examiners regarding their level of proficiency across a broad range of consumer compliance laws and regulations. We developed this in-house examination in order to continue to ensure that OTS examiners have significant knowledge regarding consumer compliance requirements and agency expectations of the institutions that we regulate. The new test will assist us in working with our examiners to develop professionally in order to effectively examine thrift institutions, many of which have complex, retail-focused business models.

D. Consumer Education and Responsibility

The OTS has worked on its own and cooperatively with various other agencies and organizations to promote consumer education and responsibility. We also have various initiatives to improve financial literacy and we work closely with our institutions to encourage them to do the same.

1. The CHARM Booklet

One interagency initiative involved working closely with the Federal Reserve Board to assist consumers in navigating their choices among mortgage products. The product of that effort, a consumer disclosure brochure entitled the Consumer Handbook on Adjustable Rate Mortgages – or CHARM booklet, was revised and re-released on December 26, 2006. The CHARM booklet provides information to consumers about the features and risks of ARM loans, including the potential for payment shock and negative amortization. It is tailored to help consumers better understand some of the issues and potential pitfalls with newer loan products

In particular, the CHARM booklet was substantially revised to address the growing use of NTM and newer types of ARM products that allow borrowers to defer payment of principal and sometimes interest. For example, it includes information for consumers on both "interest-only" and "payment option" ARMs. The revised booklet describes how these loans typically work, demonstrates how much (and how often) monthly payments could increase, and describes how a loan balance can increase if only minimum monthly payments are made. The booklet, which is a required consumer disclosure for ARM loans, also includes a mortgage shopping worksheet to help consumers compare the features of different mortgage products.

2. The Interest Only-Pay Option Mortgage (IO-POM) Brochure

The OTS also contributed to the development of an interagency consumer informational brochure addressing interest-only and payment option mortgages. This brochure describes payment shock and negative amortization. This work is ongoing, with illustrations of these types of mortgages being developed to educate consumers on the points discussed in the brochure.

3. The OTS Consumer Complaint Brochure

In connection with our agency-wide program for National Consumer Protection Week in February, the OTS issued a consumer information brochure on how consumers can resolve complaints with financial institutions. That brochure highlights various steps that consumers can take in order to attempt to resolve a complaint. First, consumers are encouraged to try to resolve a problem directly with an institution by contacting senior management or the institution's consumer affairs department. If this is unsuccessful, consumers are advised to contact the appropriate OTS regional office for institutions regulated by the OTS or, if the entity is not OTS-regulated, the guidance provides information for identifying the appropriate federal and/or state regulator for various types of financial institutions. Finally, the brochure reminds consumers that the best way to pursue a complaint or concern is to make sure that it is well documented.

4. OTS's National Consumer Protection Week Program

The OTS Consumer Complaint brochure was part of a 5-day series of consumer protection and awareness initiatives during National Consumer Protection Week. During the week, the OTS also highlighted various issues for thrift institutions and resources available to consumers on financial literacy and education via press releases. We also noted that the agency's five day National Consumer Protection Week program was part of a wider agency initiative intended to bolster OTS efforts to assist institutions in working with their customers to improve financial literacy and education. And it is part of an ongoing effort to upgrade substantially the agency's own compliance, consumer protection and consumer awareness programs.

An important aspect of the OTS's efforts to upgrade our own consumer awareness and protection programs is monitoring emerging trends and evolving financial products in order to develop appropriate guidance for institutions and resources that assist consumers in making informed financial decisions. As we stressed before the Financial Literacy and Education Commission (FLEC) earlier this year, financial literacy and education is equally important to institutions and the customers they serve.

During National Consumer Protection Week, we also issued a press release reminding consumers about the risks presented by identity theft and steps to guard against it. The release highlighted for consumers their right to take advantage of a free credit report from the major credit reporting agencies pursuant to the Fair Credit Reporting Act.

We noted that careful credit report monitoring not only helps consumers obtain credit at rates commensurate with their credit history, it also helps to guard against identity theft. We also encouraged all of the institutions we regulate to work with their customers to increase awareness of the importance of periodically monitoring their credit report. We reminded consumers that credit scores largely determine the cost they pay to receive loans and that over time, a consumer's ability to pay lower interest rates to a lender because of a positive credit score can save them lots of money. We also noted that insurance companies and employers also utilize information from credit reports, stressing how important it is for all of us to know what's in our credit reports.

E. The Impact of Mortgage Fraud

At the National Housing Forum (NHF) sponsored by the OTS in December 2006, another issue affecting the subprime mortgage market was highlighted. The NHF included a panel on mortgage fraud that featured an important discussion on the impact of mortgage fraud on financial institutions and borrowers. The panel discussion highlighted the fact that regulated institutions reported over a $1 billion in losses from mortgage fraud in 2005. And reports of suspected mortgage fraud doubled in just three years from 2003 to 2006.

The panel discussion noted that mortgage fraud can be divided into two broad categories – fraud for property and fraud for profit. Fraud for property generally involves misrepresentations or omissions designed to deceive the lender into extending a mortgage. Fraud for profit, frequently committed with the complicity of industry insiders, involves fraudulent appraisals, property flipping, straw borrowers, and identity theft. Fraud for profit frequently involves large schemes, concocted by sophisticated criminals. This is an important point in the context of the current discussion and, unfortunately, one that is not easily quantifiable with respect to the impact on subprime borrowers.

While lenders and consumers have benefited significantly from lower interest rates and a mortgage boom the past several years, higher loan volumes have encouraged lenders to develop ways to cut costs and create efficiencies in the mortgage underwriting process. And the recent moderation in housing has added pressure to exploit these efficiencies in order to capture demand while retaining profits. It is certainly true that mortgage lending innovations have produced efficiencies that are good for lenders and borrowers. Yet, while such innovations have made borrowing easier and more user-friendly, they have also provided opportunities for fraud to proliferate. This is an ongoing issue of concern to the OTS and all participants in the mortgage markets.

F. OTS Community Outreach Activities/Partnership Building

Another important aspect of OTS efforts to combat predatory lending is a community outreach program that includes designated community affairs liaisons – known as CALs – in each of our regional offices. OTS CALs conduct various regional outreach efforts to help identify community credit and banking needs, and match those needs and opportunities with our regulated thrifts. Over 30 new community contacts were established in 2006 to complement our many existing community-based partners. Such partners include financial institutions, government agencies, community based organizations, non-profit groups, and social service agencies. Our CALs address and work on affordable housing and economic development needs, best practices for serving emerging markets, elder financial abuse issues, financial literacy programs, and other initiatives targeted at low- to moderate-income individuals and communities.

Regional programs, organizations and forums in which OTS CALs and other OTS employees are involved include a Boston New Alliance Task Force in October 2006 addressing the unbanked and underbanked; two events in 2006 involving the New York New Alliance Task Force that involved outreach to community-based entities that cater to the needs of the unbanked and underbanked; a joint summit on financial fraud prevention in December 2006 sponsored by our Northeast Regional Office and the New England Consumer Advisory Council.

Other organizations that we worked with during 2006 include the Housing Leadership Council of San Mateo County, California; Lenders for Community Development, in San Jose, California; Coachella Valley Housing Coalition, Indio, California; the Fair Housing Councils of Riverside County, and Palm Springs, California; the San Francisco Housing Development Corporation; the San Francisco Planning and Urban Research (SPUR) Association; Los Angeles Neighborhood Housing Services; and the Clearinghouse for Affordable Housing CDFI.

We also worked closely to develop further relationships with nationally recognized community organizations such as the Greenlining Institute, the California Reinvestment Committee, and Operation HOPE. And we collaborated with our sister FBAs to co-sponsor three community development training events during 2006 – a National Community Reinvestment Conference, in Henderson, Nevada; the Greater Sacramento CRA Roundtable, in Sacramento, California; and "Exploring the Valley's Unbanked Opportunity," in Fresno, California.

We also assist in providing basic financial education training, such as to a class of graduating high school seniors in San Francisco, and providing financial education training at a low- to moderate-income community center in Palm Springs, California. And we plan various other financial education and literacy outreach events for 2007.

VIII. Conclusion

The OTS shares the concerns of the Committee with respect to current issues related to subprime hybrid ARMs. Clearly, nontraditional mortgage products, subprime hybrid ARMs, and predatory lending practices in both the prime and subprime markets have impacted the nationwide housing market. However, at this stage of the cycle the aggregate impact of subprime lending and predatory lending remain unclear. While some suggest that there is much more to come, others note that banks and thrifts are well-positioned from both a capital and earnings standpoint to weather even a sustained market downturn. For now, the data currently available to us indicate that regulated institutions have been migrating out of the subprime market sector. While we expect some institutions to continue to operate in this market, it appears that most insured depository institutions are fully cognizant of the risks posed with subprime hybrid ARMs and are underwriting these loans accordingly.

For our part, we will continue to work with our institutions to ensure safe and sound underwriting standards that benefit both the institutions that we regulate and their customers. In addition, we will encourage institutions to work with borrowers that are experiencing problems due to personal circumstances outside of their control. We also encourage the Members of this Committee and the public to comment on the interagency proposed subprime guidance. Finally, we will work with the Committee to address issues with subprime lending, as well as to combat predatory lending.

Thank you for the opportunity to present our views on these issues.

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TESTIMONY OF

JOSEPH A. SMITH, JR.

NORTH CAROLINA COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES"

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

March 22, 2007, 10:00 a.m.

Room 538, Dirksen Senate Office Building

Introduction

Good morning, Chairman Dodd, Ranking Member Shelby, my senator from North Carolina, Senator Dole, and other distinguished members of the Committee. My name is Joseph A. Smith, Jr., and I serve as the Commissioner of Banks for the State of North Carolina. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation.

In addition to regulating banks, 49 states plus the District of Columbia currently provide regulatory oversight of the residential mortgage industry. The one exception is Alaska, which is currently working toward a legislative solution. Under state jurisdiction are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.[1]

I am particularly interested in the topic of today's hearing because North Carolina has been a leader in providing protection of residential mortgage borrowers. The North Carolina General Assembly adopted a groundbreaking anti-predatory lending law in 1999 and a companion licensing regulatory statute, the Mortgage Lending Act, in 2001. As the Commissioner of Banks, I supervised the implementation of the Mortgage Lending Act's

[1] The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

licensing provisions in 2002 and the subsequent development of examination and supervision procedures. As of the end of 2006, my office has licensed and regulated over 1,600 mortgage lending and brokerage firms and over 16,000 individual loan officers under the Mortgage Lending Act.

Mr. Chairman, I will do my best to respond to your invitation to testify today by addressing the origins of the current situation in the subprime market and the subsequent state supervisory responses. I would also like to discuss actions that are being taken by state regulators and law enforcement agencies to address the market's problems and suggested actions that may be taken by Congress.

Specifically, I will make the following four points today:

1. The mortgage market has changed dramatically over the past two decades. The majority of loans are now originated by mortgage brokers and lenders at a local level and are financed by Wall Street firms that operate at a global level. This market evolution has many positive effects for consumers and the economy, but in some cases it has also resulted in the improvident lending practices currently witnessed in some sectors of the subprime loan market.
2. States have been the first responders to this market evolution. States have led the fight to reign in abusive lending through predatory lending laws, licensing and supervision of mortgage lenders and brokers, and through enforcement of consumer protection laws. I will describe a few of these efforts later in my testimony. State regulators are working collaboratively and effectively on many fronts with each other and our federal counterparts.

My fellow state supervisors and I welcome coordination with our federal counterparts to promote responsible lending across the residential mortgage industry. Unfortunately, state efforts to curb predatory or abusive lending have been hampered by federal preemption and/or sufficient state-federal coordination. Federal law and regulations have made it harder to protect borrowers against predatory lending and to promote sound underwriting practices. This is not an excuse, but a fact. We are encouraged, however, by your Committee's interest in mortgage supervision.

3. State government agencies and not-for-profit organizations are best positioned to develop and determine proper rescue techniques to provide relief to hard-working homeowners that have a reasonable likelihood of sustaining homeownership. My message to consumers is that you can work with your mortgage servicer on your payment problems before you reach foreclosure.
4. Going forward, I believe Congress can improve the mortgage market dramatically with a few actions, such as:
    a. Establishing a predatory lending regime similar to the one adopted in my home state of North Carolina and suggested by legislation sponsored by House Financial Services Committee Chairman Barney Frank and two of my representatives, Representative Brad Miller and Representative Melvin Watt last year;
    b. Increase consumer representation when obtaining a mortgage through education, counseling, and/or improved disclosures,

especially in the subprime market. My experiences in North Carolina have indicated that the complexity of the mortgage market can make it difficult for borrowers with demonstrated credit problems to make good choices. Policymakers and regulators should simplify the process to purchase a sound loan which will promote sustainable homeownership;

c. Provide funding and support for the ongoing effort by CSBS and the American Association of Residential Mortgage Regulators (AARMR)[2] to develop a uniform licensing system for mortgage lenders and brokers; and

d. Utilize current tools to reach the subprime market through a modernized Federal Housing Administration (FHA), government-sponsored enterprises (GSEs) financing, and enforcement of consumer protection laws. The subprime market explosion came at the cost of the FHA, as it was unable to offer competitive products for responsible subprime lending. In addition, Congress should encourage the GSEs to promote affordable and sustainable homeownership across the mortgage market.

The Revolution in Residential Mortgage Lending

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[2] AARMR is the national organization representing state residential mortgage regulators. AARMR's mission is to promote the exchange of information between and among the executives and employees of the various states who are charged with the responsibility for the administration and regulation of residential mortgage lending, servicing and brokering. More information about the American Association of Residential Mortgage Regulators can be found at: http://www aarmr.org.

To better understand the current situation in the subprime market, we need to review how we got here. The changes in the residential mortgage industry over the past two decades have been dramatic and far-reaching. Over the past two decades, the market has ushered in new players, new products, and now has a bigger impact on the economy as a whole. Twenty years ago, federal and state regulated savings and loans originated most of the residential mortgages. GSEs or agencies such as Fannie Mae, Freddie Mac, and the FHA held a significant percentage of the market share and effectively set standards for the entire industry.

Advances in information and communications technology have revolutionized the mortgage market. Before the revolution, mortgages were, as a rule, made by depository institutions (generally savings and loans) that held the loans in their own portfolios. Some institutions sold mortgage loans to Fannie Mae and Freddie Mac or had them insured by the FHA, but such activity was subject to the underwriting and recourse policies of the purchasers or insurer. In these circumstances, there was a unity of risk and reward: the originating institution had to live with the loans it made. Subsequent to the savings and loan crisis in the 1980s, the origination of mortgage loans shifted primarily to mortgage brokers and mortgage lenders. Today, mortgages are "made" in a complex network, funded by capital markets, sold by an array of originators, and touched by many hands, such as servicers and securitizers.

The explosion of product choices have allowed consumers to now choose between practically any combination of fixed, adjustable, or hybrid adjustable rate and amortizing, non-amortizing, or negatively amortizing mortgages, with terms ranging anywhere from 15 to 50 years. On top of these options, risk-based pricing has allowed more consumers than ever to qualify for home financing sooner, by trading a lower credit score or down payment for a higher rate.

The volume of loan originations has also increased over this time period. This increase in loan volume was facilitated in part by advances in technology, such as the automated underwriting systems, the increase of mortgage products available to the consumer, the evolution of the subprime market, and an expansion of the holders in the secondary market for mortgage securities, including international investors, hedge funds, and private equity funds.

The mortgage revolution has brought with it a number of good things: a vast flow of liquidity into the mortgage market, increased availability of mortgage credit, and higher rates of homeownership. It has also brought moral hazard, as the allocation of risk of a mortgage loan default became dispersed through complex contractual arrangements that began with the local mortgage broker, and ultimately ended with a Wall Street investor. This dispersal of risk created opportunities and incentives for some actors to engage in weak underwriting or fraud. As a result, there have been significant increases in fraud and foreclosures.

I am aware that some industry observers have referred to this situation as a "broker problem." Certainly, the marketing and sales practices of mortgage lenders and brokers as well as increased accountability need to be addressed. The coordinated state and federal guidance begin to address this situation. However, a mortgage broker is only as good as his or her ability to obtain funding for a loan.

Controls that were in place to govern the market have been overwhelmed by the requirements of a commission-driven origination system and a securitization machine built for volume. Years of stellar performance created a demand for subprime mortgage securities, and the mortgage origination system responded to supply that demand. In a contest between the uncompromising innovation and marketing of capitalism and the inherent checks and balances of the mortgage market, the more aggressive tenets of capitalism were a clear winner, particularly in the subprime sector.

Market conditions have changed dramatically and rapidly in the last two years, as interest rates rose at a time of weak income growth and slowing house appreciation. Instead of tightening underwriting controls, subprime brokers and lenders loosened their underwriting and controls to maintain volume in the intensely and brutally competitive residential mortgage marketplace.

The stress test for this system has now begun. Default rates far exceed past experience, and the expectations of investors have soured. Changes in the yield curve and real estate values have reduced or eliminated refinancing as a prop to the market. A number of subprime originators have gone out of business, and the largest subprime lenders have undergone substantial market capital adjustments. Because of risk dispersion through derivatives, it is not yet clear what the extent of the damage will be. Market participants are worried—and for good reason.

Federal Preemption

The United States did not arrive at the current disarray in the residential mortgage market overnight and no single party is fully responsible for our current situation. CSBS believes the rapid and drastic changes in the industry created an environment of negligence in lending practices and increased borrower confusion. States stepped in to act as the primary regulator in this new industry, but have been, and continue to be, hampered by federal preemption. State regulators do not eschew responsibility. It is possible regulators were too lenient as we struggled to find the appropriate balance between promoting homeownership opportunities and protecting consumers. But Congress, federal regulatory agencies, mortgage lenders and brokers, insured depository institutions, and borrowers must all accept a measure of responsibility for aiding in the creation of our current residential mortgage marketplace and for its problems.

While we are not here to point fingers, CSBS would be remiss if we did not point out that state efforts to regulate the mortgage market have been met with resistance or indifference from federal regulators and even Congress. Here are a few examples:

- The OCC and OTS have taken an aggressive position that federal law preempted state predatory lending laws, even as they apply to mortgage brokers that have originated loans on behalf of lenders and joint ventures of national banks with non-bank mortgage lenders.
- The OCC has supported the preemption of state licensing laws for state-chartered operating subsidiaries of national banks. In some cases, operating subsidiaries of national banks have refused to return calls from state regulators.
- The OCC has supported national banks' efforts to resist the enforcement of federal laws by state enforcement action, most notably by then New York Attorney General Spitzer's efforts to investigate fair lending concerns based on Home Mortgage Disclosure Act (HMDA) data.

This aggressive preemption has not been accompanied by aggressive enforcement of consumer protection, as the federal bank regulators have taken few, if any, significant consumer protection enforcement actions. While federal preemption does not excuse states from supervising non-bank mortgage lenders and brokers, it does make it more difficult, as state regulators constantly have had to combat arguments that lending laws must be uniform in order to avoid an unlevel playing field or to divert important resources to enforce state laws. Thus, it is ironic to me that state regulators are now being faulted for not acting more aggressively to interfere in transactions that gave low and moderate income borrowers a chance at homeownership, when we have been the only ones attempting to do so.

State Regulatory Responses

Despite the obstacles of preemption, as the residential mortgage industry has rapidly evolved, the states have played a more active role in its regulation and supervision. It is worth noting that the residential mortgage industry as we know it is relatively young. The evolution discussed above has taken place in the past 20 years. Therefore, state supervision of the industry is also relatively new. Conversely, state bank supervision in the United States has been in existence since the late 18th century. In North Carolina, the state has chartered and supervised banks since 1804. Obviously, state bank supervision has had centuries to evolve and improve. State mortgage supervision grows and improves each day.

The actions taken by the states in response to the evolving mortgage market have focused on protecting consumers through development of licensing and supervision of mortgage brokers and lenders, legislation, and enforcement of consumer protection laws.

The states have developed evolving and ever-improving supervision of mortgage lenders and brokers. My home state of North Carolina currently licenses 1,600 firms and over 16,000 loan officers. Each day state regulators take enforcement actions against mortgage lenders and brokers for abusive lending. I have attached, as Exhibit A, a few illustrations of the efforts by state mortgage regulators to supervise and regulate this industry.

Recognizing, however, that many mortgage lenders and brokers operate on a multi-state or nationwide basis, the states, through CSBS and AARMR, are developing cooperative initiatives and tools to more effectively regulate the marketplace.

CSBS-AARMR National Residential Mortgage Licensing System

On a national scale, CSBS has partnered with the American Association of Residential Mortgage Regulators (AARMR) to ensure that consumers are protected from fraudulent practices and receive adequate information regarding mortgage service providers. Over two years ago, CSBS and AARMR embarked on an initiative that will change the world of mortgage supervision. CSBS and AARMR are creating a national mortgage licensing system to improve the efficiency and effectiveness of the U.S. mortgage market, to fight mortgage fraud and predatory lending, to increase accountability among mortgage professionals, and to unify and streamline state licenses processes for lenders and brokers. Schedule to begin operations on January 1, 2008, this system will create a single record for every state-licensed mortgage company, branch, and individual that will be shared by all participating states. This single record will allow companies and individuals to be tracked across state lines and over any period of time.

Last month, 29 states announced their intent to participate in the system by the end of 2009. CSBS expects several more states to announce their similar intent over the next few months. To my knowledge, no other regulator is developing or even contemplating such a system.

State mortgage regulators began discussing ways to bring more accountability and uniformity into state mortgage licensing beginning in 2003 and 2004. In January 2005 regulators began meeting on a monthly basis to create uniform license applications and began actual development of the national licensing system.

This national licensing system will also provide consumer access to a central repository of licensing and publicly adjudicated enforcement actions. This will allow homebuyers a central place to check on the license status of the mortgage broker or lender they wish to do business with, as well as a way to determine whether a state has taken enforcement action against that company or individual.

In June 2006, CSBS contracted with the National Association of Securities Dealers, Inc. (NASD) to develop this system. The NASD developed and now operates two national systems in conjunction with or for state regulators: the securities industry Central Registration Depository (CRD) ® and the financial planning and investment advisor industry Investment Adviser Registration Depository (IARD) ® system. The NASD brings significant expertise in developing and operating national licensing systems that are subject to state regulations.

The national licensing system will contain licensing information, enforcement actions, and background data for every state-licensed mortgage broker, mortgage lender, control person, branch location, and loan originator. The system will also assign a unique identifier to each company, branch, and mortgage professional that will help mitigate the frequent migration that occurs by professionals who hide by going from one company, jurisdiction, or industry to another.

Each state will continue to retain its authority to license and supervise, but the new system will eliminate unnecessary duplication and implement consistent standards and requirements across state lines. Additionally, the state agencies will be able to divert valuable resources previously used for processing applications to more supervision and enforcement.

The system will provide immediate and profound benefits to consumers, the industry, and the state supervisory agencies. Consumers will have access to key information about the providers that they trust with the most important financial transactions of their lives. Honest mortgage bankers and brokers will benefit from the creation of a system that drives out fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications. Everyone benefits from a system that makes it easier to identify and punish the small percentage of dishonest operators in the mortgage industry.

Uniform Standards for Testing and Education

Another major initiative where states are leading is in the development of education and testing requirements for mortgage professionals. CSBS and AARMR are spearheading a cooperative project of state regulatory agencies called the Mortgage Industry National Uniform Testing and Educations Standards (MINUTES). This initiative, begun early this year, will establish acceptable uniform standards and streamline the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers are held to the same standards and expectations, regardless of the state in which they make loans. To my knowledge, no federal regulatory agency currently requires specific educational or testing standards for the mortgage professionals it supervises.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

CSBS and AARMR also partnered together to develop guidance on nontraditional mortgage product risks. In October 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) issued final Interagency Guidance on Nontraditional Mortgage Product Risks. The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance is important and useful, but did not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance. Both CSBS and AARMR strongly support the purpose of the interagency guidance and are committed to promoting uniform application of its underwriting standards and consumer protection provisions for all borrowers. In order to maintain regulatory consistency, the guidance developed by CSBS and AARMR substantially mirrors the interagency guidance, except for the deletion of sections not applicable to non-depository institutions.

Released on November 14, 2006, the CSBS-AARMR guidance has been offered to state regulators to apply to their licensed residential mortgage brokers and lenders. The CSBS-AARMR guidance is intended to hold state-licensed mortgage providers to effectively the same standards as developed by the federal regulators.

As of today, March 22, 2007, 29 states plus the District of Columbia have adopted the guidelines developed by CSBS and AARMR. Ultimately, CSBS expects all 50 states to adopt the guidance in some form.[3] Once adopted by all 50 states, all residential mortgage lenders and brokers will be held to the same consumer protection and underwriting standards.

Proposed Interagency Statement on Subprime Mortgage Lending

CSBS and AARMR have also offered our strong endorsement of the recently proposed interagency Statement on Subprime Mortgage Lending. In conjunction with the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks and the parallel CSBS-AARMR guidance, the proposed statement offers sound underwriting and consumer protection principles that institutions and all residential mortgage providers should consider when making residential mortgage loans. CSBS and AARMR are already

[3] To track state adoption of the CSBS-AARMR guidance, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase State Implementation.htm.

working to develop a parallel statement for state supervisors to use with state-supervised entities. Again, we expect that all 50 states will adopt the statement on subprime lending, providing state agencies with an additional supervisory tool to protect consumers, ensure sound underwriting standards, and hopefully decrease the number of foreclosures nationwide.

CSBS believes the Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortgage Lending strike a fair balance between encouraging growth and free market innovation and draconian, stern restrictions.

State Predatory Lending Laws

Currently, 36 states plus the District of Columbia[4] have enacted predatory lending laws. First adopted by North Carolina in 1999, these state laws supplement the federal protections of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The innovative actions taken by state legislatures have prompted significant changes in industry practices, as the largest multi-state lenders have adjusted their practices to comply with the strongest state laws. All too often, however, we are frustrated in our efforts to protect consumers by the preemption of state consumer protection laws by federal statutes. Preemption must be used for the benefit of both business and consumers.

State Enforcement of Consumer Protection Laws

In addition to the extensive regulatory and legislative efforts, states attorneys general and state regulators have cooperatively pursued unfair and deceptive practices in

[4] Source: National Conference of State Legislatures.

the mortgage market. Through settlements with Household, Ameriquest, and First Alliance Mortgage alone, state regulators have returned nearly one billion dollars to consumers. These landmark settlements further contributed to changes in industry lending practices.

But successes are sometimes better measured by actions that never reach the press. States regularly exercise their authority to routinely examine mortgage companies for compliance not only with state law, but with federal law as well. These examinations are an integral part of a balanced regulatory system. Unheralded in their everyday routine, examinations identify weaknesses that, if undetected, might be devastating to the company and its customers. State examinations act as a check on financial problems, misapplication of consumer protections, and sales practices gone astray. Examinations can also serve as an early warning system of a financial institution conducting misleading, predatory or fraudulent practices. I have attached as Exhibit B, a chart of enforcement actions taken by state regulatory agencies against mortgage providers. As an example, in 2006, states took 3,694 enforcement actions against mortgage lenders and brokers.

Proposals for Fixing the Residential Mortgage Market

The ongoing upheaval in the residential mortgage market has caused justifiable concerns among policymakers, regulators, investors, members of industry, and consumers. There is an overwhelming outcry for the regulators and Congress to "do something" to address the damage that the subprime market trauma is doing to borrowers, present and prospective, and to the economy as a whole. On the basis of five years' worth of recent experience regulating mortgage brokers and non-bank mortgage lenders, I have a few suggestions.

Cleaning Up the Mess

In addressing the damage to borrowers, we should consider a triage approach with the majority of staff time and energy devoted to treating those consumers for whom the treatment can preserve their home.

The same concepts should be applied to mortgage rescue. Borrowers with adequate remaining home equity, income to support a reasonable mortgage and credit capacity (generally, the so-called "alt-A" borrowers) can and should be refinanced through the operation of the market. Individuals who recently borrowed money in no-money-down loans without the income to support a fully-indexed mortgage debt are in unsustainable homeownership. Without a massive government bail-out, these mortgage loans will likely result in foreclosure. For those borrowers between the two extremes, rescue may be possible, but the form and effectiveness will depend on the individual circumstances of the borrowers. I would respectfully suggest that state government agencies and not-for-profit organizations are best positioned to develop and determine proper rescue techniques to provide relief to hard-working homeowners that have a reasonable likelihood of sustaining homeownership. Under any circumstances, I strongly encourage Congress to avoid using taxpayer funds to bail out the subprime lenders, brokers and investors that generated our current problem. The mortgage market is strong, complex, and vibrant and will be so even if many of the large subprime lenders suffer financial losses.

In addition to rescue efforts regarding borrowers, state and federal enforcement actions regarding mortgage fraud and predatory lending will continue.

Preventing a Recurrence

While I am sure it is tempting to address the prevention of future problems in the mortgage market by the appointment of one "super regulator," such temptation should be resisted. The current participants in the market include banks and other depository institutions regulated by state and federal agencies, mortgage bankers and brokers who are generally regulated by the states, securities firms, and GSE's (Fannie Mae, Freddie Mac and the Home Loan Banks), and hedge funds. Preempting or subordinating the current regulators will take years and could remove from the marketplace regulatory bodies who are active and who can be part of a long term solution. In my view, changing a few rules governing the market place and coordinating the application of currently available resources is the quickest, cheapest and most effective way to improve the market's health and prospects. A few specific suggestions in that regard are set forth below.

First, Congress should update the federal predatory lending law to incorporate the time-tested consumer protections implemented by the various states over the last decade, as embodied by legislation proposed last session in the House of Representatives by Reps. Miller, Watt and Frank. Introduced last year as H.R. 1182, the Miller-Watt-Frank bill would have created a national standard that would set sensible limits on high-cost subprime loans, while retaining the states' ability to address new abuses in the market. In addition, Congress should state clearly and unambiguously that lenders are required to consider a borrower's ability to repay a loan.

Second, we need to develop a default scheme to prevent unscrupulous subprime lenders and brokers from taking advantage of borrowers with credit problems. There is a dramatic asymmetry of knowledge, sophistication and bargaining power between borrowers and mortgage providers. Further, recent work in behavioral economics suggests that when confronted with information overload, bad choices often result. Congress should require that the default loan to a subprime borrower should be a thirty-year fixed rate loan that most consumers understand. Any other choice of subprime loan should depend on the borrower taking affirmative action to opt out of the default loan and receiving in-person independent counseling on the benefits of the transaction. Subprime lending should be a bridge to create sustainable homeownership, not a detour into a second-class, high-priced mortgage system.

Third, Congress should support the coordination of the supervision of non-bank mortgage brokers and lenders by the states. CSBS and AARMR have, in partnership with the NASD, organized a coordinated national system to license and track the activities of these enterprises. Through working on the development of the system, states and a number of industry representatives have begun a dialog that will lead to broadly consistent national standards with regard to licensing of firms and individuals. Congress can promote this system through funding the start-up of the system and by requiring states that do not wish to join the system to affirmatively opt-out of the system. Given the same kind of Congressional "encouragement" that the insurance regulatory community got in Gramm-Leach-Bliley, this system can be a valuable resource in regulating the market in the future.

Fourth, Congress already has tools at its disposal to facilitate the flow of credit to responsible subprime lending. Congress should take immediate steps to modernize FHA to enable it to be a viable option for homeownership by borrowers with credit blemishes. Much of the growth of the subprime industry came at the expense of FHA. Clearly, Congressional concerns over the solvency of the FHA insurance fund led it to overreact and hamstrung the FHA from serving the subprime market.

In addition, Congress should encourage the GSE's to devote their primary attention to affordable housing for all Americans, particularly the subprime market. The GSEs have done wonders to increase the liquidity in the conventional mortgage market. In addition to their potential direct impact in the subprime market, the standards set by the GSEs for loans they purchase have an impact that ripples through the marketplace.

Conclusion

Ultimately, there is a trade-off between increasing the availability of credit in the mortgage market and the level of foreclosures. CSBS is concerned by this trade-off. My fellow state supervisors and I are finely tuned to the needs of the communities we serve. Like members of Congress, state supervisors are not only concerned with national trends, but with the overall economic health of our local communities. Even a relatively small number of foreclosures can be devastating to a small town.

As regulators, we must find a balance between encouraging market innovation, product choice and credit availability with consumer protection. The states will continue to improve supervision of the mortgage industry by strengthening state statutes, signing on to the CSBS-AARMR mortgage licensing system, or adopting parallel guidance for our regulated entities. Only by continuing this type of coordinated supervision on a nationwide level, can we both protect consumers and support financial services providers.

The evolution of the residential mortgage marketplace over the past two decades has dramatically affected how we supervise the industry. Innovations in the mortgage market are positive developments, but have also allowed for an increase in predatory lending and fraudulent lending practices, which have contributed to increased foreclosure rates and the turmoil we are now experiencing. As a state financial regulator, my job is first and foremost to protect the consumers of North Carolina. But I must also allow the financial service providers the opportunity to compete and flourish in the marketplace in a safe and sound manner.

My fellow state supervisors and I will continue to improve our supervision of the residential mortgage industry to improve the quality of credit available to consumers, improve standards for loan providers, ensure consumer protection provisions, and punish those who engage in predatory or abusive practices. The economy is not benefited by putting consumers in homes they cannot afford. Instead, we are working towards a marketplace with cooperative and seamless supervision that ultimately benefits both consumers and providers.

Thank you again for your invitation to come here today and for this Committee's interest in improving our mortgage market system.

Exhibit A: Examples of Actions Taken by Individual States

In addition to the cooperative efforts of state regulators through CSBS and AARMR, I have detailed a small sampling of state regulator actions in the mortgage arena. There are similarities and differences in the initiatives undertaken by the states. I believe this differentiation is a sign of health in state supervision. State regulators with a deep knowledge and understanding of local circumstances are free to tailor their supervisory framework to the unique conditions in their state.

Arizona

In January, the Arizona Department of Financial Institutions (DFI) issued the parallel Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR.

The DFI has led other state and federal regulators to form a mortgage fraud task force. The task force, created by Superintendent of Financial Institutions Felecia Rotellini, consists of the Arizona DFI, the Arizona Department of Real Estate, the Arizona Housing Department, the Federal Bureau of Investigation, the Department of Housing and Urban Development, the Internal Revenue Service, the Arizona State Board of Appraisers, and local law enforcement. The task force was formed to pool agency resources, to share expertise and to more effectively investigate and prosecute, both civilly and criminally, individuals engaging in mortgage fraud.

In January 2007, legislation was introduced in the Arizona legislature that would require all loan officers and originators be licensed. This legislation would also define mortgage fraud as a felony, punishable up to 10 years in prison.

The DFI has been investigating mortgage fraud and illegal lending practices since 2005. In January 2006, Superintendent Rotellini created the Regulatory Enforcement Unit to assist state examiners with their increased caseload and increased enforcement actions. Also during 2006, the DFI hired two field investigators to conduct interviews and focus on the illegal practices in the residential mortgage industry. In the past three months, the DFI has been inundated with complaints, tips, and information about predatory practices, mortgage fraud, and foreclosure rescue schemes. The DFI has been working closely with state and federal law enforcement, the professional associations that represent the mortgage and real estate industries, and journalists to heighten consumer and industry awareness, to weed out the worst actors, and to send a message that industry will be held accountable for predatory or abusive lending practices.

California

The California Department of Real Estate (DRE) licenses and regulates the activities of real estate salespersons and brokers. In order to engage in licensed activity, a salesperson must be employed and supervised by a broker. Licensed activity includes, among other things, the listing and sale of real property, property management and mortgage brokering.

At the end of fiscal year 05/06, there were 137,410 license real estate brokers and 366,734 salespersons for a total licensee population of 504,144. Licenses are generally valid for four years.

In order to become licensed as a real estate broker or salesperson in California, an individual must have completed certain pre-license educational requirements, and in most cases experience requirements for broker applicants, as well as pass a written examination.

All applicants are fingerprinted and background reports are received from both the California Department of Justice and the Federal Bureau of Investigation. Once an individual is licensed, the California Department of Justice also provides subsequent arrest notices to the DRE should one occur. Real estate licenses are issued for a period of 4 years and there are continuing education requirements which must be met for all renewals. Unless working for an exempt institution, all individuals who negotiate loans in California must be licensed as either a real estate broker or as a properly licensed salesperson who works under the supervision of a real estate broker.

The DRE has the authority to issue and discipline real estate licenses. Discipline can range from a Public Reproval, suspension, or revocation of a license. The DRE has limited authority to fine and cannot criminally prosecute cases. However, referrals to criminal enforcement agencies are made when appropriate. Less substantial violations are addressed with a corrective action letter and these are not counted in the enforcement action statistic totals.

In the area of enforcement, it should be noted that California does have a predatory lending law, which is contained in Section 4970 et seq of the Financial Code. The three licensing agencies over mortgage lending in California, the DRE, the Department of Corporations (DOC), and the Department of Financial Institutions (DFI) are jointly responsible for enforcing this law within their respective jurisdictions.

As an additional note, the DRE is in the process of adopting regulations to adopt the CSBS-AARMR Guidance on Nontraditional Mortgage Products, which mirrors the interagency guidelines.

Real estate licensees have fiduciary duties to both the lender and borrower when negotiating loans and can be disciplined for violations of the Real Estate Law. Violations include making a misrepresentation, fraud, dishonest dealing, negligence, and criminal convictions. Failing to disclose all material facts about a loan to a borrower or misrepresenting the facts to a lender (such as knowingly misstating a borrower's income) are actionable offenses. A mortgage broker has an obligation to act in the best interest of the borrower.

Although the DRE does random audits, a majority of the audits are in response to complaints filed with the DRE. The 252 audits of mortgage brokers represent 38% of the total audits, even though mortgage brokers represent less than 15% of the licensee population. Of these 252 audits, 186 uncovered potentially actionable violations. Those violations not deemed sufficient to warrant formal disciplinary actions result in a compliance action letter. The most common violations found in the audits involved the failure to provide the proper Mortgage Loan Disclosure Statement. The second most cited violation in the audits involved lack of supervision and improper record keeping. Thirteen of the audits found trust fund shortages, totaling $295,394.

Of the 149 total disciplinary actions based on mortgage loan broker violations, the most common violation cited was failing to provide a borrower with the proper Mortgage Loan Disclosure Statement (29). As noted above, 23 actions were based, in part, on the mortgage broker making a substantial misrepresentation to the borrower. And 17 actions were based, in part, on the broker making a misrepresentation to the lender.

It is worth noting that nearly all the actions were initiated by a consumer complaint. Misrepresentations are difficult to prove without a complainant. And unless patently obvious, misrepresentations are difficult to discover in a random routine audit or examination of records.

Since loans can be made or arranged under a real estate broker license as well as a DOC issued Residential Mortgage Lender license (RML) and a California Finance Lender license (CFL), the DRE and DOC have a Memorandum of Understanding (MOU) to cross check license applicants and disciplinary actions. This arrangement prevents a mortgage loan broker who has been disciplined by one department from obtaining a license from the other to continue operating. Last fiscal year, the Departments crossed checked over 6,000 applicants.

In addition, to lessen the burden on consumers, the DRE proactively refers complaints to the DOC when it is determined the activity was conducted under a DOC issued license and not a DRE issued broker license. Last fiscal year, the DRE referred 75 complaints to the DOC.

As noted earlier, the DRE is an administrative agency and does not have the authority to prosecute criminal or civil violations. Such violations may be pursued by local municipalities or the Attorney General (AG). Existing law allows a district attorney or the AG to bring civil actions for unfair business practices and misleading advertising.

The DRE routinely makes referrals to local law enforcement and provides technical assistance when appropriate. Last Fiscal Year, the DRE either referred or provided assistance on over 35 criminal cases. Many of the criminal referrals involved loan fraud.

Los Angeles County has also established a Real Estate Fraud Task Force of which DRE is a member. The task force meets once a month and participants include LAPD, LA Sheriff, HUD, IRS, FBI, and the Departments of Corporations and Consumer Affairs.

With respect to broker education, the DRE has already begun a series of efforts to further ensure brokers fully understand their responsibilities to inform borrowers of the relative merits and risks of nontraditional mortgages. The DRE has recently published an article explaining that brokers have a duty to fully explain to a borrower the merits and risks of alternative mortgage programs before the point of document signing. The article also makes the point that real estate brokers have a fiduciary duty to the borrower and as such, must act in the best interest of the borrower.

With respect to marketing and advertising, existing law requires that real estate brokers disclose all material facts about a product in the ad or materials used to solicit borrowers. Any promotion of a nontraditional mortgage must include the material facts of the product so the ad or promotional material is not misleading. This would include disclosures of the possibility of negative amortization, frequency of payment or rate adjustments, and the amount of the balloon payment if the program is not fully amortized. This is also true of any verbal discussion a broker has with a borrower.

The DRE has also made an extensive effort to educate borrowers so they may make informed decisions. In this regard, the premier publication of the DRE is the consumer booklet on "Using the Services of a Mortgage Broker". This booklet educates a borrower on what questions to ask to ensure an understanding of the loan terms, especially the terms related to nontraditional mortgages. This booklet was first produced over 15 years ago and is updated periodically. The department is currently in the process of updating the booklet again so it more accurately reflects the information in the guidance.

Massachusetts

In the Commonwealth of Massachusetts, mortgage supervision has been the primary focus of the Division of Banks for well over a year.

In 2006 alone, the Massachusetts Division of Banks issued a total of 104 formal and informal enforcement actions against mortgage lenders and brokers. Included in these actions were several cease and desist orders essentially shuttering companies found to be intentionally overstating income on reduced documentation loans or engaging in other types of deceptive practices. In September 2006, the Division issued an industry letter relative to reduced documentation loans indicating that severe action will be taken should evidence of mortgage fraud be found and implemented emergency amendments to their regulations governing mortgage lenders and brokers, significantly expanding the number of existing prohibited acts and practices that constitute grounds for the issuance of cease and desist orders and license suspension or revocation.

Massachusetts was one of the first to adopt the parallel guidance on nontraditional mortgage product risks, developed by CSBS and AARMR, in the form of a regulatory bulletin. This action is essential toward ensuring a level playing field is maintained within the mortgage market and that the consumer protections within the guidance are enforced uniformly.

Finally, in an effort to develop a comprehensive strategy to address increasing foreclosure rates, the Division of Banks hosted a Mortgage Summit in November 2006. Nearly 50 individuals representing 29 government, industry, and nonprofit organizations attended the Mortgage Summit with the stated goal of seeking to address the increasing number of mortgage foreclosures across Massachusetts and to develop a statewide foreclosure prevention strategy that will put into place lasting measures to help consumers confronted with the loss of their homes.

Following the Summit, two Working Groups were established to focus on Rules and Enforcement and Consumer Education and Foreclosure Assistance. The goal of the Working Groups is to take the ideas and suggestions from the Summit and develop specific recommendations. Since January, the Working Groups have met every two weeks and set a deadline of March 31 to conclude their deliberations.

The new legislative session is also underway. Several bills dealing with mortgage foreclosures have already been introduced, including provisions which would require loan originators to be licensed and extend the Massachusetts Community Reinvestment Act to licensed mortgage lenders.

Minnesota

In December 2006, the Minnesota Department of Commerce issued the Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR to all state-licensed entities.

The Department's 2005 legislation, which became effective on January 1, 2006, requires licensed residential mortgage originators to conduct background checks on loan officers and prohibits a person convicted of a financial crime from serving as a loan officer without prior written consent of the Commissioner of the Department of Commerce. These requirements are very similar to Section 19 of the FDI Act.

A Department proposal presently under consideration by the Minnesota state legislature would improve and strengthen regulation of mortgage originators. The proposal, if enacted, would require the following:

1. That all licensees be a business entity with a minimum tangible net worth of $250,000 (or a surety bond or letter of credit of $100,000);

2. Require an affirmation that they are in compliance with the background check requirement;
3. Require maintenance of a perpetual roster of loan officers that would be provided to the Department on demand;
4. Require loan officers to have 16 hours of education on state and federal mortgage laws before serving;
5. Give the Department of Commerce the authority to examine licensees and charge for these exams; and
6. Make mortgage fraud a specific crime in Minnesota, which is based upon a recent law passed in Georgia.

This proposal is expected to be enacted.

The Department of Commerce has recently halted a kickback scheme and imposed enforcement penalties of more than $1 million on title insurance companies that set up sham affiliated businesses with real estate agents, mortgage originators and developers to get around state and federal laws prohibiting direct payments for referrals. The Department identified 35 affiliated business arrangements between First American and more than 600 referral partners that included real estate agents and brokers, mortgage originators, building contractors, land developers, and others.

North Carolina

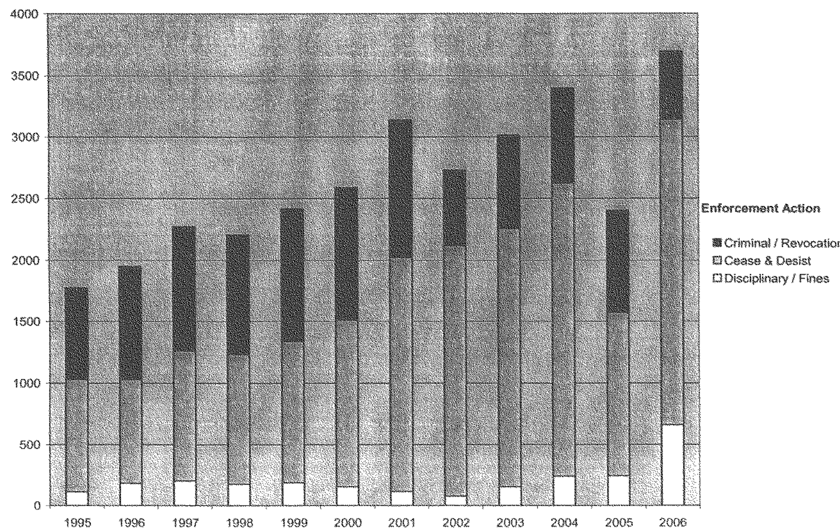
Earlier this month, the North Carolina Office of the Commissioner of Banks (NCCOB) issued Guidance on Nontraditional Mortgage Product Risks (NTM guidance) developed by CSBS and AARMR. The North Carolina NTM guidance included a specific discussion of how the NTM guidance fit within the state regulatory scheme, its application to mortgage brokers and mortgage lenders in their different roles, and provided examination procedures used by state examiners to ensure compliance.

This year, NCCOB has supported the introduction of two bills to the General Assembly to improve the mortgage market. The first bill would make mortgage fraud a felony under state law and would simplify prosecution of mortgage fraud at the state level. This legislation is modeled after the Georgia mortgage fraud law, the first of its kind. The second bill would require that all deeds of trust secured by residential property identify the name and license number of a mortgage broker, if one was involved in the transaction. This legislation is the result of a state legislative study commission on foreclosures that has met regularly over the past year.

In addition to the legislative effort on mortgage fraud, NCCOB has hired three additional staff to pursue evidence of mortgage fraud. We have trained all of our mortgage examiners on mortgage fraud (through AARMR training) and have prioritized detecting fraud in our examination process.

NCCOB has supported the development of improved standards in the mortgage brokerage business, through the encouragement of an industry-led certification program for mortgage broker firms.

Exhibit B: Enforcement Actions by State Regulatory Agencies against Mortgage Providers



Source: Mortgage Asset Research Institute

Written Statement of Alan M. White on behalf of Jennie Haliburton
Community Legal Services, Inc., Philadelphia

March 22, 2007

Thank you for giving Ms. Jennie Haliburton the opportunity to testify about her experiences as a subprime mortgage borrower. I would like to provide some additional information about the details of her loan transactions, her experiences and those of many other homeowners like her in Philadelphia. Subprime foreclosures have been hurting low-income Philadelphia homeowners and neighborhoods for ten years. Now that the pain has spread to more affluent homeowners and investors on Wall Street, the problem is in the news.

Ms. Haliburton has a 2/28 subprime ARM from Countrywide, made in April 2006. Her loan application included full documentation of her $1,766 monthly Social Security income. On that basis, Countrywide gave her a loan with an initial payment of $922.24 for principal and interest. Countrywide did not establish an escrow for taxes and insurance, which are about $180 monthly. However, after the first year of the loan, Countrywide notified Ms. Haliburton that they will increase her payment to include past and future taxes and insurance as of May 2007. She will therefore have a payment increase even before her interest adjusts.

Her initial payment is based on a discounted interest rate of 9.625%. The fully indexed rate is LIBOR plus 6.5%, which today equals 11.9%. The payment and rate will adjust in May 2008, when her monthly payment, with taxes and insurance, will be nearly $1300, which is more than 70% of her income. These facts were fully known to Countrywide, but not understood by, or explained to, Ms. Haliburton.

Countrywide refinanced a 2004 Ameriquest loan. That loan had a fixed rate of 8.7%. Copies of both Notes, and the Countrywide application, are attached.

This was not a credit repair product. Ms. Haliburton's income and property value will not increase fast enough to permit her to refinance. Her loan has a prepayment penalty that lasts for two years, until the adjustable rate feature is triggered. Ms. Haliburton is not in foreclosure yet; she has made her mortgage payment her first priority, but it is only a matter of time.

I have contacted Countrywide's loss mitigation staff and have not yet received a response. They now have two choices. They may decide to foreclose on this home, and perhaps they can recover the full $108,000 after evicting Ms. Haliburton. Or they can write down the loan amount so that she can either afford her payments, or get a reverse mortgage.

Because of Ms. Haliburton's age, income and equity, a reverse mortgage would have been a much more suitable product, and could have been recommended to her in either 2004 or 2006 when she contacted Ameriquest and Countrywide. A reverse mortgage would allow her to pay off her prior debts and have no current payment obligations, allowing her to use her Social Security for home repairs and maintenance and living expenses.

Before subprime lending came along, the same homeowners had plenty of access to credit. They bought homes with FHA and VA loans. If Mr. and Mrs. Haliburton had bought their house in 1987 instead of 1997 they would have had an FHA mortgage. Philadelphia homeowners paid for repairs with small loans from finance companies.

In the last ten years, a real estate broker seeing a low-income buyer has had a choice. Refer them for an FHA mortgage, where the property will be inspected, the loan carefully underwritten, and the process will take several months, and some applicants actually get turned down. Or, the broker could refer the buyer to a subprime lender or broker, where approval is quick and easy. The price is higher, but so what? Bad underwriting and loan products have pushed out good underwriting and loan products. This is not a reason to make FHA more like subprime; the point is to restore common sense underwriting to all mortgage sectors.

Subprime loans are not a bridge to credit repair, they are a road to foreclosure. In Philadelphia county, 40% of all subprime loans made in 1998, 1999 and 2000 were in foreclosure by the end of 2003, according to the Pennsylvania Banking Department's foreclosure study. Ms. Haliburton doesn't need more access to $100,000 mortgages. She needed suitable credit products she can afford, and now she needs Countrywide to do the right thing and write down her loan balance.

ACORN
Financial Justice Center

Background

Al Ynigues, age 65, lives in Apple Valley, MN, a suburb of Minneapolis. Mr. Ynigues teaches music lessons, runs a recording studio, and repairs instruments. He grosses approximately $2,300 to $3,000 a month.

In September 2004 Mr. Ynigues purchased a home with an 80/20 deal: a first mortgage with a 2/28 ARM to cover 80% of the home's price and a second mortgage for 20% of the price instead of a downpayment. Both were subprime loans from New Century Mortgage.

Mr. Ynigues asked for a fixed rate loan, but was told shortly before closing that he would have an Adjustable Rate Mortgage (ARM). He did not understand what this meant, so the broker explained to him that an ARM could "go up a little" after a couple of years, but that he wouldn't have to worry about that, because they would refinance his loan into an even lower, fixed rate within the first six months. They did not tell him that if he refinanced during the first two years of the loan he would have to pay a prepayment penalty of over $4,000.

Mr. Ynigues remembers at the closing there were scores of papers to be signed, and that the title agent did not give him enough time to read the loan documents- they just flipped through the pages quickly and told him where to sign.

Loan Terms

The first mortgage was for $211,520 and included $8,199 in closing costs. In addition, the broker received a yield spread premium of $4,230.

The loan is a 2-year ARM with an initial interest rate of 6.9% and a maximum possible rate of 13.9%. The interest rate is based on the LIBOR rate plus a margin of 5.5%. At the time of the loan in September 2004, the LIBOR rate was 2.1%, but in October 2006 it was 5.3898%, making his fully indexed rate almost 11%.

On November 1, 2006 the rate changed for the first time. There is a cap that the rate can only go up 1.5% at each change date, so his rate went up to 8.4% and his payment increased from $1660 to $1868. The rate will go up again on May 1, 2007 to 9.9% and the payment will go to $2,135.

The second loan was for $52,000 and has a 9.3% interest rate and a monthly payment of $430.

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Statement of Laurent Bossard

Chief Executive Officer

WMC Mortgage Company

United States Senate

Committee on Banking,

Housing, and Urban Affairs

March 22, 2006

Statement of Laurent Bossard
CEO WMC Mortgage Company
United States Senate
Committee on Banking, Housing, and Urban Affairs
March 22, 2006

Good morning [afternoon]. Chairman Dodd, Ranking Member Shelby, and other members of the committee, thank you for the opportunity to address you today on this important issue. My name is Laurent Bossard, CEO of WMC Mortgage.

I am pleased to be here today to participate in the Committee's effort to gain a better understanding of the economic and industry conditions affecting the market, and to learn from them. Like members of this committee, we believe that a vibrant and responsible industry plays an important role in consumers' ability to access credit for home ownership.

As you may know, WMC is a wholly owned subsidiary of GE Money, the consumer lending division of the General Electric Company. WMC was a company that originated non-prime mortgages and sold them in the capital markets to a variety of institutions including investment and commercial banks. WMC was acquired by GE Money in June 2004.

Along with the members of this committee, we are concerned about the impact of recent market developments. These changes affect both consumers and lenders.

WMC has been responding to these changes in a number of ways. First, we have made changes to our own business. I joined WMC in November 2006 as president and was named CEO in January. We are restructuring WMC in order to adapt its operations to the evolving market environment. In addition, GE Money made the decision post-acquisition to place WMC's mortgage operations under federal regulation. This was accomplished by bringing the mortgage business under GE Money's Federal Savings Bank. This process was completed on January 1, 2007.

Over the last twelve months, we have made improvements to our underwriting processes. WMC adheres to the Federal Interagency Guidance on Nontraditional Mortgage Products. In addition, we support the federal bank regulators' Proposed Statement on Subprime Mortgage Lending, and are implementing their recommendations. For example:

- Borrowers will be qualified using the fully indexed rate.
- Second, on new loans, prepayment penalties will expire 60 days prior to the first interest-rate reset date. This provides borrowers with enhanced flexibility to avoid prepayment fees.
- Third, WMC will not make loans based on stated income, except in the case of borrowers who are self-employed, and then only with appropriate verification.

Beyond what has been proposed in the guidance, WMC will continue its historic policy to not offer any option ARMs or products with negative amortization. And going forward, we will begin to hold a portion of this loan portfolio on our own books. This will allow us to better work with borrowers and other industry participants to help keep homeowners in their homes.

These changes help us meet our goal of providing consumers with access to fair and competitively priced mortgage products, with clear and understandable terms, and to keep them in the homes they purchase.

We are here today to contribute to a discussion that leads to a better understanding of the current market conditions. We also want to emphasize our desire to work with you and our regulators on solutions. To this end, we would support standards to govern the conduct of all participants in the mortgage process.

In closing, I would like to thank the committee for the opportunity to share our views with you today. We look forward to working with you and our regulators. We want to play a responsible role in providing consumers with products that meet their needs, allow them to live in their own homes, and invest in their future.

Thank you very much.

TESTIMONY OF

SANDOR SAMUELS

Executive Managing Director

COUNTRYWIDE FINANCIAL CORPORATION

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

March 22, 2007

Introduction

Good morning Chairman Dodd, Ranking Member Shelby, and members of the Senate Banking Committee. I am Sandy Samuels, Executive Managing Director at Countrywide Financial Corporation. Countrywide is predominantly a prime lender that offers the widest array of products available in the market place. While the subprime market represents over 20% of the overall U.S. mortgage market, it constitutes only 7% of Countrywide's loan volume. Founded in 1969 on the principle of lowering costs and barriers to homeownership, Countrywide is the largest mortgage provider in the country and the leading lender to low- and moderate-income and minority families. Offering subprime products was a natural extension of this commitment. Regardless of what channel a customer uses to come to Countrywide, every qualified borrower has access to our full range of both prime and subprime products. This paradigm gives us a unique perspective on subprime lending.

Rising delinquencies and foreclosures in the subprime market have created tremendous concern about the state of the mortgage and housing markets. I want to share with you our perspective on the importance of subprime mortgage lending in the overall housing market, our insight into why subprime delinquencies and foreclosures are increasing and our views on the recent proposed regulatory guidance covering subprime loans.

Importance of Subprime Lending

For a quarter century, from 1970 to 1994, the nation's homeownership rate remained stuck at 64%. For the most part, borrowers either met FHA, VA or GSE prime market standards, or were served by the so-called hard money lenders. In the mid-1990s, the development of a subprime secondary market made it viable for mainstream mortgage lenders like Countrywide to offer subprime programs that paralleled the prime market. Over the next decade, the combination of low interest rates and prime and subprime product innovations helped boost the homeownership rate to 69%. In 2006 alone, first time homebuyers comprised almost 40% of Countrywide's purchase originations, and 25% of those borrowers were able to buy a home because of available subprime products. Without having subprime products to meet their needs, this recent homeownership expansion would not have been as robust.

What Happened in the Market the Past Two Years?

A convergence of factors explains the growth in the subprime market and current circumstances. In the past few years, housing appreciation increased at rates far exceeding income growth causing housing affordability issues. Lenders responded by expanding underwriting guidelines to allow borrowers to qualify for loans on increasingly more expensive homes. By 2004, as interest rates began to increase from their 50 year lows and the refinance boom began to slow, there was significant overcapacity in the mortgage originations market. Competition for declining volumes was exacerbated by the cooling of the housing market in 2005 and 2006. This resulted in further expansion of credit guidelines as lenders vied to retain volumes and increase market share. At the same time, this entire period was marked by significant liquidity in the global capital markets creating an increasing demand for mortgage assets. All of these factors together contributed to the dramatic liberalization of underwriting guidelines.

So long as home prices continued to rise, there were very few market forces to counter the push toward credit liberalization. Things started to change in 2006 as appreciation began to flatten and many markets began to see home price declines. In the absence of appreciation, delinquencies have begun to increase dramatically. In response to declining home prices and increasing delinquencies, in the last several months, the market has begun to self-correct. Countrywide and the industry have made significant changes to materially tighten credit guidelines, reversing much of the liberalization that occurred over the last few years.

Where Does the Subprime Market Go from Here?

First and foremost, it is important that we preserve access to credit for those who cannot qualify for prime loans. The ultimate solutions must be based on study and analysis of all relevant data about their impact on the housing market, particularly before imposing restrictions on lenders' ability to offer affordable product options. An appropriate balance must be struck between maintaining affordability and lessening payment shock. Wherever you draw the line, someone will be shut out of the market. Every effort to raise the start rate, lengthen the fixed rate period, reduce caps and lengthen reset periods will raise the price of the loan product to the consumer.

With respect to the banking agencies proposal, we cannot agree that underwriting to the fully indexed rate is the correct standard in all situations. First, such a requirement will further worsen the current situation for borrowers seeking to refinance subprime loans in a market where values have declined and underwriting standards have already tightened. Many of the homeowners who will need to refinance will not be able to qualify under such a standard. Second, we believe that many first time homebuyers who can currently purchase a home will no longer be able to qualify for a mortgage under the proposed guidelines. This could materially reduce housing demand, especially among first time homebuyers, and delay the housing recovery. We believe that the guidance should preserve the significant affordability benefits of products that reduce payments in the early years of the mortgage in order to lower the first rung of the homeownership ladder, or help borrowers address short term financial objectives.

We do not believe that the hybrid ARM product structures are to blame for the current problems in the subprime market. In fact, our experience with hybrid ARMs demonstrates that these products have provided a critical bridge for our customers reducing costs for homeowners experiencing temporary financial challenges.

We reviewed our hybrid ARMs originated between 2000 and 2006, and tracked those who refinanced their loans with Countrywide to determine what kind of loan they received. We found that:

- Historically, 80% of our subprime borrowers refinance within 36 months of loan origination. Interestingly, this number is approximately the same for both our fixed rate and our hybrid customers.
- For these subprime refinances, of those borrowers that stayed with Countrywide, 50% received a prime loan and 25% refinanced into a subprime fixed rate loan. The borrowers moving to prime loans improved their FICO scores by an average of almost 50 points and benefited from lower interest rates on their new loans, sometimes significantly.
- However, the remaining 25% of borrowers refinancing out of a subprime ARM did refinance into a new subprime ARM and we need to be cautious before we take any actions that would eliminate that option.

- Over this time period, we have seen the proportion of hybrid ARMs used for home purchases gradually increase. In the fourth quarter of 2006, almost half of our subprime hybrid loans funded home purchases, with 70% of those going to first time home buyers.

Our experience suggests that these loans are a valuable tool for our customers to afford a first home or as a bridge to overcome temporary financial setbacks. In the past 10 years, Countrywide has originated over $100 billion in subprime hybrid ARM loans. Over that period, cumulatively we have had only 3.4% of these loans go through foreclosure. The worst single origination year was 2000, for which the cumulative foreclosure rate was 9.89%. We believe that declining home prices and the other factors I've discussed may produce foreclosures numbers on 2006 originations approaching or exceeding those on loans originated in 2000. But even if this were to come true, we cannot lose sight of the reality that more than 90% of Countrywide's subprime borrowers will not lose their homes to foreclosure and will have had the opportunity to enjoy the benefits of homeownership as a result of the availability of these products.

And for our borrowers that experience difficulties making timely payments, Countrywide has invested substantial financial and human resources to our ongoing home preservation program to help them get back on track. We have been successful in helping many homeowners preserve their homes so long as (1) the borrower responds to our communications; (2) the borrower wants to remain in the home; and (3) the borrower continues to have a source of income. In light of the difficulties many of our borrowers are currently experiencing, we have also implemented additional outreach efforts.

- We conduct aggressive loss mitigation in communities experiencing high delinquencies, sending home retention teams into the community to meet face-to-face with customers to implement workout plans.
- We provide free access to counseling, including third party counseling from community organizations like Neighborworks.
- We work with groups like ACORN to help us reach out to borrowers who are too scared to call their lender.

- We are also a founding supporter of the Homeownership Preservation Foundation, which provides 24/7 access to housing counselors through a national toll free number.

Another important concern with the proposed guidance is its limited applicability solely to federally regulated institutions. To be effective, the regulatory guidance must apply to all lenders in the market. We support the efforts of CSBS to extend the guidance to those entities not covered by the federal guidance, provided it is adopted uniformly and the application is targeted to those not already covered by the federal guidance.

We are very supportive of other parts of the agencies proposal.

- On the issue of **impound accounts**, Countrywide agrees that lenders should qualify borrowers based on the full payment of principal, interest, taxes and insurance and this has long been our practice. Currently, however, mandatory escrow accounts are not permissible in all states. Interestingly, the FHA program mandates the use of impound accounts, and we would support legislation that allowed lenders to require such accounts on all subprime loans.
- On the issue of **prepayment penalties**, Countrywide's subprime Hybrid ARM originations do not have prepayment penalties that are longer than the initial reset period. In addition, we support the agencies' proposed recommendation to provide hybrid borrowers with a window period prior to the payment reset to refinance without penalty.
- We strongly support efforts to improve the quality and readability of **disclosures** associated with hybrid ARMs. Borrowers need to understand their choices so they can determine what is best for their unique circumstances. We believe all borrowers, regardless of what lender originates the loan, should receive the same information about their transaction and we believe the regulators should amend Regulation Z to greatly enhance disclosures for these products.
- With regard to **stated income loans**, we continue to believe there is a valuable role for reduced documentation especially for those borrowers that have difficulty documenting all of their income. For example, members of immigrant populations, for a variety of reasons, may have income from sources that are not reportable on a W-2. For some borrowers, W-2s may not accurately reflect earnings because of items such as tips or the

timing of bonuses and raises. We fully recognize there is room for abuse with the use of reduced documentation and we agree with the agencies that when underwriting such loans, other mitigating factors should be present to minimize the need for direct verification of repayment capacity. This would include, for example, cash reserves, larger downpayments and higher credit scores. We also strongly support requiring a disclosure to the borrower that states there is an increased cost to stated income features and requiring the borrower to acknowledge that the amount of income being used to underwrite the loan is not overstated.

- We believe informed **consumer choice** is critically important. The guidance should encourage lenders to make multiple product options available to all borrowers so they can decide what is best for their individual circumstances. We support requiring that all subprime borrowers be offered the option of a fixed rate loan if they could qualify for one.

The prescription for helping subprime borrowers in today's market is not higher effective interest rates for qualifying borrowers. Careful consideration of the macroeconomic impacts of new laws or guidance is required so that we preserve the availability of financing options for subprime borrowers and avoid making the current subprime issues even worse.

I would like to thank the Chairman and the Ranking Member for the opportunity to share Countrywide's perspectives on the mortgage market and would be happy to answer any questions.

HSBC

The world's local bank

Testimony

Of

Brendan McDonagh

&

Tom Detelich

On behalf of

HSBC - North America

Presented to

Senate Committee on Banking, Housing, and Urban Affairs

March 22, 2007

"MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES"

Mr. Chairman and Members of the Committee:

I am Brendan McDonagh, chief executive officer for HSBC Finance Corporation and chief operating officer for HSBC - North America, a wholly owned subsidiary of HSBC Holdings plc. I am responsible for HSBC's consumer finance businesses in the United States, including our consumer and mortgage lending business.

I would like to thank you for inviting me to testify today on behalf of HSBC - North America. I will structure my remarks today around three topics:

1) An overview of HSBC Finance with a focus on our mortgage operations

2) Our perspective on issues in the mortgage market

3) How HSBC Finance is addressing these issues, both on the originations and servicing aspects of the business

An Overview of HSBC

To share with you more about our global organization – HSBC is headquartered in London and provides worldwide a range of financial services including personal financial services; commercial banking; corporate, investment banking and markets; and private banking. I work alongside 300,000 colleagues in 10,000 offices in 82 countries, serving 125 million customers worldwide.

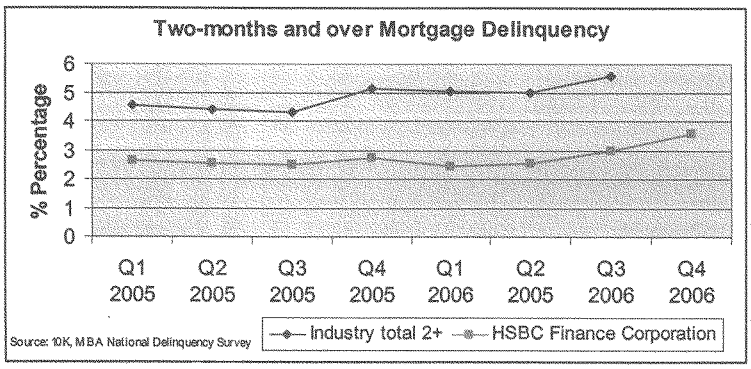
HSBC - North America is one of the ten largest banking organizations in the United States. HSBC - North America is the holding company for all of HSBC's U.S. and Canadian businesses, and our over 50,000 employees serve more than 60 million customers in the United States and Canada.

Specific to our consumer finance businesses -- these businesses operate under HSBC Finance Corporation, and serve consumers – with non-prime to prime credit characteristics -- with products including real estate secured loans, auto finance loans, MasterCard® and Visa® credit cards, and personal non-credit card loans. HSBC Finance Corporation is an SEC reporting entity.

In the area of real estate lending, HSBC Finance is a large player in the sub-prime mortgage market. HSBC Finance Corporation's consumer and mortgage lending business originates and services loans originated through retail (branch and direct) and wholesale (broker) channels, as well as portfolio acquisitions. We originate or purchase a variety of real estate secured and unsecured loans to primarily sub-prime customers. As one of the nation's largest consumer finance companies, we have more than 1,350 branches in 46 states and 11 servicing facilities across the US.

HSBC Finance has the second largest subprime servicing portfolio in the subprime industry (based off analysis of the National Mortgage News 4Q 2006 Quarterly Data Report [QDR]). Our portfolio is primarily fixed rate loans with documented income. Indeed adjustable rate loans are only 32% of HSBC Finance's subprime portfolio compared to over 70% for the industry as a whole. Stated income loans make up just 13% of the portfolio.

As a result of our origination and underwriting practices, we have seen relatively stronger credit performance compared to the industry. HSBC Finance mortgage delinquency levels are almost half of industry levels over the past two year period. The graph below depicts the percentage of mortgage loans that are two months or more past due for HSBC Finance and the subprime industry (as published in the Mortgage Bankers Association National Delinquency Survey).



Despite this more conservative makeup of HSBC Finance's mortgage portfolio, in the last year, we have faced a combination of challenges in certain portions of our portfolio. Like many of our peers in the sub-prime mortgage lending business, these challenges have been caused by a long run of rising interest rates and a slowing, and then declining, housing market. These factors have put pressure on consumers, and accordingly, on certain segments of our portfolio.

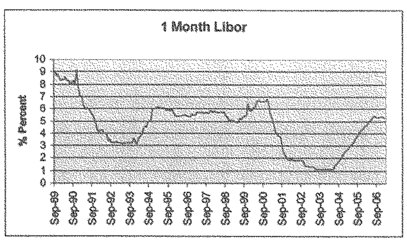
In one portion of our business, which buys loans that are already funded by other lenders, we've encountered higher than expected delinquency. These loans are primarily second lien loans, called piggy backs, because they are made in conjunction with a first lien used to buy a home. The second lien is used in lieu of a traditional down payment. We acquired a significant volume of these loans in the second half of 2005 and the first quarter of 2006. We are also experiencing higher than expected delinquency on some of our adjustable rate mortgages and stated income loans – again, acquired through one channel in our business.

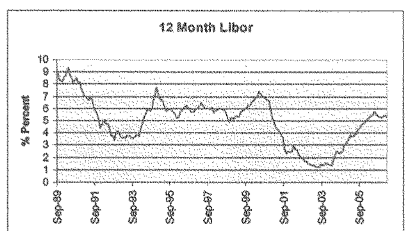
In retrospect, we don't believe we properly anticipated the future risk associated with these types of loans. Predicting the potential implications of 17 interest rate increases in a 21-month timeframe is just one example. Also, as it turned out, these types of higher risk loans purchased from other lenders during this time frame are performing much worse than loans purchased in this channel in earlier timeframes. These are the primary causes of the increased loss provision announced on February 7, 2007 in HSBC's trading statement and later confirmed on March 5th during HSBC's 2006 earnings announcement.

Our Perspective on the Issue

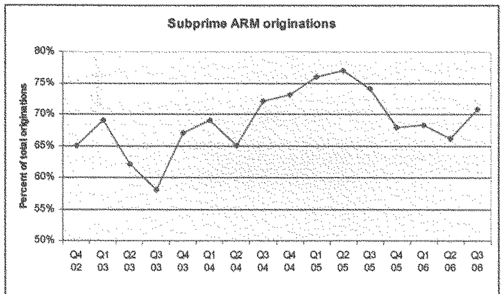
I'd like to offer some more general input and perspective on what is happening in the market, and also speak specifically to how HSBC is addressing these issues for our business and as importantly, for our customers.

As mentioned, we have had a long run of rising interest rates combined with a slowing housing market, which has put new pressures on consumers. In the past because of rising home prices, homeowners could more easily avoid foreclosure when they had interruptions in their income. They now have fewer options to use the equity in their homes for these purposes. ARM (adjustable rate mortgage) products were readily available before the historically low interest rates of 2001 to 2005 and were quite benign. It is the disparity between the all-time low rates recently experienced and the return to a more normalized interest rate environment that exacerbates the magnitude of the payment shock experienced by sub-prime customers. The products available in the sub-prime market, particularly the wholesale sub-prime market, are not well suited to this changing environment.





In addition to the interest rate impact, the wider application of products and the relaxation of industry underwriting standards (particularly around income) placed some customers into products they could not afford. As many markets appreciated, lenders focused on affordability products, even as home prices and mortgage payment growth outstripped personal income growth. The profile of subprime originations shifted dramatically towards ARM, Interest-only and stated income products. These products offered a lower starting payment to overcome the impact of a rising interest rate environment and affordability issues, but were inherently more risky. This environment also saw wider use of "teaser-rate" ARM products. While these types of products existed previously, they exacerbated the interest rate adjustment referenced above. The graph below depicts all types of subprime ARM originations (traditional, Interest-only, and teaser-rate ARM) as a percent of total subprime originations.



Source: National Mortgage News QDR, Inside Mortgage Finance

The demand for mortgage backed securities (MBS) also increased dramatically over the last several years. This trend was discussed in the recent Mortgage Banker's Association research paper: The Residential Mortgage Market and Its Economic Context in 2007 (January 30, 2007). Capital inflow to the US has increased dramatically over the past 20 years as the current account deficit has continued to grow. At the same time, there has been a dramatic increase in the percentage of foreign central banks approved to invest in MBS (2% in 1998 to 44% in 2006). In addition, the percentage of central banks investing in only US Treasuries has dropped (from 31% in 2002 to 3% in 2006). While adding excess demand for other fixed income securities, another impact of investors shifting out of Treasuries and into mortgage/debt securities is a compression of spreads across fixed-income markets. This increased liquidity drove the demand for higher risk products.

How HSBC Finance is addressing these issues - originations

HSBC Finance has been servicing customers for more than 125 years, through many credit cycles and a wide range of economic circumstances. We take the current situation seriously and we are taking strong and proactive steps to minimize the impact of the current environment on our customers.

Our first step has been to do a significant amount of analytical work to understand precisely how much risk is present for our customers and what steps we must take to minimize that risk.

In our largest channel, the retail branch network, we have had policies in place for more than five years that largely parallel the new Interagency Guidance on Nontraditional Mortgage Products. As other lenders have adopted this guidance, it has brought about a leveling of the playing field in the mortgage industry. We believe this Guidance brings appropriate strengthening to the industry's underwriting standards. These rules currently apply only to federally regulated banks and bank holding companies; for them to fully impact consumers in a positive way, they need to apply to all lenders.

Long before the notion of "suitability" was central to the discussion of appropriate underwriting standards for subprime loans, HSBC Finance had implemented a comprehensive, self executing net tangible benefits test (NTB) in its retail subprime lending business. Requiring varying levels of benefits depending on the loan type, the NTB mandates that each loan passes a rigorous and systemically applied test that ensures the loans meet a minimum threshold of benefit and affordability for the customer. Failure to meet the standards of the test prevents the approval of the loan, regardless of credit, regardless of profitability. Versions of this NTB test have now been implemented in the wholesale channel as well.

To help ensure our programs and practices are effectively delivering the value our customers expect, in 2003 we installed a "Secret Shopper" program. This initiative uses an independent third party to monitor our retail branch origination channel and ensure all of our policies and procedures are effectively followed. "Secret Shopper" also provides almost real time feedback to management on the customer experience.

Further restrictions on underwriting have taken place as the slowing of housing appreciation and other economic factors have deteriorated performance. We also have largely eliminated the purchase of loans originated by other lenders and sold in the secondary market, giving us greater control over quality and underwriting, while building on our competitive strength of making mortgage loans in customer facing channels, such as our nationwide 1,350 branch retail network.

HSBC Finance also recognizes that the long term answer to this current market condition is not just tightening credit, but also introducing appropriate products that help the subprime customer solve their financial challenges and improve their circumstances.

An example of one such product is our "Pay Right Rewards" mortgage (PRR). This mortgage product rewards subprime customers who remain in good standing with automatic rate reductions with no risk that the customers' rate will ever go up. A very high percentage of customers who chose this product enjoy rate reductions without having to incur the cost of refinancing to get a lower rate.

This product has been very successful in the retail channel and we plan to expand to other areas of our mortgage business.

Finally, for our broker origination channel, your letter referenced media speculation regarding back-end yield spread premiums. Our broker management process begins with selecting only responsible brokers that comply with all state and federal laws. Our comprehensive broker approval process and broker monitoring process are independent of the sales organization. In addition, we have systemic controls in place to ensure we conduct business with brokers who are in good standing and meet HSBC's internal requirements. HSBC Finance has a comprehensive set of controls and monitoring in place regarding loan terms and broker fees. Our back-end premium spreads are capped at 200bps, though our average is ~60bps, which we believe is better than industry standards. It is worth noting that yield spread premiums paid by the lender provide the borrower the option of deferring borrower paid broker fees in the form of a reasonable and defined increase in the interest rate. Further, our broker management and fee structures are subject to review by numerous Federal and State regulatory entities.

How HSBC Finance is addressing these issues - servicing

The issues our existing customers face are being addressed in keeping with our approach and commitment to this business. We have reviewed our most "at risk" ARM customers and implemented a proactive program that will offer payment shock relief. This program was launched in mid-October 2006 with the objective of offering rate modification plans that will reduce the rates and payments our customers would be required to pay under their contract. In the program to date, we have assisted more than 2,200 customers and we estimate our assistance will reach more than 5,500 customers in 2007.

We truly believe that foreclosure is the worst alternative for all parties concerned and go to great lengths to avoid foreclosure. Financially, it is our worst alternative with the average loss on sale at foreclosure of 20-25% of loan value. In general, accounts are charged off by the end of the month in which they become eight months delinquent. This allows substantial time to contact customers and apply one of many workout programs and to assist their situation.

Our Foreclosure Avoidance Program (FAP) was developed in October 2003 and to date has provided over $100MM in financial relief to over 9,000 customers. The program was developed to provide temporary or permanent relief to customers whose ability to repay their loan has been reduced due to a change in circumstances. In most cases, the relief period is temporary as the customer loss is due to a layoff, loss of employment, reduction in wages and other similar circumstances. In some instances the relief may be permanent when the customer change is more catastrophic, such as a permanent disability or death. The overall intent of the program is to provide a means for the customer to repay their loan and avoid foreclosure where possible. The Foreclosure Avoidance Program helps HSBC customers with real estate loans by providing them with rate and payment relief to increase the customer's monthly disposable income.

In addition to direct assistance to our own customers, we help consumers at risk of foreclosure with other lenders. We have partnerships with a number of community groups to prevent foreclosure and rescue home owners in danger of foreclosure. For your information, we have enclosed an addendum to our testimony outlining all of our homeownership preservation programs.

Closing remarks

With the above initiatives in place, we believe HSBC's efforts reflect positively on our performance in the industry. For HSBC Finance, the focus on growth will always be matched with our commitment to help our customers meet their financial goals in a sustainable manner.

Clearly, the mortgage industry is experiencing significant contraction. With just the lenders who have ceased operations, the sub-prime market has already lost 20+% of its origination capacity. This does not account for additional origination capacity reductions due to underwriting tightening. With that in mind we believe that any additional regulation needs to be carefully considered and weighed against the implications of credit availability.

Certainly we believe that uniform legislation could benefit the industry and consumers. There are numerous versions of Federal anti-predatory lending legislation that contain many of the key best practices our retail branch network has employed for several years. HSBC supports guidelines that put everyone in the industry on an even playing field.

I hope that my testimony today reflects for you that HSBC Finance's lending and servicing practices do indeed demonstrate its desire to lead the industry in responsible lending, and responsible and fair servicing. But as important, we know there is always more work to be done. We are continually looking at our current and prospective products and services in this light. Fair business practices are core to our corporate values, and the best way to build the future for our employees, our customers and our shareholders.

Once again, thank you for inviting HSBC to share with you our experiences and recommendations. I am happy to answer any questions you may have..

HSBC – North America
Center for Consumer Advocacy
HOME PRESERVATION OFFICE

HSBC

HSBC-North America funds a broad range of homeowner programs including pre-homeownership buyer education, down payment assistance, post-closing homeowner counseling and foreclosure intervention. HSBC's Home Preservation Office oversees all homeownership initiatives and creates a single source to manage program administration, monitor progress, and facilitate internal and external communication and learnings. The following is a description of the major home preservation initiatives supported by HSBC-North America.

NATIONAL

Consumer Rescue Loan Program- This program was established in 2002 in partnership with the National Community Reinvestment Coalition (NCRC): Initially designed as an Anti-Predatory Mortgage Loan Fund to rescue consumers who had been victimized by predatory lending practices, the program scope was later expanded to include any mortgage that had become unaffordable due to origination, servicing problems, or a significant change in the consumer's financial circumstances. The program, available to non-HSBC customers, provides a "fresh-start" refinance mortgage, originated by HFC. The rescue loan is underwritten using modified underwriting guidelines, there are no closing cost (points, processing fees or third-party fees) associated with the new loan and the new loan rate is subsidized. HSBC provides annual grants to support the administration of the program by NCRC and has allocated a reserve pool to fund the rescue loans.

Neighbor Works Center for Foreclosure Solutions- HSBC-North America joined this partnership in April of 2006. This national initiative, modeled after the very successful Chicago HOPI program, aims to provide solutions to foreclosures by raising consumer awareness of loss mitigation programs, provide 24/7 telephone counselling through a toll-free nationwide helpline (1-888-995-HOPE). The program provides in-person homeownership and budget counseling by Neighbor Works' (or other qualified non-profit group) local counseling agency. A national consumer awareness campaign, developed by Ad Council in support of this program, is scheduled to launch in 2007.

HSBC Early Intervention Program- HSBC is launching a signature initiative with a national non-profit partner that will provide bridge grants of up to $5,000 to homeowners who face a temporary financial hardship. The bridge grant may be used to cure mortgage delinquency and to pay down or eliminate delinquent balances on unsecured or credit card debt. Consumers participating in this program will receive budget and homeownership counseling.

Foreclosure Avoidance Program- Initiated in 2004, HSBC established this program in partnership with the Association of Community Organizations for Reform Now (ACORN) to provide special relief to HFC and Beneficial customers. Customers whose mortgage loans are delinquent are advised of the availability of budget counseling and loan modification relief and are encouraged to contact an ACORN housing counselor to receive counseling and to determine eligibility.

REGIONAL AND STATE

Chicago HOPI- Chicago Homeownership Preservation Initiative (HOPI) was launched in 2003 and includes a successful collaborative initiative between the City of Chicago, NHS of Chicago, and the telephone Hotline for Housing Counseling and lenders. This special initiative includes a city-sponsored consumer marketing campaign to reach Chicago residents who are at risk for foreclosure with budget and homeownership counseling, and referral to available city services. The program also facilitates discussions with lenders regarding workout options. The Chicago Initiative, using the City's non-emergency "311" Hotline is the program on which national and most local programs are modeled. HSBC has been a participating sponsor since the program's inception.

New York PACE- New York's Preserve Assets and Community Equity (PACE) program was launched in 2005. The program is quite similar to the Chicago program and includes three community partner organizations and focuses its marketing outreach on NYC communities with the highest foreclosure rates. HSBC has been a participating sponsor since the program's inception.

Momentive- This program was established in 2004, to provide homeownership and budget counseling to Indiana residents. It has many of the same components as the Chicago and New York programs and is available to consumers state-wide. HSBC joined the initiative in 2006 and is one of the approximately 10 lenders who provide funding support.

Detroit HOPE- This program launched in 2005, HSBC joined the initiative in 2006. The program enjoys the support of the City of Detroit and over 45 lender partners who provide training and financial support. Detroit HOPE provides consumer budget and homeownership counseling support as the other local programs and, like Chicago, also sponsors weekend homeowner foreclosure prevention workshops. Lenders are invited to attend workshops and are able to provide confidential counseling to their own customers.

OTHER SIGNATURE INITIATIVES

YourMoneyCounts.com – HSBC's consumer education website provides information in a broad range of financial and money management topics. (There are more than 1,900 site visitors per month.)

Adult Financial Literacy Workshops – In partnership with the Center for Neighborhood Enterprise (CNE), HSBC provides financial education workshops at numerous community locations. More than 5,000 families were educated in 2006.

Financial Education Grant Program - Provides $1MM in grant funding to support consumer financial education, credit management, and home buyer counseling programs. These programs are provided by twelve organizations in nine states, and assisted more than 164,000 families in 2006.

Your Future Counts - In partnership with the Society for Financial Education and Professional Development (SFED), presents credit management and personal financial management seminars in Historically Black Colleges and Universities (HBCU) campuses nationwide. More than 11, 000 students have attended seminars since program inception in August 2005.

NCLR
NATIONAL COUNCIL OF LA RAZA

Challenges to Building Sustainable Homeownership in Latino Communities

Presented at:

Mortgage Market Turmoil: Causes and Consequences

Submitted to:

U.S. Senate Committee on Banking, Housing, and Urban Affairs

Submitted by:

Janis Bowdler
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March 22, 2007

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My name is Janis Bowdler, Senior Policy Analyst on Housing at the National Council of La Raza (NCLR). I conduct research, policy analysis, and advocacy on affordable homeownership, and provide technical assistance to NCLR housing counseling grantees. Prior to coming to NCLR, I worked for a large community development corporation (CDC) in Cleveland, Ohio, as a Project Manager developing affordable housing. During my time at NCLR, I have published on a number of housing issues important to the Latino community, including *American Dream to American Reality: Creating a Fair Housing System that Works for Latinos* and *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market*. In addition, I recently provided expert testimony before the House Financial Services Subcommittee on Housing and Community Opportunity and before the Board of Governors of the Federal Reserve.

I would like to thank Chairman Dodd and Ranking Member Shelby for inviting NCLR to testify before the Committee. NCLR is deeply concerned that the home mortgage system does not work well for Latino families. Much like all Americans, Latinos rely on homeownership to build wealth for their long-term fiscal health. With research predicting that one in twelve Latino loans will end in foreclosure, the hallmark of the American dream is threatening to leave millions of families without homes, access to credit, or a financial safety net.

For more than two decades, NCLR has actively engaged in relevant public policy issues such as preserving and strengthening the Community Reinvestment Act (CRA) and HOEPA, supporting strong fair housing and fair lending laws, increasing access to financial services among low-income people, and promoting homeownership in the Latino community. In addition to its policy and research work, NCLR has been helping Latino families become homeowners for nearly ten years as a sponsor of housing counseling agencies. The NCLR Homeownership Network (NHN) works with 20,000 families annually, nearly 3,000 of whom become homeowners. NCLR has sophisticated relationships with major financial institutions, which allows NHN counselors to prequalify their mortgage-ready families according to the product specifications of their partners. Our subsidiary, the Raza Development Fund (RDF), is the nation's largest Hispanic Community Development Financial Institution (CDFI). Since 1999, RDF has provided $400 million in financing for locally-based development projects throughout the country, building the capacity of local nonprofits and creating opportunities for Latino communities. These relationships have increased NCLR's institutional knowledge of how Latinos interact with the mortgage market.

Latino families are entering the mortgage market in record numbers. Latino homeownership reached an all-time high of 49.5% in 2005, up from 42% in 1995. Despite these gains, evidence suggests that barriers existing in the mortgage industry impede Latino families' access to the best and most appropriate home loans. Recently, cooling home prices, rising interest rates, and an industry struggling to maintain the high loan volumes it saw three years ago have exacerbated the situation. In some instances, families are facing a cycle of wealth-draining refinances, and for others it could lead to foreclosure.

Obviously, these are not the reasons families decide to pursue homeownership. Homebuyers choose ownership because they believe that with it they will build the nest egg that will send their kids to college and provide for their family in times of financial crisis. However, in my testimony today I will explain how many Latino families face unique barriers that make achieving this dream difficult. The mortgage market has serious flaws that prevent it from serving Latino families well. That said, we believe there are practical solutions, which I will cover in my recommendations.

Challenges to Sustainable Latino Homeownership

Latino families face significant barriers when approaching the homeownership market. The most common barriers cited for Latino families are affordability and lack of information. While that is certainly true, the biggest challenges they face are endemic to the mortgage system itself. Many Latinos have unique borrower characteristics that are not a perfect match to the average homebuyer. Over the past decade the mortgage industry has been able to increase its efficiency for many consumers by moving to automated underwriting. If a family does not match the traditional borrower profile, they often get passed over by prime lenders, or those with the most competitively priced home loans. This is often the case for Latino families. For example, 22% of Latinos have a "thin" credit file, or no credit history, which usually results in a "0" credit score, compared to only 4% of Whites.[1] Approximately 35% of Latino families do not have basic checking or savings accounts.[2] Many Latino families have multiple wage earners or some cash income and savings. Products exist that accommodate such attributes, but they often require manual underwriting. In an automated world this translates into increased costs in terms of employee time and missed commission opportunities. As a result, many Latino families are channeled to the subprime market, which is traditionally reserved for borrowers with damaged credit. The expansion of this market has helped some families with poor credit history access home loans. However, subprime loans are typically more expensive, riskier, and, oftentimes, easier to abuse.

Latinos and other minorities often find themselves channeled toward the products most profitable to the lender, but which may be expensive and risky for borrowers, regardless of their creditworthiness. Research shows that Latinos are 30% more likely than Whites to receive a high-cost loan when purchasing their home. Other research shows that nontraditional mortgage products such as Option Adjustable Rate Mortgages (Option ARMs) and Interest-Only Mortgages are disproportionately concentrated among minority borrowers; Latinos are more than twice as likely as Whites to receive an Option ARM. In some cases, lenders sell Latino families Stated-Income loans rather than take the time to verify their cash income and savings. Lenders protect themselves with a business model that anticipates some losses. Needless to say, most families do not have such protection available to them.

The Rivera family is a good example of how this happens. This family came to visit an NHN affiliate in Seattle. They were having trouble making the payments on their mortgage, even though they had been in their home a short amount of time. Despite the family having a long

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[1] Stegman, Michael, et al., "Automated Underwriting: Getting to 'Yes' for More Low-Income Applicants," Presented before the 2001 Conference on Housing Opportunity, Research Institute for Housing America Center for Community Capitalism, University of North Carolina-Chapel Hill, April 2001.

[2] Pew Hispanic Center/Kaiser Family Foundation, *2002 National Survey of Latinos*. Washington, DC: 2002.

history of good credit, they were in a subprime loan. The family did not understand what a subprime loan was until the counselor pointed out the high rate and fees they were paying. They unknowingly had two mortgages; the first loan is a 2/28 with a five-year interest-only option. After the first two years their payments will increase every six months. They were also unaware they had a balloon on the second mortgage with a $50,233.31 payoff due in 15 years. It became clear to the counselor that the family never could have afforded this loan and should have been in a prime loan in the first place. The family reported, however, that they were referred to this mortgage broker who could help them because they had several sources of income. The Rivera family brought in the documentation for each source but were unaware they were in a Stated-Income loan, and that their loan documents misstated their income several thousand dollars a month over their actual income.

A Broken System

Given the large increase in Latino and immigrant families entering the market each year, NCLR is troubled at the mortgage industry's lack of capacity to respond to their needs. Immigrants accounted for 17% of first-time homebuyers in 2002 and 2003. As described above, these new borrowers and homeowners have unique needs that the marketplace is not equipped to meet. Unfortunately, this means they are vulnerable to predatory lending. Latino and immigrant families beginning their homeownership search often draw information and advice from informal sources such as word-of-mouth and Spanish-language outreach (print and radio media) and are likely to seek out a "trusted advisor" whose credibility has been established within these networks. Anecdotal comparisons of Spanish-language newspapers and mainstream English-language papers demonstrate a stark contrast between the products targeted to different communities. Spanish-language papers almost exclusively display advertisements from subprime financers and mortgage brokers. Even when mainstream institutions place advertisements in the Spanish-language press, they mirror those products advertised by the other lenders: Interest-Only, Option ARM, 100% financing, and Stated-Income loans. English-language newspapers, however, feature convenient charts that compare the major local mortgage institutions and their competing rates for standard mortgage products. Since financers of subprime and high-risk mortgage products have little if any incentive to up-sell their clients to less-risky mortgage products, many Latinos and other underserved communities are set on a path early on which limits the mortgage options they will be presented.

Homeowners attempting to refinance their mortgage face different challenges. Increasingly, homeowners are the focus of push marketing tactics of mortgage brokers, real estate agents, and wholesale lenders who are under increased pressure to produce volume in a shrinking market and tight profit margins. A survey completed for NCLR in 2005 revealed that 76% of Latino homeowners had been solicited to refinance their home by a financial institution within the previous year. Reports from across the country confirm that the most egregious of these predatory lending cases occur when independent third-party agents – such as mortgage brokers, real estate agents, or appraisers – partner to solicit homeowners and convince them to refinance. In most cases, borrowers are solicited for the highest-cost and riskiest mortgage products regardless of whether they fit the financial goals and capacity of the family.

Latino homebuyers and owners rely heavily on mortgage brokers, who often act as a bridge connecting them to mainstream financial institutions. In fact, many brokers are outperforming the prime and retail institutions in their service to Latino families by diversifying their workforce, offering a wider range of products, and adopting a one-on-one style that makes Latino families feel comfortable. Latino borrowers often rely on bilingual and bicultural brokers to serve as a bridge to the mainstream mortgage market. However, despite the fact that most borrowers believe their mortgage broker is obligated to work on their behalf to find "the best deal," most have few, if any, legal or professional ethical responsibility to the borrower. Yield Spread Premiums (YSPs) offered by lenders provide another financial incentive to steer borrowers to products that earn higher profits rather than those that fit the client's needs best.

This was the case for Mary and her husband in Wisconsin. Responding to advertisements, the couple began exploring the option of refinancing their home – which they purchased a year earlier for $109,000 – to catch up on some bills. Their broker had their home appraised, and they were surprised to find out that their home was worth much more than the purchase price, at $147,000. At the closing, the loan did not match up with the Good Faith Estimate (GFE) and the fees were nearly double, but the broker pressured the family into signing the documents anyway. Because of the high fees, the couple received less than expected to consolidate their outstanding debt. Their new loan payment is $1,300, which is nearly 80% more than their original loan payment. Mary reached out to an NHN organization in Waukesha, Wisconsin. Unfortunately, the family has few options since the appraisal was faulty. They recently discovered their home is only worth $112,000 and they are in a negative equity situation.

Many industry stakeholders point to the borrower's responsibility to be a savvy consumer, to shop around for the best deal and enter the mortgage transaction with a healthy skepticism. While NCLR certainly believes that shopping is an important part of the homebuying process, enhanced shopping capacity alone will not correct the market's shortcomings. Consumers do not have the tools necessary to shop effectively. Mortgage packages vary considerably from lender to lender and change often, sometimes daily, making it difficult to compare multiple loan opportunities. GFEs are not guaranteed, and many Latino consumers report feeling obligated to complete the loan process with a given agent once they have begun, especially at the late hour of closing. Perhaps more importantly, the mortgage transaction has become so complex that it is unreasonable to assume a borrower could, or should be obligated to, become a regulatory force in the market. As the earlier stories demonstrate, the borrowers were at a complete information disadvantage. They did not understand the terms and features of their loans or, worse, were not even aware of inclusion of certain terms and features in their mortgage. Most consumers rely heavily on mortgage brokers to shop on their behalf and trust their advice. With approximately 40% of all loans made to Latinos being subprime (compared to 19% of loans to Whites), NCLR is deeply concerned that borrowers are being mismatched to loan products that do not meet their needs simply because they have nontraditional borrower profiles or because of how they access the credit market. The common experiences described above are problematic since industry best practice is to price a clean, nontraditional credit history as prime credit. Equating these characteristics as inherently more risky has a disparate impact on Latino and immigrant borrowers.

NCLR serves many of the families targeted by the subprime market through NHN. Nine out of ten NHN families have incomes below 80% of Area Median Income (AMI), more than a third make use of alternative credit, and many have at least some cash income. Recently, NCLR conducted a survey of mortgage products most commonly used by families who closed loans through their NHN homeownership counselor. More than half used a 30-year fixed rate mortgage product of some sort to purchase their first home.[3] This information and experience busts the myth that the exotic mortgage products dominating the subprime mortgage market are the only avenue for underserved communities to access the market. Some have argued that tightening underwriting standards would result in credit drying up. We disagree. Tightening of underwriting standards should help guarantee that families are matched to better products since there are products in the marketplace that are clearly successful and safe alternatives for hard-to-serve borrowers. Rather, the system is broken, preventing families from connecting to the home loan that fits them best.

Recommendations

The mortgage market clearly has some challenges meeting the needs of low-income, Latino, and immigrant borrowers. Although some suggest that investors realigning their investments in the secondary market will lead the primary market to self-correct, there is still a need for intervention from Congress. In the wake of a dramatic increase in foreclosures and the shrinking of the mortgage market, many families will be stuck with bad loans they cannot afford. Congress must explore models for saving homes and helping families maintain their fiscal safety net. Moreover, Congress must put the tools in place now to deal with abusive loans that are likely to resurface during the next housing boom. Regulators and lawmakers must put borrowers on a level playing field with originators and investors. NCLR makes the following recommendations:

- **Improve originator accountability standards.** Borrowers need a higher level of security and transparency when purchasing their home. Similar to how average families rely on the professional legal and ethical responsibilities of other experts – such as doctors, lawyers, accountants, and stockbrokers – originators should be obliged to give consumers information they can trust. Congress and regulators should craft a standard of accountability that protects the integrity of the borrower-originator relationship. Such a standard should expressly prohibit steering consumers to a high-cost product or an entity that exclusively offers high-cost products and should promote the making of affordable loans. Mortgage brokers and independent agents must declare on whose behalf they are working and be held accountable according to the relationship.

- **Strengthen enforcement and consumer remedies.** The existing HOEPA regulation was intended to solve predatory practices common in the mid-'90s, which primarily consisted of abuses in the refinance market. Much of the abusive activity in the Latino community

[3] This includes conventional 30-year fixed rate mortgage (FRM) products, 30-year FRMs without mortgage insurance, and 30-year FRMs insured through the Federal Housing Authority (FHA).

occurs during the initial home purchase stage, often setting a family up to refinance a few years later. HOEPA should be amended to address home purchase abuses such as targeted and push marketing, steering to high-cost products and lenders, and the use of teaser interest rates. The new interagency guidance on nontraditional mortgages promotes stronger underwriting practices. The Federal Reserve should set a high standard for compliance by holding unethical lenders accountable and ensuring that victims have access to meaningful remedies. Moreover, the guidance should be extended to all mortgage companies.

- **Invest in homeownership and foreclosure prevention counseling.** While many industry stakeholders have held increased education as a potential remedy for the lack of information in the marketplace, few are doing enough to support and strengthen the counseling industry. NCLR urges Congress and regulators to establish an incentive for investing in housing counseling. We applaud Congress for its continued support of the HUD Housing Counseling Program and urge appropriators to drastically increase funds available for this program given the anticipated rise in the number of families who need such services. Moreover, Congress should create a national foreclosure rescue program to address the needs of the millions of families likely to face foreclosure in the next two years. Federal intervention in the foreclosure crisis could come in the form of emergency funds for short-term financial challenges, refinance rescue loan products, and tools for foreclosure prevention counselors to work with mortgage servicers to resolve a family's delinquency. Such a program should be available to borrowers who are facing financial crisis through no fault of their own, or who are the victims of abusive lending tactics.

TESTIMONY OF
L. ANDREW POLLOCK
PRESIDENT & CEO
FIRST FRANKLIN FINANCIAL CORPORATION

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

HEARING ON THE SUBPRIME MORTGAGE MARKET

March 22, 2007

Mr. Chairman and Members of the Committee:

My name is Andy Pollock and I am President and CEO of First Franklin Financial Corporation. I appreciate the opportunity to testify today on the state of the subprime mortgage industry.

Over the last few weeks, the mortgage industry has been at the center of the financial news, with the current market conditions presenting significant challenges for some firms in the industry. I wanted to take this opportunity to share with you my thoughts on the subprime market and where First Franklin fits into that market.

First Franklin has been in the residential mortgage business for 25 years, successfully managing the business through various economic and credit cycles. We are proud of our long history of providing expanded and fair access to credit to all creditworthy individuals. We have a proven history as a responsible lender, and a critical component to our success has been the disciplined underwriting we embrace as a company. We have enabled hundreds of thousands of hard-working families and individuals to realize the American Dream of homeownership over the quarter century that we have been in business. Three months ago we were acquired by Merrill Lynch and we operate as a stand-alone operating subsidiary of Merrill Lynch Bank & Trust Co., FSB.

First Franklin is an acknowledged leader in the subprime marketplace, originating loans with higher credit scores, lower delinquency rates, and generally higher performing mortgages than many other subprime lenders.

As I will demonstrate, we also are committed to responsible lending standards which help protect consumers.

Our Lending Practices

By strategic design, First Franklin has strengths that many other lenders in the subprime market do not. Specifically, we employ underwriting standards that assure the quality of the loans we originate. These underwriting standards are designed to ensure that borrowers can afford to repay the mortgages we originate, as well as those we have originated in recent years.

First Franklin has one of the lowest delinquency rates in the industry—a testament to our underwriting standards and to the high quality of the loans we originate. It is our goal not only to allow more Americans to be able to buy homes, but to assure they have the capacity to keep them. To further our goal, as a matter of policy:

- We do not originate or purchase "high cost" loans as defined by federal or state law.
- Prior to making owner-occupied refinance mortgage loans, we require a net tangible benefit to the borrower.

- We do not make loans based solely on collateral value; specifically, all loans are underwritten based on the applicants credit history and ability to repay the debt.
- We do not originate or purchase negative amortization subprime loans.
- We do not engage in packing fees; specifically, we limit the amount of origination fees and costs which can be financed.

In addition:

- If prepayment penalties apply, they are fully disclosed, and they are limited to the first 3 years of the loan. Borrowers are always offered a "no prepayment penalty" option.
- We maintain strict broker approval and monitoring guidelines.
- We cap broker compensation.
- We do not sell single premium credit life insurance or similar coverages.
- We do not originate or purchase short term balloon loans.
- Interest rates do not increase upon payment related default.

We also comply fully with the Interagency Guidelines on Non-Traditional Mortgage Product Risks. These agencies have also recently proposed a Statement on Subprime Lending, of which we endorse the key principles.

Conclusion

The shake-out in the mortgage market has taken place quickly for those originators that did not maintain a commitment to quality or a culture of discipline. First Franklin's 25 years of industry experience and our commitment to responsible lending standards has allowed us to weather the current difficult situation, and will enable us to continue to succeed in the future.

First Franklin intends to remain a leader in the residential mortgage market by adhering to prudent industry practices that will help consumers achieve and maintain homeownership. Wealth creation and financial security often begin with homeownership. We have a commitment to lending practices that help homeowners make economically sound decisions, and to keep their homes.

First Franklin appreciates the opportunity to appear before you today. I would be happy to answer any questions that you may have.

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs
Written Statement of Irv Ackelsberg, Esquire
March 21, 2007

My name is Irv Ackelsberg. I am an attorney specializing in defending mortgage foreclosure and associated with the Philadelphia law firm of Langer and Grogan, P.C. I am also a member of the National Association of Consumer Advocates and I am on the board of the recently launched Americans for Fairness in Lending (www.affil.org). I retired last year, after 30 years of service, from Community Legal Services of Philadelphia, the nation's leading civil aid program.[1] I and my former colleagues at CLS have probably reviewed more abusive subprime transactions than any other law firm in the country. We are familiar with the practices of the companies that once dominated the subprime mortgage market, and the ones now in the news.

The subprime mortgage market has, for the last decade, grown at an astronomical rate. This growth has been fueled in large part by a collapse in underwriting practices and responsible lending principles; by a sales-pressured, get-rich-quick environment that has infected the market with blatant fraud and abuse, and a regulatory apparatus that has abdicated its traditional role to protect the American consumer from exploitive lending practices. In my view, and in the view of most consumer housing specialists, this fraud-infested market has been producing very little social benefit. While the particular abuses most prevalent are somewhat different than those we saw in the late 90's, the effects on the American homeowner have been steadily growing: unprecedented levels of foreclosures and equity-theft, all happening in full view of banking regulators.

At the ground level, from the standpoint of the America's neighborhoods, this growth in subprime lending has been the equivalent of a gold rush, where the gold being prospected is the home equity wealth of American homeowners. This gold rush has erupted because of the complete collapse in mortgage underwriting integrity. To put it bluntly, mortgage origination practices have been run over by the pursuit of profits at any cost. I want to describe for you some of this gold-rush-induced collapse in underwriting, but first I want to dispel two myths about subprime mortgage loans that the industry has been promoting.

First, it is not true that the typical subprime borrower is a low-income, first-time home-buyer purchasing his or her home. The majority of these loans are to existing homeowners who are being convinced to refinance their debt inappropriately. Sometimes the occasion for the transaction is a home improvement; sometimes runaway credit card balances drive the deal; sometimes the reasons for the loan are hard to discern. The bottom line is that if we want to look at these transactions as "opportunity" loans, the opportunity lies with the broker or lender profiting on the deal, not with the homeowner.

[1] CLS was, until 1996, funded by the Legal Services Corp. It had to give up that funding in order to avoid the restrictions imposed by Congress in 1996. Those restrictions would have prohibited much of my anti-predatory lending work.

The second myth is that these mortgages are credit-repair products. If that were true, most borrowers with subprime loans would be transitioning into prime products and the industry would essentially be lending itself out of existence. In fact, the opposite is the true. The subprime portion of the market has been steadily rising. Data gathered by researchers from The Reinvestment Fund on subprime lending in Philadelphia confirms that, particularly with low and moderate income borrowers, there is scant evidence of credit repair. On the contrary, there has been significant movement in the opposite direction, with borrowers in prime mortgage products transitioning into subprime.

The current abuses we are seeing include the following:

- Exploding adjustable mortgages with initial teaser rates that are underwritten to the teaser rate, not to the subsequent inevitable adjustment. This means that, at the time the loan is being made, there is no evidence of borrower repayment ability past the first two or three years of the loan.
- The widespread use of "no-doc", "stated" income loans.
- The absence of escrow for tax and insurance obligations which adds deception to the advertised payment and increases the likelihood of foreclosure.

In testimony I gave to the Federal Reserve Board last year, I called their attention to a sample securitization of New Century from the first quarter of 2006. Of the $1.4 billion of mortgage loans in that pool, only 10% were traditional 30-yr. fixed-rates, and an amazing 45% of those mostly adjustable-rate loans were "no-docs." The coming foreclosure crisis should not be a surprise to anyone, except perhaps for the magnitude. What we are seeing today, I believe, is a runaway train that is only starting to gather its speed. These recent foreclosures reflect large numbers of early payment defaults, that is, homeowners defaulting during the fixed-rate periods on their loans. We have yet to see the full effect of such a large share of outstanding mortgages starting to adjust upward. It is not unreasonable to predict as many as 5 million foreclosures over the course of the next several years. A number this high would represent one out of 15 homeowners in this country.

The inevitable question, then, is what can be done to reverse this course. We need to focus on constructing relief for those in trouble now and on imposing appropriate limits on the future lending practices of this industry. I have several suggestions.

In terms of addressing the coming foreclosure tsunami, we first have to recognize who is doing the foreclosures and why. It may be that the lenders testifying today have no interest in taking homes, but it is not the lenders who will be foreclosing. These loans are all made to order for Wall Street investors who purchase them almost immediately after they are created. Foreclosure decisions are made by massive servicing organizations that work for these investors. In the ordinary course of their business, these servicers never have to justify a quick foreclosure; they do, however, have to answer to their investors for any forbearance being offered to the borrowers. I believe that Congress will need to mandate moratoriums and debt restructuring in order to avoid a national disaster and to insure that the investors are absorbing some of the losses that otherwise will fall solely on America's homeowners. In the long run, however, the interests of financial markets and of homeowners are not in conflict: the downward spiral in property values that will be caused by massive foreclosures is something that only real estate speculators should wish to see.

As for civilizing this origination market gone amok, there are many sensible proposals that consumer advocates have been offering, such as imposing a suitability standard on mortgage-writing like what exists in the sale of securities, and imposing assignee liability on those who purchase these loans and fuel the market. On the latter approach, Congress already has used this tool effectively in the HOEPA legislation to successfully drive down the excessive points and fees that represented an earlier form of market abuse. Congress can and should take similarly dramatic action to curb these so-called "exotic" mortgages which, I submit, should be properly named "poisonous" or "irresponsible" mortgages. Actually, the Federal Reserve Board can do this on its own, using the "unfair and deceptive practices" authority that Congress granted the Board in HOEPA. And, finally, at the very least, Congress should let the states continue to make progress in this area and put to rest the specter of industry-sponsored, federal pre-emption.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM SANDRA THOMPSON

Q.1. There is a sense of outrage about those of us who have worked so hard to get people into homeownership, particularly people in the minority communities where they are so underrepresented among homeowners. And to now see what is coming, what we are seeing and what is coming, which is a backtracking, which is the horrible disappointment of seeing your dream of homeownership now turn into a nightmare of lifetime debt.

As we look at what we can do in the future to prevent this from occurring again, how can the bank regulators have allowed so many loans to be made which are obviously not designed to be performing loans in sixty days, a year, or two years, with not having qualifying standards for the higher rate that is inevitably coming, but only looking at the current qualification standards under the current rate?

Q.2. I believe that we have a sound banking system in this country. So how, in terms of underwriting standards, can making loans that are unsustainable from the very day of inception be safe and sound? How do we as legislators and you as regulators look out for the consumers who now find themselves in nightmare scenarios? How have we failed those families?

A.1. & 2. The financial industry created certain adjustable rate mortgage (ARM) products that were intended from their outset to be temporary credit accommodations in anticipation of early sale or refinancing rather than long-term loans. These products originally were extended to prime customers in anticipation of the borrowers' intended temporary residence or in expectation of future earnings growth. For these narrow circumstances, this product structure was a reasonable fit for the borrowers' needs. Later, lenders subsequently broadened their use and began to offer them to subprime borrowers as "credit repair" or "affordability" products.

On June 29, 2007, the federal financial regulatory agencies issued the *Statement on Subprime Mortgage Lending (Subprime Statement)*. The FDIC believes the implementation of the *Subprime Statement* will address the loosened underwriting standards that contributed to consumers, especially subprime borrowers, receiving loans that they cannot afford after the interest rate resets. The FDIC also supports the Federal Reserve Board taking action through its authority under the Home Ownership and Equity Protection Act to prohibit certain inappropriate underwriting practices.

These regulatory measures would do much to promote the provision of credit to both prime and subprime borrowers on terms that they understand and under which they can reasonably expect to repay. It seems clear that past inadequacies in underwriting practices have contributed to the increases in problem subprime mortgages, and this additional regulatory guidance can help improve the future performance of mortgage credit markets.

In addition, the federal financial regulators and Congress could take additional important steps to improve protections for consumers obtaining credit. These include:

- The creation of national standards for subprime mortgage lending by all lenders which could be done by statute or through HOEPA rulemaking;
- Expand rulemaking authority to all federal banking regulators to address unfair and deceptive practices;
- Permit state Attorneys General and supervisory authorities to enforce TILA and the FTC Act against non-bank financial providers; and
- Provide funding for "Teach the Teacher" programs to provide for more financial education in the public schools.

The FDIC would welcome an opportunity to assist in the implementation of these important reforms.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SANDRA THOMPSON

Q.1. What can be done to stop the fall out in the housing market, particularly in the sub-prime sector?

A.1. In the April 2007 interagency *Statement on Working with Borrowers,* the FDIC, along with the other federal financial institution regulatory agencies, encourages financial institutions to work constructively with residential borrowers who are financially unable to make their contractual mortgage obligations or are reasonably believed likely to become delinquent. The agencies believe prudent workout arrangements that are consistent with safe and sound underwriting practices are generally in the long-term best interest of both the financial institution and borrowers.

Restrictions in the securitization documents of loans that have been securitized into mortgage-backed securities may hamper the ability of servicers to consider loan modifications for borrowers. However, the American Securitization Forum issued a *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans* in June 2007. If widely adopted, these guidelines might provide servicers with greater flexibility when considering workout arrangements with subprime borrowers. A copy of the *Statement of Principles* is attached.

Additionally, the FDIC—working through its new Alliance for Economic Inclusion (AEI) initiative—has partnered with the NeighborWorks® Center for Foreclosure Solutions to promote foreclosure-prevention strategies for consumers at risk of foreclosure from subprime and nontraditional mortgage lending. The goal of the partnership is to keep good-faith borrowers in their homes. The partnership will focus its efforts in nine markets around the country that are served by both organizations. The partnership between the FDIC and NeighborWorks® seeks to build capacity at the local level to reach out to at-risk homeowners, identify successful foreclosure intervention strategies and deliver homeownership education counseling.

Finally, the *Statement on Subprime Mortgage Lending* released by the federal financial institutions regulatory agencies on June 29th should help to ensure that future originations and mortgage refinancings are sustainable and that borrowers can meet their obligations because the loans will be underwritten using fully-indexed and amortizing terms.

Q.2. Some argue that the market is already working to pull itself out of this downturn. What practices do you see mortgage holders and lenders taking to help struggling borrowers?

A.2. Mortgage lenders and servicers are taking a variety of actions to work with borrowers. For example, some contact borrowers in advance of the reset date to remind them of the pending change to their monthly payment amounts. If the borrowers indicate that they anticipate not being able to meet the higher payments during these contacts, the lenders and servicers may discuss the possibility of workout arrangements or the availability of financial counseling.

Servicers also are increasing the amount of contact with borrowers who have fallen behind on their payments in order to develop an appropriate workout option.

Some lenders and servicers also have indicated they are revising their processes for loan workout arrangements by working with nonprofit counseling agencies and supporting initiatives such as a national toll-free number for borrowers to call. Finally, lenders and servicers are considering a wide array of workout arrangement options, such as converting the loan to a fixed-rate or extending the maturity. The success of all of these efforts relies on increasing the amount of contact between servicers and borrowers. The earlier these conversations occur, the greater is the likelihood of a successful outcome.

Q.3. What Congressional or regulatory actions could potentially harm the market or slow a recovery?

A.3. Regulators should avoid imposing rules that unduly interfere with the ability of lenders to make credit available to subprime borrowers in a safe and sound manner. The Statement on Subprime Mortgage Lending provides strong guidance without imposing unduly restrictive rules that may stifle safe and sound innovations in the mortgage credit market. In addition, investor liability could be a potential impairment to the credit markets, as it might lower demand for subprime backed paper and could affect credit availability.

Q.4. In Mr. Smith's written testimony, he stated that refinancing will have little or no effect on boosting the market. Yet, it seems that several subprime and prime lenders are offering no-penalty refinancing to save borrowers from costly resets that may drive them into foreclosure. Do the rest of you agree with Mr. Smith's assessment?

A.4. The FDIC agrees that higher interest rates, a reversal or slowing in home appreciation trends, and tighter underwriting standards have made it more difficult for all borrowers to refinance their loans. We also agree that individuals who recently purchased homes with little or no equity and without the income to support a fully-indexed mortgage rate are very likely not in a sustainable homeownership situation. However, refinancing into a fixed-rate loan or entering into workout arrangements with borrowers who have demonstrated an ability to perform are usually in the best interests of both the financial institution and the borrower.

Attachment follows Ms. Thompson's answers to Senator Crapo.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SANDRA THOMPSON

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. The FDIC tracks subprime origination trends using external data sources that closely follow the market. These data sources indicate that subprime mortgage origination volume is down significantly from the high levels reported over the past three years. The FDIC does not make forecasts regarding credit availability, but does consider forecasts made by outside parties as part of our analysis.

Origination volume was about 32 percent lower in the first quarter of 2007 than a year ago, and the lowest since the third quarter of 2003.[1] There are a number of possible explanations for the decline in subprime mortgage origination volume. Market forces, such as declining liquidity in the subprime market, have increased the cost of making subprime loans. In addition, lenders have tightened their underwriting standards for loans made to consumers with less than perfect credit.

According to the April 2007 *Senior Loan Officer Opinion Survey on Bank Lending Practices*, almost one-third of respondents reported that they have tightened lending standards on subprime loans "considerably," while another one-quarter indicated they have tightened standards "somewhat."[2] More than 45 percent of respondents also reported that they have tightened lending standards on nontraditional mortgages.

Q.2. Is it true that 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 service, and the investor? Please explain why or why not.

A.2. The FDIC believes that prudent workout arrangements that are consistent with safe and sound underwriting practices are generally in the long-term best interest of both the financial institution and borrowers. Determining whether a workout arrangement is the best economic proposition depends on several critical factors. When considering a workout arrangement, lenders and servicers need to reevaluate all aspects of the transaction, including the borrowers' financial capacity and the collateral, according to safe and sound underwriting practices. Lenders also must ensure that their accounting for the transaction conforms to generally accepted accounting principles (GAAP). The lenders and servicers should compare the anticipated recovery under the loan modification to the anticipated recovery through the legal process.

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[1] *Inside B&C Lending,* May 18, 2007.

[2] April 2007 *Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

This analysis can indicate that it is more economically feasible to enter into a workout arrangement than to foreclose the property. In most cases where the borrower occupies the home, has made regular payments, and commits to a workout arrangement tailored to his ability to pay, the calculations for a workout scenario usually indicate a more favorable result to the lender, and thus the borrower, than a foreclosure scenario. Securitization can complicate matters, bringing a variety of participants with different objectives into the decision making process.

The American Securitization Forum released a *Statement of Principles, Recommendations and Guidelines for Modification of Securitized Subprime Residential Mortgage Loans* in June 2007, which states that when loan modifications are permitted, the servicer should be allowed to conduct them so long as the modification is in the best interests of investors in the aggregate. These principles attempt to harmonize the interests of the various parties. A copy of the *Statement of Principles* is attached.

Q.3. Please (a) describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you (b) provide hypothetical examples of bow this modification process works? What are (c) the limitations placed on a servicers' ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. Workout options that allow homeowners facing difficulties to remain in their homes typically involve some type of permanent interest rate reduction, extension of the maturity date or a combination of these two factors. While loan modifications that provide temporary relief (*i.e.,* granting short-term interest rate concessions, adding payments in arrears, or rollover refinancing into another unaffordable loan) lower the monthly payments for a short period, borrowers still might not be able to perform when their loans reset to their contractual terms.

Loan modifications are generally considered and made on a loan-by-loan basis, taking into account the unique combination of circumstances for each loan and borrower, including the borrower's current ability to pay. One type of temporary modification provides a short-term "freeze" or continuation of the initial fixed-rate after it was originally scheduled to expire. The interest rate reverts to the original variable rate after the extension ends. However, many borrowers will not be able to meet the higher monthly payments after the loan reverts to its original contract terms.

Lenders and services also can consider a variety of permanent loan modifications in a workout arrangement. For example, the lender or servicer might convert a variable rate to a fixed rate for the remaining term of the loan. This modification provides borrowers with a predictable payment amount. Lenders and servicers also might combine two or more types of modifications, such as converting a variable interest rate to a fixed interest rate (but at a higher level than the previous illustration) and extending the term of the loan from 30 years to 40 or 50 years. This modification would lengthen the repayment period substantially but would lower the borrowers' monthly payment amount.

The lender and servicer must calculate the net present value of the modified terms and the cost of foreclosing on the property. A workout arrangement is generally considered more favorable when the net present value of the payments on the loan as modified is likely to be greater than the anticipated net recovery that would result from foreclosure.

Servicers' ability to modify loans is governed by the pooling and servicing agreement (PSA). Most, but not all, PSAs authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable. Permitted modifications include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages, and extending the maturity date. However, many PSAs place limits on the dollar volume or the number of loans in the pool that can be modified. Further, the PSAs require the modifications to be in the best interests of, or not materially adverse to, the security holders. In addition, entities that hold certain types of derivatives may contest any modifications that result in reduced defaults. Changes to the PSA to allow for increasing the loan modification restrictions would often require an investor vote, which could be very difficult to accomplish.

Attachment follows.

American Securitization Forum

Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans

June 1, 2007 [DRAFT]

I. Introduction

The American Securitization Forum (ASF)[1] is publishing this Statement as part of its overall efforts to inform its members and promulgate relevant securitization industry guidance in light of the widespread challenges currently confronting the subprime residential mortgage markets.

Current subprime residential mortgage market conditions include a number of attributes of concern that impact securitization transactions and the broader environment for subprime mortgage finance: an increase in delinquency, default and foreclosure rates; a decline in home price appreciation rates; a prevalence of loans with a reduced introductory rate that will soon adjust to a higher rate; and a reduced availability of subprime mortgage lending for refinancing purposes. In light of these concerns, the ASF is of the view that loan modifications, for subprime mortgage loans that are in default or for which default is reasonably foreseeable, are an important servicing tool that can both help borrowers avoid foreclosure and minimize losses to securitization investors.

Moreover, the ASF recognizes that it is an important goal to minimize foreclosure and preserve homeownership wherever possible. Higher than normal rates of foreclosure may harm borrowers and their communities, and may adversely affect housing values and therefore collateral values on both performing and non-performing loans. Accordingly, the ASF recommends the use of loan modifications under appropriate circumstances as described in this Statement.

The overall purpose of this Statement is to provide guidance for servicers modifying subprime residential mortgage loans that are included in a securitization. It is our hope that publication of these principles, recommendations and guidelines will help to establish a common framework relating to the structure and interpretation of loan modification provisions in securitization transactions, thereby promoting greater uniformity, clarity and certainty of application of these provisions throughout the industry. As a consequence, ASF hopes that this guidance will facilitate wider and more effective use of loan modifications in appropriate circumstances.

[1] The American Securitization Forum is a broad-based professional forum of over 350 organizations that are active participants in the U.S. securitization market. Among other roles, ASF members act as insurers, investors, financial intermediaries and professional advisers working on securitization transactions. ASF's mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. This statement was developed principally in consultation with ASF's Subprime Mortgage Finance Task Force and Loan Modifications Working Group, with input from other ASF members and committees. Additional information about the ASF, its members and activities may be found at ASF's internet website, located at www.americansecuritization.com. ASF is an independent, adjunct forum of the Securities Industry and Financial Markets Association.

While this Statement addresses certain legal, regulatory and accounting matters, it does not constitute and should not be viewed as providing legal or accounting advice.

This Statement is focused on modifications of first lien subprime residential mortgage loans. Many of the principles reflected in this Statement would also apply to modifications of other types of residential mortgage loans. This Statement does not address modifications of second lien residential mortgage loans.

II. Overview of Typical Securitization Document Modification Provisions

Servicing of subprime residential mortgage loans included in a securitization is generally governed by either a pooling and servicing agreement or servicing agreement. These agreements typically employ a general servicing practice standard. Typical provisions require the related servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities" and/or certain procedures that such servicer would employ for loans held for its own account.

Most subprime transactions authorize the servicer to modify loans that are either in default, or for which default is either imminent or reasonably foreseeable. Generally, permitted modifications include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages, and extending the maturity date. The "reasonably foreseeable" default standard derives from and is permitted by the restrictions imposed by the REMIC sections of the Internal Revenue Code of 1986 (the "REMIC Code") on modifying loans included in a securitization for which a REMIC election is made. Most market participants interpret the two standards of future default – imminent and reasonably foreseeable – to be substantially the same.

The modification provisions that govern loans that are in default or reasonably foreseeable default typically also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, most subprime pooling and servicing agreements and servicing agreements permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing but extend the time for payment. In addition, these agreements typically permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs.

Beyond the general provisions described above, numerous variations exist with respect to loan modification provisions. Some agreement provisions are very broad and do not have any limitations or specific types of modifications mentioned. Other provisions specify certain types of permitted modifications and/or impose certain limitations or qualifications on the ability to modify loans. For example, some agreement provisions limit the frequency with which any given loan may be modified. In some cases, there is a minimum interest rate below which a loan's rate cannot be modified. Other agreement provisions may limit the total number of loans that may be modified to a specified percentage (typically, 5% where this provision is used) of the initial pool aggregate balance. For agreements that have this provision: i) in most cases the 5% cap can be waived if consent of the NIM insurer (or other credit enhancer) is obtained, ii) in a few cases the 5% cap can be waived with the consent of the rating agencies, and iii) in all other cases, in order to waive the 5% cap, consent of the rating agencies and/or investors would be required. It appears that these types of restrictions appear only in a minority of transactions. It does not appear that any securitization requires investor consent to a loan modification that is otherwise authorized under the operative documents.

III. Loan Modification Principles

Based upon extensive consultation with its members and other securitization market participants, ASF believes that the following principles articulate widely-accepted industry views regarding the use of loan modifications in connection with securitized subprime residential mortgage loans:

1. For subprime mortgage loans that are in default or where default is reasonably foreseeable, loan modifications are an important loss mitigation tool that should be used in the circumstances described in this Statement. Modifications may include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages and extending the maturity date. Other loss mitigation alternatives include forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing, and also non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. Unlike other loss mitigation alternatives, loan modifications have the additional advantage that they can be used prior to default, where default is reasonably foreseeable.

2. Establishing early contact with borrowers is a critically important factor in the success of any loss mitigation initiative. Servicers should be permitted and encouraged to reach out affirmatively and proactively to borrowers for whom default is more likely, determine whether default is reasonably foreseeable, and then explore modification possibilities. In particular, such outreach should be permitted and encouraged prior to an upcoming first adjustment date on a hybrid ARM loan.

3. Loan modifications should be considered and made on a loan-by-loan basis, taking into account the unique combination of circumstances for each loan and borrower, including the borrower's current ability to pay. The ASF is opposed to any across-the-board approach to loan modifications, and to any approach that would have all modifications structured in a particular manner. The ASF is also opposed to any proposals that would provide an across-the-board moratorium or delay period on foreclosures.

4. Generally, the ASF believes that loan modifications should only be made:

a. Consistently with applicable securitization operative documents (including amendments that can be made without investor or other consents);

b. In a manner that is in the best interests of the securitization investors in the aggregate;

c. In a manner that is in the best interests of the borrower;

d. In a manner that, insofar as possible, avoids materially adverse tax or accounting consequences to the servicer and, to the extent known, to the securitization sponsor or investors;

e. Where the loan is either in default or default is reasonably foreseeable, and if the latter, where there is a reasonable basis for the servicer determining that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future;

f. Where there is a reasonable basis for the servicer concluding that the borrower will be able to make the scheduled payments as modified; and

g. In a manner that is designed to provide sustainable and long-term solutions, but does not reduce the required payments beyond the magnitude required to return the loan to performing status, or beyond the anticipated period of borrower need.

5. The ASF believes that loan modifications meeting the criteria in Loan Modification Principles point 4 above are generally preferable to foreclosure where the servicer concludes that the net present value of the payments on the loan as modified is likely to be greater than the anticipated net recovery that would result from foreclosure.

6. In considering loss mitigation alternatives that reduce the interest rate prospectively, servicers should consider whether to make the rate reduction temporary (such as a relatively short term extension of the initial fixed period on a hybrid ARM), or permanent, based on the anticipated period of borrower need. For temporary rate reductions, servicers should re-evaluate the borrower's ability to pay, and the continued need for a rate reduction, at the end of the temporary period.

7. Any loan modification that reduces otherwise lawful, contractually required payments of principal or interest must be understood to be a financial concession by the securitization investors. There is no basis for requiring such concessions from investors unless the modification is determined to be in the best interests of the investors collectively. Loan modifications should seek to preserve the originally required contractual payments as far as possible.

8. Reasonable determinations made by servicers with respect to loan modifications, *where made in good faith and in accordance with generally applicable servicing* standards and the applicable securitization operative documents, should not expose the servicer to liability to investors and should not be subject to regulatory or enforcement actions.

IV. Loan Modification Interpretive Guidance

The ASF endorses the following interpretive positions on specific issues arising in connection with loan modifications:

1. The ASF believes, based on prevailing existing practice, that standard and customary servicing procedures for servicing subprime mortgage loans included in a securitization, as typically used as an overarching servicing standard in securitization operative documents, should be interpreted to allow the servicer to: a) permit loan modifications (including prospective interest rate reductions which may be either temporary or permanent, forgiveness of principal, capitalizing arrearages, or maturity extension not beyond the securitization maturity date) for loans that are in default or for which default is reasonably foreseeable, so long as the modification is in the best interests of investors in the aggregate, and b) engage in other loss mitigation alternatives including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing, and also non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. The ASF believes that existing securitization pooling and servicing agreements should be interpreted, to the maximum extent possible, to authorize the servicer to take the actions referenced above.

2. With respect to existing pooling and servicing or other operative agreements that expressly prohibit or restrict the servicer from taking the actions referenced above, the ASF believes that amendments to those agreements authorizing such actions should be approved by all parties required to consent to such amendments, as and when requested to do so.

3. The ASF believes that securitization operative documents should not impose numerical limitations on loan modifications, such as limits based on the percentage of the pool that may be modified.

4. The modification standards "default is imminent" and "default is reasonably foreseeable" should be interpreted to have the same meaning.

5. The modification standard "default is reasonably foreseeable" should be deemed to be met where there has been direct contact between the servicer and the borrower, where the servicer has evaluated the current ability to pay of the borrower, and has a reasonable basis for determining that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future. (This interpretation is intended to provide guidance only as to a set of

circumstances where the standard would generally be viewed to be met, and not to reflect any view that the standard would not be met in other circumstances.)

6. In evaluating whether a proposed loan modification will maximize recoveries to the investors, the servicer should compare the anticipated recovery under the loan modification to the anticipated recovery through foreclosure on a net present value basis. Whichever action is determined by the servicer to maximize recovery should be deemed to be in the best interests of the investors.

7. The standards "in the best interests of" or "not materially adverse to the interests of" investors or securityholders in any securitization should be interpreted by reference to the investors in that securitization in the aggregate, without regard to the specific impact on any particular class of investors, and in a manner that is neutral as to the effect on the cash flow waterfall or any particular class of securities.

V. Loan Modification Recommendations

The ASF recommends the following further actions in respect of loan modifications:

A. Existing and future securitizations:

1. The ASF endorses and encourages the adoption of the position articulated in the Mortgage Bankers Association position paper titled "FAS 140 Implications of Restructurings of Certain Securitized Mortgage Loans", dated May [24], 2007 (the "MBA Position Paper").

2. Servicers should maintain policies, procedures and guidelines that are reasonably designed to identify and manage any actual or perceived conflicts of interest that may arise in connection with their loan modification activities and decisionmaking. Such policies, procedures and guidelines should address, among other topics, situations in which a servicer (a) has an ownership interest in one or more classes of bonds supported by principal and/or interest collections on subprime mortgage loans that it services; (b) receives servicing fees or other compensation that is tied to various attributes of subprime mortgage loans that it services (e.g., outstanding principal balance, delinquency/default status); and (c) is not reimbursed for the costs of loan modifications from collections on subprime mortgage loans that it services.

3. Securitization operative documents should clearly state, for purposes of "delinquency triggers" or "cumulative loss triggers" which control whether excess cash flow may be released to the residual, the following: (a) whether and under what conditions a modified loan is to be considered "current", and (b) whether and how any interest rate reduction or forgiveness of principal resulting from a loan modification should be treated as a realized loss.

4. As an urgent, high priority matter, the ASF should develop guidelines under which delinquency triggers and cumulative loss triggers in securitization operative documents, which control whether excess cash flow may be released to the residual, should be interpreted in a manner consistent with the parties' intent and in a manner that appropriately reflects any loan modifications that have occurred. It is the sense of investors that (a) any partial forgiveness of principal should be treated as a loss for purposes of cumulative loss triggers, and (b) a modified loan performing in accordance with its modified terms should be treated as delinquent for purposes of delinquency triggers for some appropriate period of time.

5. Greater clarity, transparency and consistency should be established regarding how any interest rate reduction or forgiveness of principal resulting from a loan modification should be reflected for purposes of investor reporting, and for purposes of allocating payments for the cash flow waterfall.

6. Consistent with the foregoing recommendations, servicers should not make decisions to use or not use loan modifications for the purpose of manipulating the application of delinquency triggers or cumulative loss triggers which control whether excess cash flow may be released to the residual.

7. The ASF will conduct a survey of typical document provisions and interpretations, on the question of whether and under what conditions a modified loan is to be considered current for purposes of investor reporting, and for purposes of delinquency triggers and cumulative loss triggers which control whether excess cash flow may be released to the residual. Additional guidelines should be developed and recommendations should be made and evaluated regarding amendments to securitization transactional documents, based on the results of this survey.

B. Future securitizations:

1. The ASF will develop standard, uniform model contractual provisions governing the servicer's ability to provide loan modifications for use in future securitizations. Such provisions should expressly authorize the actions referenced in Loan Modification Interpretive Guidance point 1 above.

2. Use of an increased or supplemental servicing fee should be considered for loans that have been modified to defray the additional costs of administering modifications.

3. The ASF will develop standard, uniform model contractual provisions, both as to timing and priority, to govern the servicer's ability to obtain reimbursement for P&I advances and servicing advances made in respect of loans where there has been a loan modification, or where other types of loss mitigation have been used.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM EMORY W. RUSHTON

Q.1. What can be done to stop the fallout in the housing market, particularly in the sub-prime sector?

A.1. Many of the problems facing the subprime market stem from relaxed underwriting standards and the layering of risk characteristics (e.g., reduced documentation, higher loan-to-value limits) on mortgages originated during the past two years. The increase in credit risk in the subprime market, and to a lesser extent the Alt-A market, is now prompting the capital markets to reassess exposure to, and tolerance for, credit risk across all market segments. In response, investors have dramatically reduced their tolerance for risk and tightened credit standards, greatly diminishing available mortgage market liquidity.

We are closely monitoring mortgage portfolio conditions and available market liquidity at all national banks significantly engaged in mortgage banking activities. While our attention is currently focused on market conditions and the tightening of market liquidity, we believe that the stability of market conditions in the long-term can best be addressed by improving the quality of the information borrowers receive prior to selecting a product, strengthening the underwriting of new loans, and seeking effective ways to work with borrowers facing difficulties performing on their existing mortgages.

To facilitate more enduring changes, the OCC and the other federal banking regulators responded to concerns about subprime and Alt-A mortgage lending by issuing the “Interagency Guidance on Nontraditional Mortgage Product Risks” in October 2006, and the “Interagency Statement on Subprime Mortgage Lending” in June 2007. These issuances highlight the risks inherent in nontraditional and subprime mortgage products, and communicate regulatory expectations for prudent underwriting, risk management, and the control systems necessary to effectively administer these products. The guidance also describes recommended practices to ensure consumers have clear and balanced information about the relative benefits and risks of both nontraditional and subprime mortgage products. Adherence to these issuances will promote stronger credits in these higher risk tiers going forward.

Because subprime mortgages are predominantly originated by non-federally regulated lenders, it is critical that state regulators enact standards comparable to those adopted and applied by the federal banking agencies. It is vital that state regulators with the authority to oversee the activities of state-licensed subprime mortgage lenders take the actions necessary to prevent those lenders from originating loans with no realistic prospect of repayment. The OCC is encouraged that 38 states, led by the Conference of State Bank Supervisors (CSBS), have adopted or endorsed policies and regulations similar to the nontraditional mortgage guidance, and that a similar effort is underway with respect to the subprime mortgage guidance. However, it is imperative that the states not only adopt, but effectively enforce these prudent mortgage origination standards.

Q.2. Some argue that the market is already working to pull itself out of this downturn. What practices do you see mortgage holders and lenders taking to help struggling borrowers?

A.2. The market is exhibiting greater discipline when originating subprime mortgages. In the past several months, many subprime mortgage lenders have discontinued more problematic products (2/28 and 3/27 loans), and all are tightening their underwriting standards (e.g., higher minimum credit scores, lower loan-to-value limits, increased documentation requirements), and reinforcing the repayment analyses. The OCC expects these actions to result in improved future performance and long-term stability in the subprime mortgage market.

In addition, several national banks, state authorities, the GSEs and HUD, and various nonprofit housing groups have announced and implemented programs and actions designed to assist troubled subprime borrowers refinance or modify their loans and avoid foreclosure.

In June 2007, the OCC published the report, "Foreclosure Prevention: Improving Contact with Borrowers," which sets forth a variety of strategies lenders can use to reach borrowers for whom loan workouts may be necessary and appropriate (available at: *http://www.occ.gov/cdd/Foreclosure_Prevention_Insights.pdf*). A number of banks are implementing initiatives to work with borrowers to avoid foreclosure and loss of their homes, for example, by contacting borrowers at an earlier stage to inform them of reset information and potential options; offering toll free numbers for additional help; and referring them to credit counseling services or third party debt management programs if appropriate. Examples of programs that may be available to assist customers to remain in their homes include refinancing plans; repayment plans for delinquent balances; forbearance programs; and loan modification programs in which one or more of the terms are permanently changed. Examples of programs that may be available if remaining in the home is not an option include sale; short sale (a workout option where the borrower sells the secured property for an amount less than that which is owed to avoid foreclosure); auction programs with deficiency notes; or deed-in-lieu-of-foreclosure programs.

The OCC has stressed the importance of national banks prudently working with residential loan borrowers facing difficulty in meeting their contractual payment obligations. The OCC is using all available tools to encourage lenders and borrowers to work together, facilitated by supportive organizations such as counseling agencies, to maintain the smooth functioning of the residential lending industry and to help keep borrowers in their homes except where foreclosure is the only prudent course of action. To this end, we are co-hosting forums in parts of the country hit hard by foreclosures to introduce banks to the range of delinquency intervention services that community-based counseling organizations can provide.

In April of this year, the OCC and the other federal regulators published the interagency "Statement on Working with Mortgage Borrowers." This statement encourages institutions to consider prudent, safe, and sound workout arrangements that increase the potential for financially stressed borrowers to keep their homes. It emphasizes that existing guidance and standards do not require institutions to immediately foreclose on homes when a borrower exhibits repayment difficulties. The Statement also reminds financial institutions that the Homeownership Counseling Act requires institutions to inform certain borrowers who are delinquent on their mortgage loans of the availability of homeownership counseling. Finally, the statement informs lenders that they may receive favorable Community Reinvestment Act consideration for programs that transition low- and moderate-income borrowers from higher cost loans to lower cost loans, provided that the loans are made in a safe and sound manner. Similarly, in September, the agencies issued the "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages" that encourages servicers of mortgage loans that have been securitized, to review and make full use of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

In addition to guiding national banks in these outreach efforts, we also are working with nonprofit partners to encourage borrowers to work with their lenders. One very promising partnership is the NeighborWorks Center for Foreclosure Solutions, a partnership among mortgage lenders, insurance companies, government-sponsored enterprises, and community-based nonprofits. The Center, which builds capacity among foreclosure counselors through training, researching borrower behavior, working with the industry, and conducting public outreach campaigns, is sponsored by NeighborWorks America and the Homeownership Preservation Foundation. Once contact is established, the NeighborWorks Center and its foreclosure prevention coalitions are able to help many borrowers negotiate loan workouts with their lenders. Local nonprofit housing counseling groups then work with these borrowers to help ensure that they have the personal financial and money management tools to meet their restructured obligations under these workout plans.

Many borrowers in default do not realize that loan workouts are an available option, in part because they avoid contact with their lenders and servicers, viewing them as adversaries once they fall behind in their payments. Yet, the record shows that a large number of delinquent borrowers can avoid foreclosure if they make that call—and the sooner the better. Because early contact is so important, the OCC helped to launch NeighborWorks America's national ad campaign, made up of TV, radio, print, and web Public Service Announcements (PSAs), all of which were aimed at encouraging delinquent mortgage borrowers to contact their lenders or a trusted housing counselor in order to avoid foreclosure. The OCC also produced its own radio and print PSAs, which ran in both English and Spanish and reached a potential audience of 100 million people in 35 states. Both sets of PSAs encourage homeowners having difficulty paying their mortgages to call the Center's toll-free hotline—888–995–HOPE—which is open twenty-four hours a day, seven days a week. Calls flow into a national call center staffed by HUD-approved English- and Spanish-speaking counselors for borrowers to discuss their problems. The hotline, which has been in operation since April of 2005, has received over 100,000 calls from borrowers in distress and has lately been averaging 1,000 calls each day.

Depending on the nature of the problem, counseling can be provided as part of that initial call or through a series of follow-up calls or in-person visits to a local housing counseling service. These on-the-ground referrals are fielded by community-based nonprofits, including a growing number of local NeighborWorks America® and consumer credit counseling organizations. If a workout can be arranged with the lender, then these groups' counselors can provide budgeting assistance and other financial education to help ensure that these borrowers are able to meet the terms of their workout agreements.

Q.3. What Congressional or regulatory actions could potentially harm the market or slow a recovery?

A.3. Congressional and regulatory interest focuses attention on key issues and helps spur discussion and analysis. The importance of the housing sector to our economy, borrowers, lenders, and other interested parties warrants discretion and care to avoid jeopardizing market segments that are working well, and to resolve weaknesses in those that are not. Prudent and well-conceived actions are especially important in the current environment of market turmoil. The OCC is closely monitoring and consulting with all national banks that have significant exposure to the mortgage market, activities facilitated by our on-site examiner presence at the largest institutions. Overly prescriptive government directives, regulations, or guidance could further disrupt market liquidity, thereby placing financial institutions at risk and impairing homeownership opportunities for new and existing borrowers.

At the OCC, we believe that an effective approach to improving performance and promoting the long-term stability of the subprime mortgage market involves prudent underwriting of new mortgages in combination with the reasonable administration of existing loans. As discussed above, the federal bank regulatory agencies are promoting this balance with the Nontraditional Mortgage Products guidance and Statement on Subprime Mortgage Lending. These issuances call for the application of prudent underwriting standards and effective loan portfolio supervision. They also remind financial institutions to avoid predatory lending practices and to follow fundamental and appropriate consumer protection principles.

Q.4. In Mr. Smith's written testimony, he stated that refinancing will have little or no effect on boosting the market. Yet, it seems that several sub-prime and prime lenders are offering no-penalty refinancing to save borrowers from costly resets that may drive them into foreclosure. Do the rest of you agree with Mr. Smith's assessment?

A.4. The agencies believe that prudent workout arrangements consistent with safe and sound lending practices, including mortgage refinancing and loan modifications, are generally in the long-term best interest of borrowers, financial institutions, and the overall subprime market. In the interagency "Statement on Working with Mortgage Borrowers," and the interagency "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages", the federal regulators encourage financial institutions and mortgage servicers to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes. The Statement on Subprime Mortgage Lending re-emphasizes the benefits of prudent workout arrangements.

We recognize that in the current market environment many mortgage originators are having difficulty originating mortgages that are not eligible for FHA guaranty or sale to Fannie Mae or Freddie Mac. The GSEs announced their intent to broaden the eligibility standards for additional mortgage products, including additional Alt-A and subprime loans. The OCC will continue to encourage national banks to make use of the GSE expanded loan programs, FHA programs, and other available alternatives to assist existing mortgage borrowers. We expect that these actions will help provide long-term stability to the subprime market.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM EMORY W. RUSHTON

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. Rapidly deteriorating subprime loan performance and concerns about the volume and impact of upcoming ARM rate resets have resulted in a dramatic tightening of credit risk acceptance across all segments of the capital markets. This has greatly diminished available liquidity for borrowers, particularly in the subprime segment. Mortgage originators are currently having difficulty pricing and selling mortgages that are not eligible for FHA guaranty or sale to Fannie Mae or Freddie Mac, severely constricting credit availability for subprime borrowers.

In response, the GSEs announced their intent to broaden the eligibility standards for mortgage products, including additional Alt-A and subprime loans. Consequently, many mortgage originators are revising their products and criteria to ensure that new mortgages are eligible for the expanded GSE programs or FHA guaranty. Hopefully, this will expand the credit options and opportunities for subprime borrowers.

To monitor changes in credit availability, our sources of information include industry trade statistics on originations by product segment and funding source, as well as product-level origination and servicing volumes in the larger institutions we supervise. However, please note that our "internal" view is somewhat limited in that only a small fraction of subprime originations come from national banks, i.e., less than 10% in 2006.

Subprime mortgage originations declined significantly in 2007. According to Inside Mortgage Finance, origination of new subprime mortgages totaled $56 billion in second quarter 2007, down 41% from first quarter 2007 and off 66% from the $165 billion originated in second quarter 2006. Issuance of new subprime mortgage-backed securities was 32% lower in the first half of 2007 than the first half of 2006. Second quarter 2007 issuance was down 12% from the first quarter 2007, and down nearly 30% from the fourth quarter 2006. Various market publications report that new subprime mortgage originations have been virtually nonexistent during the first weeks of August. This is the result of a number of factors:

- Lack of market liquidity;
- Reduced capacity, *i.e.,* the number of non-bank subprime mortgage originators that have gone out of business, and those that are for sale and operating at reduced production levels;
- Elimination or modification of the subprime and Alt-A products offered by many institutions;
- Tightened underwriting standards, including higher credit score and larger down payment/equity requirements.

Forecasting the full impact of these changes is extremely difficult. However, we expect that while subprime originations will increase once the market stabilizes, they will not return to the origination levels of the past few years. This is not necessarily a bad thing. Rather, since the issuance of the Interagency Statement on Subprime Mortgage Lending, lenders have refocused on the importance of repayment capacity. This should help avoid situations where borrowers get into situations where they cannot perform and face the prospect of losing their homes.

We will continue to encourage the availability of prudently underwritten credit to all potential homeowners, and to support banks' efforts to work with existing borrowers with financial difficulties.

Q.2. Is it true that 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? Please explain why or why not.

A.2. The OCC believes that reasonable workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. The OCC recognizes and appreciates the many benefits of home ownership to the borrower, the community, and to the economy as a whole. We also acknowledge the benefits to lenders, servicers, and investors of promoting borrowers' continued ability to make mortgage payments. The interagency Statement on Working with Mortgage Borrowers and the interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages encourage financial institutions and mortgage servicers to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes.

However, we also recognize that there may be instances when workout arrangements are not economically feasible or appropriate. Lenders and/or investors in mortgage-backed securities have the right to expect timely repayment of the loan to the fullest extent possible. There may be cases where the borrower's financial condition has changed, or they simply borrowed more money than they can reasonably expect to repay. In either case, prolonging an untenable position may not be in any party's best interest. In those cases where reasonable workout arrangements cannot be developed, it may be in the borrower's best financial interest to preserve any remaining equity by selling the home. We will continue to encourage national banks to exercise an appropriate degree of customer sensitivity when home sale or foreclosure is the only available option.

Q.3. Please describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you provide hypothetical examples of how this modification process works? What are the limitations placed on a servicer's ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. Workout options can vary widely based on the borrower's financial capacity and whether an institution holds the loan on its own books or is servicing the mortgage for a third party. Workout options are also affected by conditions in the mortgage markets. Current market disruptions are making it difficult for many mortgage originators to refinance mortgages that are not eligible for sale to Fannie Mae or Freddie Mac. While the GSEs have announced their intent to broaden the eligibility standards for additional mortgage products, including additional Alt-A and subprime loans, many current mortgages may not be eligible for the GSE programs.

Workout arrangements not involving the refinance of an existing mortgage may include the modification of loan terms, such as reducing the interest rate and/or principal balance, extending the final maturity of the loan, or converting variable rate loans into fixed-rate products. Many of these workout programs and actions involve the coordination of efforts among servicers, lenders, investors, and community-based non-profit groups. The OCC's Community Developments Spring 2006 newsletter article titled "National Community Organizations' Foreclosure Prevention Initiatives" (copy available at: *http://www.occ.gov/cdd/spring06b/cd/index.html*) highlights various community organization foreclosure prevention initiatives, including the Neighborhood Assistance Corporation and several others. In June 2007, the OCC Community Affairs Department published the report "Foreclosure Prevention: Improving Contact with Borrowers" (available at: *http://www.occ.gov/cdd/Foreclosure_Prevention_Insights.pdf*). This report discusses best practices used by loan servicers to improve contact with delinquent mortgage borrowers, the first step in helping prevent foreclosures. The report also highlights a variety of foreclosure prevention options that may be available to subprime borrowers. These alternatives may provide financially stressed borrowers with predictable and affordable mortgage payments, thereby enabling them to retain their homes. However, in some cases where a workout program may not be feasible, it may be in a borrower's best financial interest to sell the home. In these cases, we will continue to encourage national banks to exercise an appropriate degree of sensitivity when working with their mortgage customers.

There is considerable ongoing discussion about whether servicer agreements, accounting and tax considerations, and fiduciary responsibilities to various investor classes limit a servicer's ability to work with troubled borrowers. The SEC addressed one of these potential impediments in July when it stated that a mortgage held in a securitization trust may be modified when default is "reasonably foreseeable," and that it would not trigger on-balance sheet accounting. Earlier this month, the federal financial regulatory agencies and the Conference of State Bank Supervisors (CSBS) issued a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review and make full use of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership. Nonetheless, determining when it is likely that a borrower will not be able to make future mortgage payments continues to be a challenge in terms of when to initiate effective workout arrangements. Another difficulty is determining whether a workout arrangement benefits all investors in a mortgage securitization structure. Market participants, including the federal regulatory agencies, industry, and consumer groups are continuing efforts to resolve remaining issues and concerns. The OCC strongly favors a reasoned approach to resolving these issues in line with our belief that workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of the financial institution, the borrower, and the investor, and hence, the mortgage markets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ROGER T. COLE

Q.1. What can be done to stop the fallout in the housing market, particularly in the sub-prime sector?

A.1. Until recently, both the housing and the subprime mortgage lending sectors have enjoyed robust growth driven by relatively low interest rates, strong home price appreciation, and an abundant supply of mortgage financing. As interest rates rose and home price growth began to decelerate, real estate sales slowed and mortgage defaults, especially in the subprime sector, began to increase. Lending to subprime and near-prime borrowers likely boosted home sales in 2005 and 2006; curbs on this lending are expected to be a source of some restraint on home purchases and residential investment in coming quarters. Tighter standards on subprime lending may affect the broader economy primarily through the housing market. The cooling of the housing market that has occurred has likely been an important factor restraining economic growth over the past year. However, given the fundamental economic factors in place that should support demand for housing, the effect of the troubles in the subprime sector on the broader housing market going forward is expected to be contained.

Q.2. Some argue that the market is already working to pull itself out of this downturn. What practices do you see mortgage holders and lenders taking to help struggling borrowers?

A.2. Although there are indications that the market is correcting itself, the Board remains concerned that over the next one to two years, existing subprime borrowers, especially those with more recently originated adjustable rate mortgages (ARMs), may face further difficulties. The Board and the other federal banking agencies (the Agencies) have encouraged financial institutions to identify and contact borrowers who, with counseling and financial assistance, may be able to avoid entering delinquency or foreclosure. As

I outlined in my statement, the Federal Reserve Banks' community affairs offices have initiatives underway to increase awareness and understanding of the issues surrounding troubled borrowers and identify strategies to respond to their needs.

Additionally, many lenders, sometimes in conjunction with community groups or state governments, have expressed a willingness to modify loan terms for borrowers at risk of foreclosure. Other lenders and market participants have formed programs to assist troubled borrowers. These programs include the following:

- Fannie Mae and Freddie Mac announced that they will purchase $20 billion or more of subprime loans to help minimize defaults and foreclosures.
- Washington Mutual has committed up to $2 billion to help homeowners with subprime mortgage loans avoid foreclosure. The funds will be used to refinance subprime loans at discounted interest rates.
- Neighborhood Assistance Corporation of America (NACA) recently announced it would commit $1 billion to refinance loans of lower-income people at risk of losing their homes. The financing is being provided by Bank of America and CitiGroup. NACA anticipates using the funds to refinance 7,000 to 10,000 adjustable rate subprime mortgages into fixed rate loans.
- The State of Ohio has announced that it is establishing a $100 million fund to aid troubled borrowers. The fund will be financed by municipal bonds.

Because many subprime loans are in securitized pools, loan modifications and workouts can have an added layer of complexity. Servicing agreements in securitizations sometimes restrict the share of accounts that the loan servicer can modify prior to obtaining investor approval. Additionally, accounting rules, such as FAS 140, may require the modified pool to be brought back on the originator's balance sheet if the servicer does not specifically follow the accounting statement. Extensive modifications that change expected cash flows to the securities can also trigger a rating agency review.

Q.3. What Congressional or regulatory actions could potentially harm the market or slow a recovery?

A.3. The Board believes the rise in subprime delinquencies and foreclosures needs to be addressed in a way that minimizes abusive practices while preserving prudent lending standards and product innovation in order to maintain access to credit by non-prime borrowers. To that end, on June 29, 2007, the Board and the other Agencies issued the *Interagency Statement on Subprime Mortgage Lending* emphasizing the need for prudent underwriting and clear communications with consumers about adjustable rate mortgages targeted to subprime borrowers.

In June 2007, the Board held a public hearing to gather information on how it might use its rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA) to address concerns about abusive lending practices in the subprime market. Rising foreclosures in the subprime market over the past year have led the Board to consider whether and how it should use its rulemaking authority to address these concerns. In doing so, however, the Board must determine how to reduce abuses while also preserving incentives for responsible lenders in order to maintain continued access to credit for deserving borrowers.

Q.4. In Mr. Smith's written testimony, he stated that refinancing will have little or no effect on boosting the market. Yet, it seems that several sub-prime and prime lenders are offering no-penalty refinancing to save borrowers from costly resets that may drive them into foreclosure. Do the rest of you agree with Mr. Smith's assessment?

A.4. Mr. Smith states that borrowers with adequate equity and income can be refinanced through the operation of the market. He further states that individuals who recently borrowed with "no-money-down" loans are in unsustainable homeownership and these loans will likely result in foreclosure without government assistance. He also discouraged a federal government bailout program for subprime borrowers.

Many lenders, sometimes in conjunction with community groups or state governments, have expressed a willingness to modify loan terms for borrowers at risk of foreclosure. Other lenders and market participants have formed programs to assist troubled borrowers (as discussed above). In April 2007, the Agencies issued a statement encouraging financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. This statement was reiterated in the June 2007 interagency *Statement on Subprime Mortgage Lending*. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower and increase the potential for financially stressed residential borrowers to keep their homes. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM ROGER T. COLE

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. Underwriting standards for credit to nonprime borrowers are becoming more conservative. In the Board's most recent Senior Loan Officer Opinion Survey of April 2007, more than half of the respondents who indicated that they originated subprime mortgages, reported that they had tightened standards on such loans. Additionally, preliminary information on subprime mortgage-backed securities (MBS) issued in the first quarter of 2007 indicates that these securities contain fewer loans with simultaneous second-liens that allow borrowers 100 percent financing. Borrower credit scores in these securities also showed signs of improvement in the first quarter.

Issuance of subprime mortgage backed securities (MBS) has fallen over 25 percent from peak issuance during the first half of 2006. Although there has been a reduction in volume, based on subprime MBS issuance data, industry surveys of originations, special questions on bank lending practices, proprietary datasets and (for earlier years) the HMDA data, to date, we have not seen a sudden halt in lending to borrowers with less than perfect credit.

Q.2. Is it true that 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? Please explain why or why not.

A.2. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. High rates of foreclosure can have adverse consequences on borrowers and their communities and can decrease housing values and, therefore, lenders' collateral values. In April 2007, the federal financial institutions regulatory agencies issued a statement encouraging financial institutions to work constructively with residential borrowers who are financially unable to meet their contractual payment obligations on their home loans. Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable and sustainable payment requirements.

Q.3. Please describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you provide hypothetical examples of how this modification process works? What are the limitations placed on a servicers' ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. Lenders generally determine loan workout strategies on a case-by-case basis, taking into account the unique circumstances of each borrower. For example, a workout arrangement would normally be considered for a borrower who exhibits fundamentally sound economic prospects, but is facing a temporary income shortfall such as a job loss or other emergency. However, loans to borrowers who are fundamentally unable to meet their obligations may need to be resolved through the foreclosure process or by the lender and borrower coming to some other mutually acceptable agreement that provides a sustainable solution. These agreements can vary widely, including temporary or permanent interest rate reductions, forgiveness of principal, maturity extensions in some cases, and other non-foreclosure alternatives such as the lender accepting less than the full amount due through a short sale or discounted payoff in a refinancing transaction.

Because many subprime loans are in securitized pools, workouts can have an added layer of complexity. Servicing agreements in securitizations sometimes restrict the share of accounts that the loan servicer can modify prior to obtaining investor approval. Additionally, accounting rules, such as FAS 140, may require the modified pool to be brought back on the originator's balance sheet if the servicer does not specifically follow the accounting statement. Extensive modifications that change expected cash flows to the securities can also trigger a rating agency review.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM ROGER T. COLE

Q.1. There is a sense of outrage about those of us who have worked so hard to get people into homeownership, particularly people in the minority communities where they are so underrepresented among homeowners. And to now see what is coming, what we are seeing and what is coming, which is a backtracking, which is the horrible disappointment of seeing your dream of homeownership now turn into a nightmare of lifetime debt.

As we look at what we can do in the future to prevent this from occurring again, how can the bank regulators have allowed so many loans to be made which are obviously not designed to be performing loans in sixty days, a year, or two years, with not having qualifying standards for the higher rate that is inevitably coming, but only looking at the current qualification standards under the current rate?

A.1. The Board shares the concern that certain mortgage products targeted to subprime borrowers (such as those with low initial payments, very high or no limits on how much the payment or interest rate may increase, and limited or no documentation of a borrower's income) present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of product terms and features before they take out a loan. In response to these concerns, the Board and the other Agencies issued the *Statement on Subprime Mortgage Lending.* The statement provides guidance on the criteria and factors that an institution should assess in determining a borrower's ability to repay the loan. The statement also provides guidance to protect consumers from unfair, deceptive, and other predatory practices, and to ensure that consumers are provided with clear and balanced information about the risks and features of these loans.

One key aspect of the *Statement on Subprime Mortgage Lending,* which is also addressed in the 2006 *Guidance on Nontraditional Mortgage Product Risks,* is that borrowers should be qualified for a loan based on the fully indexed rate, with a fully amortizing repayment schedule. This analysis should consider both principal and interest obligations, plus a reasonable estimate for real estate taxes and insurance, whether or not escrowed.

Additionally, the Agencies believe that verifying income is critical to conducting a credible analysis of a borrower's repayment capacity. The *Statement on Subprime Mortgage Lending* provides that stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity, and that such factors should be documented. The statement also encourages institutions to structure prepayment penalties so as to allow borrowers a reasonable period of time in which to refinance to avoid payment shock.

Many residential borrowers may face significant payment increases when their ARM loans reset in the coming months. These borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Agencies encourage financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower and increases the potential for financially stressed residential borrowers to keep their homes. Finally, the Agencies have long encouraged borrowers who are unable to meet their contractual obligations to contact their lender or servicer to discuss possible payment alternatives at the earliest indication of such problems.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOSEPH A. SMITH, JR.

Q.1. What can be done to stop the fall out in the housing market, particularly in the sub-prime sector?

A.1. From a capital markets perspective, we are experiencing a lack of confidence in the mortgage markets and lender underwriting. Both regulators and the industry have been responding. One thing that I believe will help restore confidence is the recently issued Statement on Subprime Mortgage Lending. Investors are recognizing the importance of this guidance and should be assured that it will be consistently applied across the industry. The Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators (NACCA) are developing a parallel Statement on Subprime Lending, which will be applicable to state-supervised mortgage providers.

In addition CSBS and AARMR recently issued a consumer alert, encouraging borrowers with adjustable rate mortgages (ARMs) that are scheduled to reset to educate themselves on the characteristics of their mortgage, contact their mortgage servicer for additional information, and to seek the advice of a trained adviser for assistance or guidance. CSBS and AARMR also issued an industry letter urging mortgage providers and servicers to conduct outreach to their customers to provide assistance or information as necessary. Please see the attached consumer alert and the industry letter.

In an effort to prevent abuses in the future, CSBS and AARMR have developed the Nationwide Mortgage Licensing System to improve and coordinate mortgage supervision. Scheduled to go live on January 2, 2008, the system will enhance consumer protection and streamline the licensing process for regulators and the industry. The Nationwide Mortgage Licensing System is a major step in improving the accountability of mortgage brokers and lenders and keeping the bad actors out of the industry.

All too often, it also seems, that complicated and numerous disclosure statements have been used to take advantage of borrowers. Therefore, CSBS is developing a model disclosure form to provide vital information in a clear manner. The model form has not yet been finalized, and is currently intended as a way to increase public discussion and debate on the need for improved consumer disclosure. Please see the attached model disclosure form and explanatory statement.

With regard to regulatory structure, maintenance of the existing state system of regulation is essential. What is needed is more seamless and coordinated state and federal supervision of the mortgage industry. State authorities are working diligently to assist borrowers. These efforts should be supported, not supplanted by federal actions. I acknowledge the need for state and federal activities in policing the market to be coordinated; my only exception to that statement is that the coordination should not compromise meaningful state authority.

Q.2. Some argue that the market is already working to pull itself out of this downturn. What practices do you see mortgage holders and lenders taking to help struggling borrowers?

A.2. I am aware that representatives of the mortgage lending industry, government and consumer advocates are meeting and working together to resolve structural issues in securitizations that may inhibit work-outs. FDIC Chairman Bair and her staff deserve a great deal of credit for facilitating roundtable discussions with all market participants to determine what is possible in terms of restructuring. I believe these discussions have been helpful in determining that loan servicers do have flexibility in working with borrowers. I believe the public attention to this issue has provided the necessary pressure on loan servicers to use the authority they have to work with borrowers. This will undoubtedly improve the mortgage market going forward as the industry develops standard documentation and servicing agreements.

In addition, a number of activities are taking place at the state and local level to address the needs of distressed homeowners. One good example is the mortgage summit sponsored by Commissioner Steven Antonakes of the Commonwealth of Massachusetts, which brought together representatives of the private, public and nonprofit sectors to review problems in the subprime market and propose solutions. Several of the suggestions that emerged from the Summit have recently been included in proposed legislation. Please see the attached Report of the Mortgage Summit Working Groups. This participation between industry, consumer groups and regulators should serve as a model for a coordinated approach to fixing the housing market.

Q.3. What Congressional or regulatory actions could potentially harm the market or slow a recovery?

A.3. The mortgage finance market has evolved dramatically in the past decade. Because of the complexity and sensitivity of securitization markets, there is an even greater risk of unintended consequences from legislation or regulations.

Recent regulatory guidance has encouraged more appropriate underwriting, encouraged more coordinated state and federal supervision to apply applicable law and regulation, and increased transparency so investors can more clearly understand product risk and the integrity of origination.

In my opinion, three actions could do harm:

1. A tax-funded "bail out" of investors. We need to address those in foreclosure without eroding market or borrower discipline. Therefore, any efforts to address foreclosures must be targeted in order to avoid assistance to any speculators, incompetent lenders and improvident borrowers. Such a bail out could further mask the problems in the market and therefore allow lenders and borrowers to repeat the practices that caused the current crisis.
2. Congressional action that would undermine state authority to police the mortgage market. Any solution which does not recognize the local nature of real estate and foreclosures, and therefore does not recognize the role local authorities must play, can prove detrimental or insufficient.
3. Congress should carefully examine issues of liability whether for investors or originators. Congress should draw from state successes and challenges in their attempts to create more accountability.

Q.4. In Mr. Smith's written testimony, he stated that refinancing will have little or no effect on boosting the market. Yet, it seems that several sub-prime and prime lenders are offering no-penalty refinancing to save borrowers from costly resets that may drive them into foreclosure. Do the rest of you agree with Mr. Smith's assessment?

A.4. In my written testimony, I intended to convey that refinancing will address some, but not all, of the problems we are seeing in the housing market. Instead, it is vital to maintain market discipline and establish accountability for both lenders and borrowers. Underwriting practices must be sufficient to allow analysis of a borrower's ability to repay a loan. Based upon some underwriting practices that were utilized, the lender was often not aware if the borrower could repay the loan they were purchasing. Sound underwriting principles must be utilized and borrowers must exercise discipline when purchasing loans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOSEPH A. SMITH, JR.

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. In my home state of North Carolina, my agency is following the volume growth of our mortgage market (total and subprime) relative to the Southeast and the US to assess the effects of our regulatory efforts. Nationally, a comparable measure would have to be found; perhaps, mortgage market growth compared to GDP growth. In my view, the ultimate best measure of what is going on is the home ownership rate. The effects of the current "mortgage meltdown" will be most clearly revealed by the home ownership rate in two or three years compared to today.

In an effort to improve data, a number of states are working on legislation that will collect foreclosure data on a statewide basis. This will allow for banking departments to better analyze foreclosure data.

Q.2. Is it true that 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? Please explain why or why not.

A.2. Finding a way to keep a customer in their home is most often in the best interest of the homeowner, the servicer or lender, and the investor.

Foreclosure is personally disruptive to customers, destructive to communities and almost always results in a loss to the lender or investor.

But it is wise to recall that this is our first housing crisis that has occurred since the dramatic growth of the secondary housing market. The industry, regulators, consumers and Congress are all effectively learning as we go through this crisis. There is no precedent for us to recall as we struggle with the market downturn. Therefore, regulators and Congress should allow some time for the market to correct itself, flexibility for the industry to adjust their practices, and ensure that the solution we create does not reward poor lender underwriting or consumer behavior. It is vital that our corrective actions do not erode or block market discipline.

Q.3. Please describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you provide hypothetical examples of how this modification process works? What are the limitations placed on a servicers' ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. As stated in the testimony of several witnesses, the mortgage market has changed significantly over the last 20 years, with new products, origination channels, and securitization. For the most part, this market has not experienced a significant housing crisis. This has forced all of the market participants to evaluate what is possible to assist borrowers. Assistance is complicated due to the tax laws and contracts necessary to facilitate a secondary market. Above contractual limits, restructurings require approval of all security holders.

While the options for restructuring are numerous, it most certainly will require some investor loss. In order for the process to work, the borrower will need to work with the servicer to fully document the loan to determine the true ability to repay. If a loan can not be restructured, the servicer and borrower may be able to agree to a "short sale," where the borrower sells the home and the servicer accepts the sale proceeds.

FDIC Chairman Bair and her staff deserve a great deal of credit for facilitating roundtable discussions with all market participants to determine what is possible in terms of restructuring. I believe these discussions have been helpful in determining that loan servicers do have flexibility in working with borrowers. I believe the public attention to this issue has provided the necessary pressure on loan servicers to use the authority they have to work with borrowers. This work will undoubtedly improve the mortgage market going forward as the industry develops standard documentation and servicing agreements.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SANDOR SAMUELS

Q.1. We all know that lenders much prefer owning mortgages to owning homes. What steps are your companies taking to help struggling borrowers?

A.1. Countrywide's comprehensive efforts to prevent foreclosures and preserve borrowers' ability to stay in their homes are long-standing and pre-date recent challenges in the housing market.

Countrywide makes every effort to work with our borrowers who are experiencing financial hardships. We have established industry-leading home retention programs designed to reach distressed borrowers in order to evaluate their individual situations and develop customized solutions. As part of our efforts to help our customers sustain the dream of homeownership, we strive to keep hard working families in their homes should they experience difficulty making their payments. The reasons people suffer financial setbacks are as varied as the individual circumstances of the people themselves.

Despite the mortgage industry's efforts to reach delinquent borrowers, a recent study from Freddie Mac indicates that 50% of borrowers do not call their lenders when they are in financial distress. This lack of communication can have significant consequences. For example, in 2006, when a customer contacted Countrywide to inform us of an inability to make their payment due to hardship, we were able to establish a workout plan with the borrower 80% of the time. Many borrowers, however, are unaware of options available to avoid foreclosure, and this lack of knowledge causes them to avoid contact with their lender.

At Countrywide, we encourage our borrowers to call us the very first time they anticipate problems with sending in the mortgage payment. We maintain a team of employees dedicated to assisting homeowners who are experiencing financial difficulties. This team with currently 2,400–2,600 specialists is known as our HOPE team (HOPE: Helping homeowners, Offering solutions, Preventing foreclosures, Envisioning success).

Countrywide recognizes that homeowners are sometimes reluctant to contact a lender when their payments become delinquent. We reach out to borrowers in a variety of ways:

- To encourage communication, we include helpful information in borrowers' monthly statements and attempt to reach our borrowers by phone. We utilize other methods to get information out to borrowers who are not responsive to our outreach by mail and phone. For example, we provide borrowers with a DVD that they can view in the privacy of their own homes that explains the possible repayment options. (A copy of this DVD is enclosed.) We also mail out a copy of our brochure entitled "Keeping the dream of homeownership: Solutions for the times when hardship makes it difficult to meet a monthly home loan payment." This brochure includes our toll-free number for borrowers (1–877–327–9225) to contact our dedicated team of specialists. (A copy of the brochure is enclosed.) Finally, we have planned but not yet implemented a strategy that would allow homeowners to access a secure website where they could obtain information about a possible workout, modification or other solution.

- Countrywide extends its outreach to distressed homeowners in their own communities. Our HOPE team specialists travel to our local branch offices around the country to personally meet with our borrowers who need help.
- Countrywide leverages our efforts to reach and communicate with our borrowers by forming partnerships with local and national nonprofit counseling organizations, like ACORN Housing, in order to make the important connection with our borrowers. Our efforts have included co-branding joint communication letters and advertisements encouraging the borrowers to contact either Countrywide directly or to work with a third party counselor who can assist them through the process. We augment this written outreach with local counselors who make 'face-to-face' contact with the borrowers. inviting them to work with us. To support the efforts of the many local counseling agencies around the country, we also have established a dedicated contact system (via phone and email) that allows the counseling agencies working with our borrowers to quickly and directly contact Countrywide's HOPE team specialists and identify what we can do to assist our borrowers.
- Because Countrywide appreciates the role that others can play in conducting successful outreach to distressed borrowers, Countrywide is also a founding sponsor of the Homeownership Preservation Foundation ("HPF"), a national nonprofit foreclosure prevention counseling agency that assists borrowers in all markets, every day. I currently serve on the Board of Directors for HPF. The most important development in assisting borrowers in trouble is the "1–888–995–HOPE" hotline developed by the HPF with the support of Countrywide and others in the mortgage lending industry (*www.995hope.org*). Borrowers are often bombarded with foreclosure rescue scams and other solicitations directing them to untrained counselors or untrustworthy organizations. The HOPE hotline provides borrowers with qualified and highly trained counselors whose sole mission is to help borrowers avoid foreclosure. In June 2007, the National Ad Council launched a multimedia campaign for the "1–888–995–HOPE" hotline.
- Countrywide hosts homeownership preservation seminars in local communities. These seminars are designed to bring together lenders and housing counselors to educate our borrowers and the general public on the options available to avoid foreclosure. We have held such seminars in cities as diverse as Atlanta, Dallas, Detroit, New Orleans, and New York. We also provide free access to counseling, including third party counseling from community organizations like Neighborhood Housing Service, ACORN Housing, and Consumer Credit Counseling Service. Across the country. Countrywide works with almost 60 different counseling organizations.

Once we are in contact with our borrower, we take the following steps:

Assess Homeowner Circumstances.	Reason for default—Our counselors are trained to determine the reason for the default and to learn other relevant information that can help us develop a plan to keep borrowers in their homes. Customized help—A counselor determines the most appropriate next steps based on the information gathered (*e.g.*, review financials, assess workout options. *etc.*)
Assess Ability to Pay Going Forward.	Gathering financials to enable us to assess a borrower's ability to make timely monthly mortgage payments. • Short Term Default—Financial analysis shows ability to pay; options presented to the borrower may include a short term forbearance and repayment plans allowing the homeowner to recover over a 3–9 month period. • Long Term Default—If unable to complete a short term recovery/repayment plan, our counselors engage the homeowner in discussions about longer term workout options.
Identify Workout Options ...	Home retention—Repayment plans; loan modification. Liquidation—Short sale or deed in lieu of foreclosure. (Foreclosure is a last resort.)

Countrywide employs a number of internal procedures to ensure that our borrower reviews are thorough and complete. We have no tolerance for improper referrals to foreclosure. We carefully monitor loans for any outstanding regulatory notices, pending workouts or other servicing issues that need to be resolved prior to referring a home to foreclosure. Likewise, we review all declined workouts to determine whether there is more that should be done in the particular situation. Countrywide monitors all workouts so that no particular type of workout is under-utilized and to help us assess a success ratio as compared to foreclosures.

Every borrower's situation is different and this often drives the options that are available when the borrower encounters financial difficulties. We offer the following as specific examples of workouts that reflect the range of possibilities:

- Health issues placed the borrowers in distress with one of them ultimately being placed on long term disability. Our efforts to help them retain their home included reducing the interest rate by almost 3 percentage points for a period of one year and capitalizing the missed payments to help them rebuild their credit.
- Unexpected medical problems for the family forced the borrower to quit his job and use emergency funds to pay rising medical expenses. The borrower contacted Countrywide's Home Retention Division to request assistance. The borrower was offered and accepted a 90-day forbearance with a provision that the situation can be reviewed every 90 days to determine if additional assistance is necessary.
- The borrower was in contact with a non-profit organization when her home was referred to foreclosure. The organization works with Countrywide on a regular basis and contacted the Home Retention Division on the borrower's behalf. Countrywide arranged a loan modification that included a write down of a portion of the loan balance and a fixed rate almost 4 percentage points lower than the original rate for the remainder of the loan term.

As you are aware, servicers are required to observe accounting and contractual obligations that limit the ability to offer certain workout or loan modification alternatives. The limits and available options are defined by the pooling and serving agreements and the trust documents that accompany each securitization. The accounting constraints on a servicer's ability to anticipate a default are rooted in FASB Statement No. 140. Indeed, the interpretation of this FASB statement by the accounting industry has required servicers not to initiate a loan workout with a borrower until the loan was two payments in default. With Senator Dodd's encouragement, robust discussion continues between servicers and investors on how to best work within these constraints and appropriately assist borrowers experiencing financial difficulties.

Lastly, Countrywide appreciates the effects that foreclosures can have on neighborhoods and communities. We are working on an innovative program to work with local officials to address the maintenance and appearance of properties that borrowers vacate during the foreclosure process or that become our real estate owned properties.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SANDOR SAMUELS

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. Between January 1, 2007 and May 31, 2007, the availability of credit has tightened for borrowers whose credit histories and/or choices of loan features place them within Countrywide's categories of nonprime borrowers.[1] This tightening reflects a response to market conditions coupled with the impact of the Interagency Guidance on Nontraditional Mortgage Product Risks. The data below for our nonprime lending illustrates the impact.

	January 2007	May 2007	% Change
Total Loan Volume (millions)	$2,733.6	$1,708	−38
Purchase Loans (% of monthly number of loans)	36%	15%	−58
First Time Home Buyers (% of monthly number of loans)	25%	8%	−68
Borrowers with 100% financing (% of monthly number of loans)	26%	2%	−92
Stated income borrowers with >90% financing (% of monthly number of loans)	33%	2%	−94

Forecasting further credit tightening on a short term or long term basis is very difficult, at best, given the number of variables that affect or influence the credit markets and their implications for a diverse universe of potential borrowers.

Q.2. Is it true that 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? Please explain why or why not.

[1] "Nonprime" refers to loans to borrowers who (a) had one or more late mortgage payments on an existing mortgage in the last 12 months, (b) had a FICO score below that allowed in our prime loan programs (generally 620), or (c) required a product feature not offered in our prime loan programs and generally requiring higher minimum FICO scores.

A.2. It is generally true that where there is a willing borrower, the best economic proposition for that borrower, the servicer, and investor is to have the borrower remain in the home and continue to pay his/her mortgage. In order for borrowers to suffer losing their homes to foreclosure, two things need to occur. First, they must lose the ability or desire to make payments, and second they must be unable or unwilling to sell the property and pay off the lien holder(s).

Foreclosures are overwhelmingly the product of life events and not loan products. Our analysis of the reasons for foreclosure on Countrywide's loans shows that foreclosure due to a payment increase occurred less than 1% of the time. On the other hand, factors like curtailment of income, divorce, medical issues, and death remained the top four reasons accounting for 91% of the foreclosures. When the resulting loss of the ability or desire to make payments combines with the borrower's inability to sell the property and pay off lien holders [2], foreclosure is the ultimate outcome.

These types of life events need not, however, be insurmountable and result in foreclosure. Countrywide actively pursues workouts that assist willing borrowers with positive income to remain in their homes. These workouts can take the form of repayment plans that cure prior delinquencies, forbearance that temporarily suspends or reduces payments followed by a period of repayment to bring the loan current. or modifications to one or more terms of the loan. For more details, please see our response to item 3 below.

In those regrettable situations where the borrower has no ability to maintain payments or adhere to a reasonable workout, Countrywide still makes efforts to work with borrowers so that they may obtain a more favorable economic resolution than foreclosure. Three such avenues are short sales, where less than the payoff amount is accepted, assumption of the loan by a new buyer, provided the loan permits, and a deed in lieu of foreclosure. Though the borrower does not remain in the home under these scenarios, the borrower avoids foreclosure with its negative effects on the borrower's credit report.

Q.3. Please describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you provide hypothetical examples of how this modification process works? What are the limitations placed on a servicer's ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. Countrywide's comprehensive efforts to prevent foreclosures and preserve borrowers' ability to stay in their homes are longstanding and pre-date recent challenges in the housing market.

Countrywide makes every effort to work with our borrowers who are experiencing financial hardships. We have established industry-leading home retention programs designed to reach distressed borrowers in order to evaluate their individual situations and develop customized solutions. As part of our efforts to help our customers sustain the dream of homeownership, we strive to keep hard working families in their homes should they experience difficulty making their payments. The reasons people suffer financial

[2] In our experience, it is rare for a homeowner to not take advantage of selling their home where there is equity, *i.e.*, an amount in excess of that required to pay off lien holders.

setbacks are as varied as the individual circumstances of the people themselves.

Despite the mortgage industry's efforts to reach delinquent borrowers. a recent study from Freddie Mac indicates that 50% of borrowers do not call their lenders when they are in financial distress. This lack of communication can have significant consequences. For example, in 2006, when a customer contacted Countrywide to inform us of an inability to make their payment due to hardship, we were able to establish a workout plan with the borrower 80% of the time. Many borrowers, however, are unaware of options available to avoid foreclosure, and this lack of knowledge causes them to avoid contact with their lender.

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Lastly, Countrywide appreciates the effects that foreclosures can have on neighborhoods and communities. We are working on an innovative program to work with local officials to address the maintenance and appearance of properties that borrowers vacate during the foreclosure process or that become our real estate owned properties.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM IRV ACKELSBERG

Q.1. To what degree has credit tightened for consumers with less than perfect credit, and what indicators do you follow to track this movement? What are your short term and long term forecasts?

A.1. As an attorney who has been specializing in assisting homeowners who have been fooled into abusive and dangerous subprime mortgage transactions, I must confess to regarding the tightening of this kind of credit as generally a positive development. I realize that there is a common assumption that more credit is good, and that tightening credit is bad. Before the rise of Wall Street securitizations that fueled the subprime mortgage explosion, I myself generally subscribed to that view, particularly as it related to credit access in low-income and minority communities. However, current realities in the mortgage market require us to be more selective in our reaction to market shrinkage and to consider the negative, as well as positive, aspects of the kinds of mortgage products and practices that have been dominating the subprime market in particular.

In fact, there is evidence that, in any case, many of the same abusive mortgages are still being made, despite all the current attention on this market. I refer you to the testimony provided the Committee by Michael Calhoun, President of the Center for Responsible Lending, on June 26, 2007, in which he analyzed mortgage pools underlying recent securitizations and discovered the same kind of mortgage characteristics that are now associated with the foreclosure explosion. His view, which I share, is that market forces cannot be counted on to control the practices that have produced the crisis now upon us. Action by Congress or the Fed is, in our mind, essential.

Q.2. Is it true that 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? Please explain why or why not.

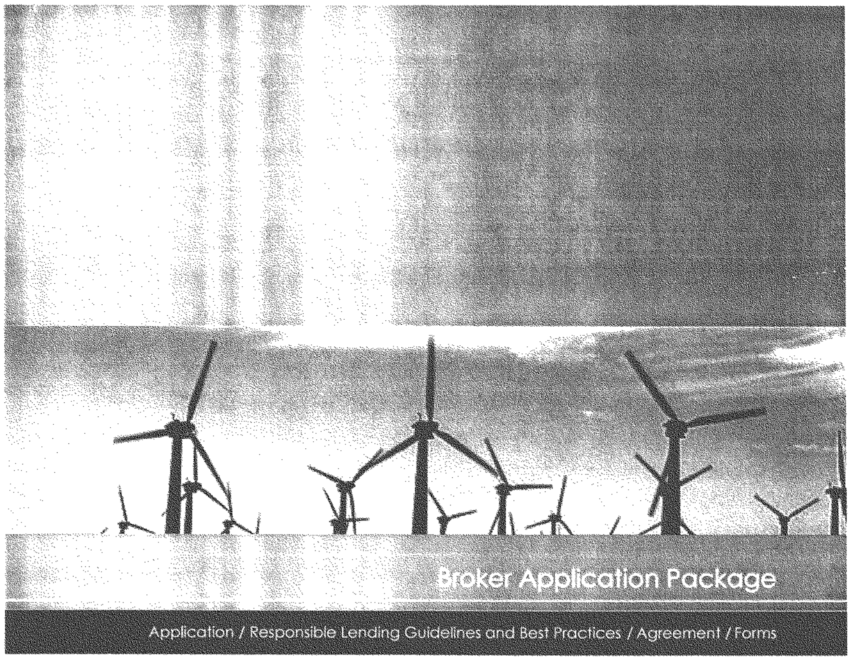
A.2. As a lawyer representing homeowners in foreclosure, the goal of my case work has usually been to persuade the servicer, and the investors represented by that servicer, that a modification of the underlying mortgage loan—i.e., reconstructing the obligation into an affordable one going forward—is in their economic interest, as well as the interest of my client. More recently, however, there appears to be a growing consensus between consumer advocates and industry groups that finding a way to keep the homeowner in the house, and making an affordable, monthly payment, is often the smartest direction for all concerned. From a purely economic standpoint, investors are coming to a realization that a modification of the underlying mortgage can produce greater value over time when compared to the anticipated net recovery from a foreclosure. This is, of course, a matter for case-by-case analysis, but I do believe that there is a greater receptivity to loan modifications than before.

I am enclosing a copy of a just released publication by the American Securitization Forum, a trade organization of various participants in the U.S. securitization market, entitled, "Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans." The purpose of this paper is to push for "wider and more effective use of loan modifications in appropriate circumstances" by establishing "a common framework relating to the structure and interpretation of loan modification provisions in securitization transactions, thereby promoting greater uniformity, clarity and certainty of application of these provisions throughout the industry."

Q.3. Please describe the workout options that allow homeowners facing difficulties to remain in their homes. Can you provide hypothetical examples of how this modification process works? What are the limitations placed on a servicer's ability to modify a loan by investors or others involved in the securitization of mortgage loans?

A.3. Both of these topics—the contents of a typical modification agreement and the limitations, both real and imagined, of a servicer's ability to modify a loan—are discussed at length in the enclosed paper from the American Securitization Forum. As described in that paper, customary work-outs include a) loan modifications that include rate reductions, either permanent or temporary, forgiveness of principal, capitalizing of arrearages or maturity extensions and b) other loss mitigation techniques such as forbearance plans and short pay-offs. My experience is that some servicers are very receptive to doing work-outs, while others resist doing so, often claiming to be constrained by their investors. The ASF paper confirms this, and suggests that in-house interpretations of what is, for the most part, similar contractual language in securitization agreements accounts for this divergence in attitude and practice. For that reason, ASF is calling for the adoption of standardized industry practices and documentation that acknowledge and support the importance of broad servicer work-out authority, including loan modification.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD



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for your interest in working with Decision One Mortgage. We are pleased that you have chosen to do business with our company. To become an Approved Broker you must first submit a complete Broker Application Package to the Decision One local branch office or account executive. Your Broker Application Package will be reviewed, and approved by Decision One if all our requirements are met. This booklet contains the information you will need to complete the Broker Application process. If you have questions, please contact your local account executive for assistance.

☐ **Broker Application (pages 6-8)**
Completed and signed by all Principals of the broker. Include the name of the local Decision One Account Executive on the front page of the Broker Application.

☐ **Broker Agreement (pages 9-17)**
The Broker Agreement must be executed and returned with the Broker Application Package.

☐ **Application Resolution (pages 18-20)**
Specify the entity type (Individual/Sole Proprietorship, Corporation, Partnership, or LLC) accurately on the proper form. If the broker is an Individual/Sole Proprietorship, an Application Resolution need not be completed.

☐ **W-9 Form (pages 21-22)**

☐ **Resume(s)**
All Principals should include a resume with the Broker Application Package.

☐ **Licenses**
Copies of applicable licensure must be provided for each state in which the broker conducts business.

Send a completed Broker Application Package to the Decision One local branch office of the account executive assigned by Decision One to you.

BROKER APPLICATION PACKAGES MUST BE SENT TO THE LOCAL BRANCH FOR REVIEW.

The Decision One local branch must review a completed Broker Application Package to conduct its review. The Decision One local branch office will notify you if additional information must be submitted. Once the Decision One local branch office has reviewed your Broker Application Package and confirmed that it is complete, the Broker Application Package will be transmitted to the Broker Approval Department in Decision One's Support Office.

Our Commitment

Best Practices

At Decision One Mortgage, our business practices are intended to promote fair and responsible lending. We work with Approved Brokers and Investors to create homeownership opportunities for borrowers who may not be able to secure financing with traditional lending institutions. We inform Approved Brokers about Mortgage Products the borrower may qualify for so the Broker can work with the borrower to select the Mortgage Product that best fits the borrower's mortgage-financing needs.

Decision One Mortgage opposes predatory lending practices because they have the potential to harm both lenders and borrowers and, if unchecked, could have an adverse effect on the mortgage lending industry and secondary market. Decision One has procedures in place to monitor its compliance with federal and state regulatory requirements as they relate to lending practices. Decision One practices ethical standards within our organization and promotes ethical standards on the part of Approved Brokers and Investors. Our Responsible Lending Guidelines and Best Practices are a part of the required "Broker Agreement" and can be viewed on our website.

Decision One's Expectation of Approved Brokers

To maintain a business relationship with Decision One Mortgage, Approved Brokers are required to:

1. Compy with all Federal and State lending requirements.
2. Be properly licensed in the States where they conducts business.
3. Submit applicaitons that satisfy the matrix/guidelines issued by Decision One.
4. Conduct business and offer loans that are in the best interest of the borrower.
5. Compy with Decision One's Broker Agreement.
6. Provide Decision One with accurate information regarding a potential borrower including the borrower's stable monthly income, monthly housing expenses, installment and/or revolving credit expenses, reserves and other liquid assets, and information on how the borrower has paid obligations in the past.
7. Only submit applications if the borrower will obtain a benefit by accepting the terms of the proposed loan.

Decision One's Standards

Because Decison One is committed to fair and responsible lending practices, Approved Brokers should be aware that we follow the standards listed below:
1. Decision One Mortgage will only originate loans where fees and points (including the Mortgage Broker Fee) have been disclosed. Decision One imposes caps on the amount of fees a consumer is charged by both the broker and lender.
2. Decision One Mortgage does not originate high cost loans as defined under State law. In States where there are regulations regarding maximum points and fees, Decison One systemically reviews its loans to confirm compliance with the caps.
3. Decision One Mortgage does not originate Section 32 HOEPA loans.
4. Deicison One prohibits practices which result in loans which do not provide a tangible net benefit to the borrower, including multiple refinancings within a short period of time.
5. Decision One does not originate or payoff unique mortgages (i.e. reverse mortgages, special interest rate loans, government subsidized loans).
6. Decision One's Broker Approval process is independent of Sales.

Decision One's Broker Approval and Monitoring Process

Relationships with third parties can present reputation, legal, compliance and credit risk. Decision One Mortgage takes a very proactive approach to managing those risks by monitoring third parties with whom it has relationships. The following key points summarize Decision One Mortgage's approach to managing risk with its prime and non-prime loan broker relationships:

1. The Approval Process – Each Approved Broker must pass a variety of screening procedures before it can do business with Decision One, including background checks, OFAC screening, Politically Exposed Party screening and database searches for adverse information (complaints, licensing, litigation, etc.). In addition, an Approved Broker cannot appear on Decision One's ineligible part list.
2. Written Contracts & Loan Guidelines – Each Approved Broker must sign an Broker Agreement which specifies performance requirements including Broker's commitment to comply with all laws and regulations and to comply with Deicison One's loan terms restrictions (interest rates, points and fees), appraiser and appraisal guidelines, and other responsible lending practices.
3. Renewal Process – Decision One monitors Approved Brokers by conducting licensing reviews and updated due diligence. Decision One also performs an annual review of Approved Broker's compliance with the Broker Agreement.
4. Relationship Management – Decision One uses internal controls to prevent 1) loan originations that do not comply with the broker Agreement and Operating Manuals; and 2) loans that do not comply with Sate and Federal Regulations. Decision One uses a loan origination system to track broker licensing by state prevent closing loans in States where an Approved Broker is not currently licensed.
5. Post-closing Monitoring and Review – After a loan has been closed, Decision One conducts quality assurance reviews and tracks early payment defaults. An independent fair lending assessment can be conducted annually on a broker-by-broker basis.

Decision One will discontinue conducting business with any broker who fails to comply with the Broker Agreement.

Our Commitment

Decision One's Commitment to Branch Training and Quality

Decision One conducts verification procedures of its lending practices including:
1. The Decision One Mortgage Compliance Department reviews each credit matrix and loan origination platform to asses compliance with applicable Federal and State laws. Decision One updates its document preparation system to incorporate current Federal and State requirements as well as Decison One's Fair Lending Guidelines.
2. Decision One Mortgage conducts branch level training for compliance with its Fair Lending Guidelines and State and Federal Laws.
3. Decision One Mortgage employees are required to take online Anti-Money Laundering training modules annually.
4. Decision One's Quality Control Department conducts branch visits and reviews approximately 10% of monthly production.
5. Decision One's Internal Risk Review Department conducts annual compliance reviews for each local Branch office.

Customer Disputes

Decision One Mortgage adheres to the following policies and procedures regarding both telephone and written complaints:
1. Decision One's Customer Service Department will track responses and resolution of all complaints including, but not limited to, regulatory complaints and complaints regarding specific brokers.
2. Decision One will take action, if appropriate, following its review of the complaint.
3. Resolution of the complaint is listed on the customer's account.

Decision One Mortgage
Member HSBC *Group*

last revised 11/06

Application For Retail Broker Program

Decision One Mortgage
Member HSBC *Group*

Account Executive Name: ______________________

Decision One Branch Location: ______________________

Company Name: ______________________

Mailing Address: ______________________

Street Address: ______________________

Contact Person: ______________________ Title: ______________________

Telephone: ( ) ______________ Fax: ( ) ______________ E-mail: ______________

I would like to occasionally receive e-mails with product updates, tips, special offers and information from Decision One. Yes ☐ No ☐

Entity Type: Please check one: Individual/Sole Proprietor ( ) Corporation ( ) Partnership ( ) Other ( )

Are you currently an Approved Correspondent lender with Decision One Mortgage? ☐ Yes ☐ No

If yes, please provide legal name of company ______________________

Address: ______________	Address: ______________
Telephone: ( ) ______________	Telephone: ( ) ______________
Fax: ( ) ______________	Fax: ( ) ______________
Contact Person: ______________	Contact Person: ______________
Title: ______________	Title: ______________
E-mail: ______________	E-mail: ______________

Please list additional Branch offices on a separate sheet and provide licensing information for each branch.

1. Name: ______________________ % of Ownership: ______________
   Address: ______________ City ______________ State ______ Zip ______________
   Date of Birth: ______________ Social Security Number: ______________
2. Name: ______________________ % of Ownership: ______________
   Address: ______________ City ______________ State ______ Zip ______________
   Date of Birth: ______________ Social Security Number: ______________
3. Name: ______________________ % of Ownership: ______________
   Address: ______________ City ______________ State ______ Zip ______________
   Date of Birth: ______________ Social Security Number: ______________

Please list any additional Principal Officers on a separate sheet.

last revised 11/06

Application For Retail Broker Program

Decision One Mortgage
Member HSBC *Group*

1. Have you done business with Decision One in the past? ____________
2. Number of years in operation: ____________
3. Number of years originating home equity loans (Second Mortgages and/or non-purchase RE loans): ____________
4. Number of employees: ____________
5. Mortgage production volume last calendar and/or fiscal year: Firsts ____________ Seconds ____________
6. Estimated yearly volume to Decision One Mortgage: ____________
7. States in which company originates loans: ____________

Please provide at least four business references (lenders to whom you currently broker or sell loans)

1. ____________
Company Name and Address
____________ ( )
Contact Title Telephone

2. ____________
Company Name and Address
____________ ( )
Contact Title Telephone

3. ____________
Company Name and Address
____________ ( )
Contact Title Telephone

4. ____________
Company Name and Address
____________ ( )
Contact Title Telephone

Application For Retail Broker Program

Decision One Mortgage
Member HSBC *Group*

Have you ever done business under a different name?

Please check one: Yes ( ) No ( )

If yes, what was that name? ____________________

Have you/the Partners/the Stockholders ever been convicted of a felony?

Please check one: Yes ( ) No ( )

If yes, please explain: ____________________

____

It is understood and hereby authorized that Decision One Mortgage or its designated agent, will check references and that it may, at its own expense, order credit reports and/or conduct any independent investigations of the applicant company and its Principals. No individual credit reports will be requested for Principals, Partners or Members of any company that is wholly owned by a federally chartered institution.

Name/Title ____________________ Signature/Date ____________________

Name/Title ____________________ Signature/Date ____________________

Name/Title ____________________ Signature/Date ____________________

Name/Title ____________________ Signature/Date ____________________

Please note: All Principals must sign

Broker Agreement

Broker Agreement

This Broker Agreement (this "Agreement") is made this ___ day of ____________, ______, between ____________ ________________, located at ________________ ________________("Broker") and Decision One Mortgage Company, LLC, located at 3023 HSBC Way, 3rd Floor, Fort Mill, South Carolina 29715, and if applicable, any state-specific affiliate engaged in lending under the directive of Decision One Mortgage Company, LLC (collectively referred to herein as "Decision One").

WHEREAS, Broker negotiates loans and credit transactions for individuals seeking loans or other extensions of credit;

WHEREAS, Broker desires to submit to Decision One loan applications and other inquiries on behalf of Broker's customers for consideration by Decision One;

WHEREAS, Decision One makes loans and other extensions of credit on its own behalf as a lender and provides services to and/or acts on behalf of other third party lenders; and

WHEREAS, the Broker and Decision One desire to define and conform their business relationship pursuant to the terms of this Agreement.

THEREFORE, in consideration of the recitals set forth above, the covenants and agreements hereinafter set forth, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties, intending to be legally bound, hereby agree as follows:

1. Broker and Decision One acknowledge and agree that the recitals to this Agreement are true and correct, and that such recitals are fully incorporated herein by this reference with the same force and effect as though restated herein.

2. Broker shall submit to Decision One applications for loans or other credit transactions for consideration by Decision One pursuant to Decision One's sole and absolute discretion. Decision One shall specify from time to time the types of loans and the terms, rates, security and other requirements for the loans and other credit transactions it will consider making. However, nothing herein shall be construed as creating any obligation on the part of Decision One to accept such applications and make such loans or other credit transactions.

3. (a) At the time each application is submitted, Broker will furnish to Decision One, at Broker's expense, the credit data, financial statements, real estate information and such additional information as Decision One from time to time may require in order to decide whether to grant the loan or other credit transaction. Broker hereby covenants, represents and warrants to Decision One that when Broker submits credit information or other information to Decision One on behalf of Broker's customer, the loan or other credit transaction for which the Broker's customer is applying will not have been already approved and funded by some other party, including

Broker. Further, if Decision One notifies Broker that Decision One has made a preliminary decision to make a loan or other credit transaction, Broker will perform, at Broker's expense, such other functions as Decision One may require to facilitate the closing of the loan or other credit transaction. In the event any application is not approved by Decision One, Broker will provide an adverse action notice to the Broker's customer, in accordance with both Regulation B, and the Fair Credit Reporting Act, including its affiliated regulations, as each may be amended, modified or supplemented.

(b) Before submitting an application to Decision One as described herein, Broker may request that Decision One make a prequalification determination with respect to the Broker's customer and advise Broker in a written Loan Pricing Estimate whether the Broker's customer would likely qualify for credit under Decision One's underwriting standards and, if so, the amount of credit and loan terms for which the Broker's customer would likely qualify. Broker acknowledges that a Loan Pricing Estimate is a preliminary determination only and that by providing a Loan Pricing Estimate Decision One has not accepted an application for credit from the Broker's customer, or from the Broker on the Broker's customer's behalf, nor made a final credit decision.

(c) After submission of an application to Decision One as described herein, Decision One may elect to issue a Pre-Approval Determination subject to conditions that must be satisfied before a final credit decision can be made by Decision One. Following the issuance of a Pre-Approval Determination, Decision One may provide the Broker with credit information, a consumer report obtained by Decision One from a consumer reporting agency, or information contained therein (collectively "Credit Information") to evaluate the Broker's customer's creditworthiness. Such Credit Information may contain information regarding account delinquencies, collection actions, or judgments that must be resolved by the Broker as a condition to the qualification of Broker's customer for credit from Decision One. Broker hereby covenants, represents and warrants that it will first obtain the written consent of the Broker's customer to the sharing of the Credit Information between Decision One and the Broker prior to accepting any such Credit Information from Decision One; that Broker will not provide the shared Credit Information to any other person or entity without the express written prior approval of Decision One; and that Broker shall act at all times in compliance with all applicable provisions of the Fair Credit Reporting Act and its affiliated regulations, as they shall be amended, modified or supplemented. Broker further covenants, represents and warrants that it will return to Decision One, or alternatively, will destroy, all Credit Information provided to it by Decision One, once the loan or other credit transaction is consummated or the Credit Information is no longer needed for a credit decision by Decision One.

4. Decision One's Loan Products Guidelines are available on its website and are hereby incorporated into this Agreement by this reference. Decision One may amend or change the Loan Products Guidelines from time to time. Broker will comply at all times in all respects with the current Loan Product Guidelines.

Decision One's Responsible Lending Guidelines ("Lending Guidelines") are attached to this Agreement and are hereby incorporated into this Agreement by this reference. Broker will comply at all times with all provisions of the Lending Guidelines as they apply to the Broker. Broker acknowledges that Decision One may amend or change the Lending Guidelines from time to time. Broker acknowledges that any amendment or change to the Lending Guidelines will be effective and applicable to Broker thirty (30) days after Broker is given notice of such amendment or change.

5. (a) Broker hereby covenants, represents and warrants to Decision One that all information, credit or otherwise, submitted to Decision One in connection with proposed loans or other credit transactions shall be accurate and truthful. In addition, Broker hereby covenants, represents and warrants to Decision One that all documents or instruments submitted by Broker to Decision One in connection with such loans or other credit transactions will be valid and genuine in every respect, and will be what they purport to be on their face. Further, Broker hereby covenants, represents and warrants to Decision One that Broker will comply with all state

and federal laws, rules and regulations that apply to Broker, Decision One and/or the loans and other credit transactions, including but not limited to state and federal truth-in-lending acts, state and federal equal credit opportunity acts, and state and federal brokerage laws. In the event any applicable statute or other legal authority requires the Broker to be licensed and/or authorized to conduct business, Broker covenants, represents and warrants to Decision One that the Broker is so properly licensed and/or otherwise authorized to conduct business and will remain so licensed and/or authorized at all times this Agreement is in force. Broker, upon written request by Decision One, shall promptly furnish to Decision One evidence of Broker's then current licenses and other authorizations required for Broker to conduct its business.

(b) Decision One and Broker also acknowledge and agree that they are both committed to full compliance with the federal Equal Credit Opportunity Act (ECOA) and all other applicable state and federal fair lending laws. Discrimination based on race, color, religion, national origin, sex, marital status, age, public assistance or the good faith pursuit of rights under the Consumer Protection Act, is strictly prohibited. Credit will be extended to all creditworthy applicants on a fair and consistent basis.

6. Each party hereto agrees to protect, indemnify and hold the other harmless from and with respect to any and all losses, liabilities, costs and expenses (including attorney's fees and expenses) that may be incurred by the non-breaching party arising out of, with respect to, connected with, or resulting from, any breach of any of the terms or provisions of this Agreement by the breaching party, including but not limited to any covenant, representation or warranty made herein or in connection with this Agreement. Neither party to this Agreement shall be liable to the other party for consequential, indirect, incidental or special damages, including lost profits or revenues, arising from default in the performance of their respective obligations under the Agreement. However, the provisions of this section shall not apply to Broker's obligation to maintain the confidentiality of all Credit Information and to comply with all applicable requirements of Title V of the Gramm-Leach-Bliley Act of 1999 and its implementing regulations, including any amendments, modifications or supplements thereof.

7. Broker shall notify Decision One, in writing, no later than three business days after Broker receives notice or information indicating that any judicial action or administrative proceeding has been instituted by any person or entity which might reasonably be expected to result in any loss, injury, damage, or claim against Decision One, or which has or may have any effect on Broker's ability to perform under this Agreement.

8. Broker shall not engage in any form of advertising whatsoever utilizing either the name of Decision One or any subsidiaries or affiliates of Decision One or any of Decision One's loan products, unless specifically authorized to do so in writing. Broker further agrees that it shall not use the name, service marks, or trademarks of Decision One or subsidiaries or affiliates of Decision One or reveal the existence of this Agreement or the terms or conditions hereof in any written advertising, publicity release or sales representation, other than disclosure required by any governmental laws or regulations, without the prior express written consent of Decision One.

9. Neither Broker nor its officers, directors, agents, employees or affiliated entities shall, for a period of 2 years from the date of closing of any loan or other credit transaction made by Decision One, solicit any individual who has received such loan or other credit transaction from Decision One (the "Borrower") for the purpose of making a new loan or other credit transaction which would be secured by the same property which secures such Borrower's loan or other credit transaction made by Decision One. However, if a Borrower requests an additional loan or other credit transaction from Broker without solicitation by or on behalf of Broker, which loan or other credit transaction would be secured by the same property as the loan or other credit transaction made by Decision One, Decision One shall be given a right of first refusal with respect to such additional loan or other credit transaction. The term "solicit" as used herein shall not include mass advertising via newspaper, radio, television and other similar forms of communication not specifically directed to the Borrowers.

10. This Agreement shall be governed by and construed and enforced in accordance with the laws of the state of North Carolina. All disputes, issues and controversies arising under or about this Agreement shall be decided by arbitration in Charlotte, North Carolina, in accordance with the Rules of Commercial Arbitration of the American Arbitration Association, or its successor. The provisions of §§ 1-567.1 et seq. of the General Statutes of North Carolina, any amendments thereto and any statute or law containing similar provisions, shall apply in any such arbitration. If the American Arbitration Association, or its successor, is not then in existence or fails or refuses to act within a reasonably prompt period of time (which shall mean not more than sixty (60) days from the date a request for arbitration is filed), the arbitration shall proceed in accordance with the laws relating to arbitration then in effect in the State of North Carolina, including but not limited to §§ 1-567 et seq. of the General Statutes of North Carolina, as amended or superseded from time to time. The judgment upon the award rendered in any such arbitration shall be final and binding upon the parties and may be entered in any court having jurisdiction over any party. The arbitration award may not include punitive damages.

11. This Agreement may be canceled by either party giving written notice of such cancellation to the other party, no less than thirty (30) days prior to the effective date of such cancellation, except as provided in Section 18(b) below. However, such cancellation shall not affect or modify any liabilities existing or to become existent with respect to loans or other credit transactions which are approved or pending for approval prior to the effective date of cancellation. All terms and provisions of this Agreement shall survive any cancellation of this Agreement insofar as they relate to loans or other credit transactions which are approved or pending for approval prior to the effective date of cancellation.

12. (a) Broker hereby acknowledges and agrees that it is an independent contractor and not an agent, partner, employer or employee of Decision One. Broker agrees not to hold itself out as an agent, partner, employer or employee of Decision One. Broker has no authority to bind Decision One by representation, contract or agreement of any kind.

(b) Broker shall provide a written disclosure ("Disclosure") to each Broker's customer for a loan or other credit transaction which Broker submits or intends to submit to Decision One that accurately and adequately describes: (i) Broker's status as an independent contractor or, if applicable, its agency or other relationship with the Broker's customer; (ii) the amount and terms of the compensation to be paid to Broker in connection with the loan or other credit transaction and whether such compensation will be paid in whole or in part by Decision One or entirely by the Broker's customer; (iii) the correlation between the interest rate and points and the compensation that will be paid to the Broker; and (iv) a statement that a lower interest rate may be obtained with respect to the loan or other credit transaction if the Broker's customer elects to pay the Broker's compensation in cash at the loan settlement. The form and content of the Disclosure shall at all times during the term of this Agreement conform to applicable provisions of the Real Estate Settlement Procedures Act of 1974 (RESPA) and its implementing regulations or interpretive rules published by the Department of Housing and Urban Development (HUD), as amended, modified or supplemented. Broker's financial arrangement with the Broker's customer must provide that the Broker's customer will receive the benefit of any compensation paid by Decision One to Broker. (Such benefit may be realized by the Broker's customer in the form of a credit against compensation otherwise due from the Broker's customer to Broker for services.) The Disclosure shall be provided to each Broker's customer as soon as practicable during the loan application process and, in each instance no later than prior to the Broker's customer's tender of a non-refundable deposit for payment of Broker's compensation. Broker shall provide a copy of the Disclosure, duly acknowledged by the Broker's customer, at the time the application is submitted.

(c) Prior to the closing of any loan approved by Decision One, Broker shall: (i) deliver Decision One's Notice to Loan Applicant(s) ("Notice") to the Broker's customer(s); (ii) obtain the written acknowledgment of Broker's customer(s) on the Notice; and (iii) transmit the fully acknowledged Notice to Decision One.

13. This Agreement supersedes all prior oral and written agreements and communications between the parties hereto pertaining to the transaction contemplated by this Agreement and constitutes the entire understanding regarding the subject matter hereof. Each party agrees and acknowledges that in executing this Agreement it does not rely and has not relied upon any representation or statement made by the other party or by any of the other party's agents, attorneys, employees or representatives with regard to the subject matter, basis, or effect of this Agreement or otherwise, other than those specifically stated in this written Agreement. This Agreement shall not be modified or amended except in writing duly executed by the authorized representative of each of the parties hereto.

14. By signing this Agreement, Broker consents to receive faxes, including advertisements, sent by or on behalf of Decision One. This consent shall also extend to faxes sent on behalf of third party lenders for whom Decision One is acting as agent, servicer, or in some other capacity as described herein. This consent is effective until revoked in writing. Broker agrees to promptly notify Decision One, in writing, of any changes in any fax numbers for which consent has been, or is to be, provided. Broker also consents to receive e-mails or other electronic communications from Decision One, via Broker's website or employee e-mail addresses.

15. Decision One shall have the right to inspect and audit at any time and from time to time all of Broker's business records that relate in any way to Broker's obligations under this Agreement. Broker shall provide Decision One and its agents and consultants with full access to Broker's business premises and books and records, wherever such books and records may be located. Such inspection and audit may include the involvement of accountants, attorneys or other third parties acting on behalf of Decision One. Decision One may copy or otherwise duplicate any such records but shall not disclose them to third parties except as authorized in this Agreement, or as may be determined necessary by Decision One in its discretion to enforce this Agreement, or for similar purposes. Any such inspection and audit shall occur during normal business hours unless Broker consents otherwise. Decision One shall give at least twenty four (24) hours notice of intent to conduct such an inspection and audit.

16. (a) Broker hereby covenants, represents and warrants to Decision One that it has developed, implemented and will maintain effective information security policies and procedures that include administrative, technical and physical safeguards designed to: 1) ensure the security and confidentiality of confidential or proprietary information provided to Broker hereunder; 2) protect against anticipated threats or hazards to the security or integrity of such confidential or proprietary information; and 3) protect against unauthorized access or use of such confidential or proprietary information. Broker hereby covenants, represents and warrants to Decision One that all of its personnel handling such confidential or proprietary information have been, and hereafter will be, appropriately trained in the implementation of Broker's information security policies and procedures. Broker shall regularly audit and review its information security policies and procedures to ensure their continued effectiveness and determine whether adjustments are necessary in light of circumstances including, without limitation, changes in technology, customer information systems or threats or hazards to confidential or proprietary information.

(b) Broker shall keep an accurate record of all transactions that occur under this Agreement. Any "Interested Party" may examine the books and records of Broker that are relevant to this Agreement. An "Interested Party" includes Decision One and its agents with respect to any transaction involving Decision One, and any third party lender (and the agents of such third party lender) on whose behalf Decision One is acting with respect to any transaction involving such third party lender. Such examination will be conducted during normal business hours upon reasonable written notice to Broker. Broker will cooperate fully with any Interested Party and allow inspection of its relevant books and records in order to review and assess performance of and compliance with the terms of this Agreement, including, without limitation, the sufficiency of information security policies and procedures with respect to confidential information. In evaluating the sufficiency of Broker's information security policies and procedures, any Interested Party shall be provided access to reports of audits, tests and/or other evaluations of Broker's information security policies and procedures conducted by Broker in the ordinary course of its business. Broker acknowledges that any Interested Party may be subject to audit and examination by governmental regulatory authorities. Broker agrees to provide access to the books and records that pertain to its relationship with any Interested Party, upon being granted a reasonable period of time to do so, to any such governmental regulatory authority, upon the request of such authority or of the other party for that purpose. All examinations conducted hereunder by a party, its agent, or a governmental regulatory authority shall be at the expense of such party.

(c) Broker shall not make any unauthorized disclosure of or use of any personal information of individual consumers which it receives from Broker's customers, Borrowers or from any Interested Party other than to carry out the purposes for which such information is received, and shall comply in all respects with all applicable requirements of Title V of the Gramm-Leach-Bliley Act of 1999 and its implementing regulations, including any amendments, modifications and supplementation thereof.

17. (a) From time to time and at any time, Decision One shall have the exclusive right to give Broker notice of new and/or different terms ("New Terms") that shall become a part of the Agreement between Decision One and Broker. Such New Terms shall be binding on Broker as set forth in Section 18(b). Such New Terms may include but shall not necessarily be limited to new, additional and/or amended: (i) requirements that are binding on Broker; (ii) covenants or promises deemed made by Broker; and/or (iii) representations and warranties deemed made by Broker. Any notice of such New Terms is referred to in this Agreement as a "New Terms Notice." A New Terms Notice shall be in writing. Decision One shall give Broker a New Terms Notice in the manner provided for notices generally under the Agreement.

(b) Decision One shall give Broker notice of a New Terms Notice at least thirty (30) days in advance of the date as of which the New Terms Notice is to be effective (the "Effective Date"), unless Broker waives in writing the right to such notice. A New Terms Notice shall expressly state its Effective Date. No New Terms Notice shall affect in any way the terms of the Agreement in effect between Decision One and Broker prior to the Effective Date of the New Terms Notice. For example, but not in limitation, an event involving Decision One and Broker that occurs one day prior to the Effective Date of a New Terms Notice shall be governed by the form of the existing Agreement between Decision One and Broker, without giving any effect to the New Terms set out in the New Terms Notice. However, as of the Effective Date of a New Terms Notice, all New Terms set forth therein shall apply in all respects to Broker just as if Decision One and Broker had both executed a written document amending the Agreement between them by expressly incorporating therein all of the New Terms, unless Broker gives notice in writing to Decision One at least fifteen (15) days prior to the Effective Date that Broker is terminating the Agreement between Decision One and Broker as of the Effective Date. Broker shall give Decision One notice of such termination in the manner provided for notices generally under the Agreement. Any such termination shall be prospective only, and the Agreement in its then form shall apply to and govern all rights and obligations between Decision One and Broker with respect to loans, other credit transactions and other facts which occurred prior to the Effective Date.

18. All notices or other information transmitted in connection with this Agreement shall be in writing and sent by (a) personal delivery, (b) prepaid overnight courier, (c) certified mail, return receipt requested, postage prepaid or (d) telefacsimile transmission with confirmation sheet attached, and addressed as follows:

If to Broker:

____

____

____

Attn: ____________________

With a copy to:

____

____

____

If to Decision One:

Decision One Mortgage
3023 HSBC Way
3rd Floor
Fort Mill, SC 29715
Fax: 803-835-9990

Attention: Ann Wells/Broker Approvals

With a copy to:
General Counsel
Decision One Mortgage
2700 Sanders Road
Prospect Heights, Illinois 60070

Either party may change its address for notice purposes by giving notice of the change in the manner described in this Section 18. A notice or other communication sent in compliance with the provisions of this Section 18 shall be deemed good and sufficient service regardless of whether the parties actually received such notice.

19. Broker shall not submit any applications to Decision One from a branch location that is not listed in Broker's application package. If Broker desires to submit loan applications from a branch location that is not listed in Broker's application package, Broker shall transmit a written request for approval of such Broker's branch location to Decision One, in a form approved by Decision One, together with any additional information required by Decision One for approval of such branch location, including, but not limited to, a copy of the required state or other governmental license for such branch, if applicable. If a Broker's branch location is terminated as a branch location of Broker, Broker shall notify Decision One in writing of such termination within twenty-four (24) hours of such termination. Irrespective of Broker's obligations under this Section, Broker expressly acknowledges that it remains liable to Decision One under the terms of this Agreement for any and all applications submitted and loans funded by Decision One under Broker's applicable state broker's license.

20. Co-brokering of loans or other use of any third party loan originators is prohibited without the prior written consent of Decision One. Broker and related fees paid hereunder shall only be paid to Broker and Broker's bona fide employees.

21. This Agreement shall be binding upon and inure to the benefit of the parties hereto; provided, however, this is an Agreement for the personal services of Broker and Broker's services may be provided by Broker only. Broker acknowledges and agrees that Decision One may assign this Agreement to any business entity (such as another limited liability company) into which or with which Decision One is merged, consolidated or otherwise combined. Decision One may also assign this Agreement to any entity to which Decision One transfers and conveys all or substantially all of Decision One's assets. If any such assignment occurs, the assignee or successor shall be substituted for Decision One in all respects under this Agreement, and shall receive all benefits of and assume all obligations of Decision One under this Agreement.

22. (a) Broker hereby covenants, represents and warrants to Decision One that Broker has complied with all applicable anti-money laundering laws and regulations, including without limitation the USA Patriot Act of 2003, and the laws and regulations administered by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC"), which prohibit dealings with certain countries, territories, entities and individuals named in OFAC's Sanction Programs and on the Specially Designated Nationals and Blocked Persons List (collectively, the "Anti-Money Laundering Laws"). Broker hereby covenants, represents and warrants to Decision One that Broker has

established an anti-money laundering compliance program to the extent required by the Anti-Money Laundering Laws, has conducted the requisite due diligence in connection with the origination of each loan or other credit transaction submitted by Broker to Decision One for purposes of the Anti-Money Laundering Laws, including with respect to the legitimacy of the applicable Borrower and the origin of the assets used by such Borrower to purchase the property in question, and maintains, and will maintain, sufficient information to identify the applicable Borrower for purposes of the Anti-Money Laundering Laws. Broker hereby covenants, represents and warrants to Decision One that no loan or other credit transaction submitted by Broker to Decision One is subject to nullification pursuant to Executive Order 13224 (the "Executive Order") or the regulations promulgated by OFAC (the "OFAC Regulations") or in violation of the Executive Order or the OFAC Regulations, and no Broker's customer or Borrower is subject to the provisions of such Executive Order or the OFAC Regulations nor listed as a "blocked person" for purposes of the OFAC Regulations.

(b) Broker hereby covenants, represents and warrants to Decision One that Broker does not own or have a controlling interest in any of the following: a money service business; a casino or other type of gaming/gambling operation; a company that is engaged in the production or distribution of arms or other military products, unless Broker has so notified Decision One in writing of such ownership or controlling interest.

IN WITNESS HEREOF, the parties hereto have executed this Agreement as of the date first set forth above.

DECISION ONE MORTGAGE COMPANY, LLC	______________________ **Broker**
By: ______________________	**By:** ______________________
Name: ______________________	**Name:** ______________________
Title: ______________________	**Title:** ______________________

Application Resolution

Unanimous Written Consent Form Use This Form if LLC

UNANIMOUS WRITTEN CONSENT WITHOUT A MEETING OF MEMBERS OF

____, LLC

The undersigned, being all of the members of ____________________, LLC, (the "Company"),

a ____________________ limited liability company, hereby consent to and agree that the following
(State of organization)
shall and does hereby constitute their actions taken by unanimous written consent without a meeting:

RESOLVED that

____________________________ the ____________________ and
Name of Member Title

____________________________ the ____________________ and
Name of Member Title

____________________________ the ____________________ and
Name of Member Title

____________________________ the ____________________ and
Name of Member Title

of this limited liability company, or any one or more of them or their duly elected or appointed successors in office, be and each of them is hereby authorized and empowered in the name of and on behalf of this limited liability company, from time to time while this resolution is in effect, to sell mortgage loans to Decision One Mortgage Company, LLC, to execute any and all agreements, contracts, and assignments, endorse any notes, checks or drafts and deliver any and all documents and information related to the mortgage loans as required or deemed necessary by Decision One Mortgage Company, LLC, and/or its affiliates, in connection with the sale of such mortgage loans.

IN WITNESS WHEREOF, the afore going actions of the Members of the Company, taken by unanimous written consent, without a meeting have been read and are hereby ratified, confirmed and approved by all the Members of the Company.

Dated as of this ________ day of ________, 20 ____.

Member and Manager ____________________ Member ____________________

Member ____________________ Member ____________________

Member ____________________ Member ____________________

CONFIDENTIAL

Application Resolution

Partnership Resolution: Use This Form If Partnership

The undersigned ______________________________hereby certify to Decision One Mortgage Company, LLC, that they are all the General Partners of ______________________________

(hereinafter "Partnership"), a partnership existing under the laws of the State of ______________________

RESOLVED that

______________________________ the ______________________ and
Name of Partner Title

______________________________ the ______________________ and
Name of Partner Title

______________________________ the ______________________ and
Name of Partner Title

______________________________ the ______________________ and
Name of Partner Title

of this partnership, or any one or more of them or their duly elected or appointed successors in office, be and each of them is hereby authorized and empowered in the name of and on behalf of this partnership, from time to time while this resolution is in effect, to sell mortgage loans to Decision One Mortgage Company, LLC, to execute any and all agreements, contracts, and assignments, endorse any notes, checks or drafts and deliver any and all documents and information related to the mortgage loans as required or deemed necessary by Decision One Mortgage Company, LLC, and/or its affiliates, in connection with the sale of such mortgage loans.

IN WITNESS THEREOF to the execution thereof this __________day of ______________, 20________.

I have hereunto set my name as General Partner.

____
General Partner Name

By ______________________________ ______________________________
Partnership Name General Partner Signature

CONFIDENTIAL

Application Resolution

Corporate Resolution - Use This Form if Corporation

Legal Name of Company: ______________________________

RESOLVED that

______________________________ the ______________________ and
Name of Officer Title

______________________________ the ______________________ and
Name of Officer Title

______________________________ the ______________________ and
Name of Officer Title

______________________________ the ______________________ and
Name of Officer Title

of this Corporation, or any one or more of them or their duly elected or appointed successors in office, be and each of them is hereby authorized and empowered in the name of and on behalf of this corporation and under its corporate seal, from time to time while this resolution is in effect, to sell mortgage loans to Decision One Mortgage Company, LLC, to execute any and all agreements, contracts, and assignments, endorse any notes, checks or drafts and deliver any and all documents and information related to the mortgage loans as required or deemed necessary by Decision One Mortgage Company, LLC, and/or its affiliates, in connection with the sale of such mortgage loans.

I HEREBY CERTIFY that the foregoing is a true and correct copy of a resolution presented to and adopted by the Board of Directors of ____________________ at a meeting duly called and held at ____________ ____________ on the ________ day of ____________ 20____, at which a quorum was present and voted, and that such resolution is duly recorded in the minute book of this corporation; that the officers name in said resolution have been duly elected or appointed to, and are the present incumbents of, the respective offices set after their respective names.

____
Signature

CONFIDENTIAL

last revised

Form **W-9**
(Rev. January 2002)
Department of the Treasury
Internal Revenue Service

Request fo[illegible] Identification Num[illegible]

Give form to the requester. Do not send to the IRS.

See Specific Instructions on page 2.
Print or type

Name

Business name, if different from above

Check appropriate box: ☐ Individual/ Sole proprietor ☐ Corporation ☐ Partnership ☐ [illegible] ☐ Exempt from backup withholding

Address (number, street, and apt. or suite no.)

Requester's name and address (optional)

City, state, and ZIP code

List account number(s) here (optional)

Part I Taxpayer Identification Number (TIN)

Enter your TIN in the appropriate box. For individuals, this is your social security number (SSN). **However, for a resident alien, sole proprietor, or disregarded entity, see the Part I instructions on page 2.** For other entities, it is your employer identification number (EIN). If you do not have a number, see **How to get a TIN** on page 2.

Note: *If the account is in more than one name, see the chart on page 2 for guidelines on whose number to enter.*

Social security number

or

Employer identification number

Part II Certification

Under penalties of perjury, I certify that:

1. The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me), **and**
2. I am not subject to backup withholding because: **(a)** I am exempt from backup withholding, or **(b)** I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or **(c)** the IRS has notified me that I am no longer subject to backup withholding, **and**
3. I am a U.S. person (including a U.S. resident alien).

Certification instructions. You must cross out item **2** above if you have been notified by the IRS that you are currently subject to backup withholding because you have failed to report all interest and dividends on your tax return. For real estate transactions, item **2** does not apply. For mortgage interest paid, acquisition or abandonment of secured property, cancellation of debt, contributions to an individual retirement arrangement (IRA), and generally, payments other than interest and dividends, you are not required to sign the Certification, but you must provide your correct TIN. (See the instructions on page 2.)

Sign Here	**Signature of U.S. person ▶**	**Date ▶**

Purpose of Form

A person who is required to file an information return with the IRS must get your correct taxpayer identification number (TIN) to report, for example, income paid to you, real estate transactions, mortgage interest you paid, acquisition or abandonment of secured property, cancellation of debt, or contributions you made to an IRA.

Use Form W-9 only if you are a U.S. person (including a resident alien), to give your correct TIN to the person requesting it (the requester) and, when applicable, to:

1. Certify the TIN you are giving is correct (or you are waiting for a number to be issued),

2. Certify you are not subject to backup withholding, or

3. Claim exemption from backup withholding if you are a U.S. exempt payee.

If you are a foreign person, use the appropriate Form W-8. See Pub. 515, Withholding of Tax on Nonresident Aliens and Foreign Entities.

Note: *If a requester gives you a form other than Form W-9 to request your TIN, you must use the requester's form if it is substantially similar to this Form W-9.*

What is backup withholding? Persons making certain payments to you must under certain conditions withhold and pay to the IRS 30% of such payments **after** December 31, 2001 (29% **after** December 31, 2003). This is called "backup withholding." Payments that may be subject to backup withholding include interest, dividends, broker and barter exchange transactions, rents, royalties, nonemployee pay, and certain payments from fishing boat operators. Real estate transactions are not subject to backup withholding.

You will **not** be subject to backup withholding on payments you receive if you give the requester your correct TIN, make the proper certifications, and report all your taxable interest and dividends on your tax return.

Payments you receive will be subject to backup withholding if:

1. You do not furnish your TIN to the requester, or

2. You do not certify your TIN when required (see the Part II instructions on page 2 for details), or

3. The IRS tells the requester that you furnished an incorrect TIN, or

4. The IRS tells you that you are subject to backup withholding because you did not report all your interest and dividends on your tax return (for reportable interest and dividends only), or

5. You do not certify to the requester that you are not subject to backup withholding under 4 above (for reportable interest and dividend accounts opened after 1983 only).

Certain payees and payments are exempt from backup withholding. See the instructions on page 2 and the separate **Instructions for the Requester of Form W-9.**

Penalties

Failure to furnish TIN. If you fail to furnish your correct TIN to a requester, you are subject to a penalty of $50 for each such failure unless your failure is due to reasonable cause and not to willful neglect.

Civil penalty for false information with respect to withholding. If you make a false statement with no reasonable basis that results in no backup withholding, you are subject to a $500 penalty.

Criminal penalty for falsifying information. Willfully falsifying certifications or affirmations may subject you to criminal penalties including fines and/or imprisonment.

Misuse of TINs. If the requester discloses or uses TINs in violation of Federal law, the requester may be subject to civil and criminal penalties.

Specific Instructions

Name. If you are an individual, you must generally enter the name shown on your social security card. However, if you have changed your last name, for instance, due to marriage without informing the Social Security Administration of the name change, enter your first name, the last name shown on your social security card, and your new last name.

If the account is in joint names, list first and then circle the name of the person or entity whose number you enter in Part I of the form.

Sole proprietor. Enter your **individual** name as shown on your social security card on the "Name" line. You may enter your business, trade, or "doing business as (DBA)" name on the "Business name" line.

Limited liability company (LLC). If you are a single-member LLC (including a foreign LLC with a domestic owner) that is disregarded as an entity separate from its owner under Treasury regulations section 301.7701-3, **enter the owner's name on the "Name" line.** Enter the LLC's name on the "Business name" line.

Other entities. Enter your business name as shown on required Federal tax documents on the "Name" line. This name should match the name shown on the charter or other legal document creating the entity. You may enter any business, trade, or DBA name on the "Business name" line.

Exempt from backup withholding. If you are exempt, enter your name as described above, then check the "Exempt from backup withholding" box in the line following the business name, sign and date the form.

Individuals (including sole proprietors) are not exempt from backup withholding. Corporations are exempt from backup withholding for certain payments, such as interest and dividends. For more information on exempt payees, see the Instructions for the Requester of Form W-9.

If you are a nonresident alien or a foreign entity not subject to backup withholding, give the requester the appropriate completed Form W-8.

Note: *If you are exempt from backup withholding, you should still complete this form to avoid possible erroneous backup withholding.*

Part I—Taxpayer Identification Number (TIN)

Enter your TIN in the appropriate box.

If you are a **resident alien** and you do not have and are not eligible to get an SSN, your TIN is your IRS individual taxpayer identification number (ITIN). Enter it in the social security number box. If you do not have an ITIN, see **How to get a TIN** below.

If you are a **sole proprietor** and you have an EIN, you may enter either your SSN or EIN. However, the IRS prefers that you use your SSN.

If you are an **LLC** that is **disregarded as an entity** separate from its owner (see ***Limited liability company (LLC)*** above), and are owned by an individual, enter your SSN (or "pre-LLC" EIN, if desired). If the owner of a disregarded LLC is a corporation, partnership, etc., enter the owner's EIN.

Note: *See the chart on this page for further clarification of name and TIN combinations.*

How to get a TIN. If you do not have a TIN, apply for one immediately. To apply for an SSN, get **Form SS-5,** Application for a Social Security Card, from your local Social Security Administration office. Get **Form W-7,** Application for IRS Individual Taxpayer Identification Number, to apply for an ITIN, or **Form SS-4,** Application for Employer Identification Number, to apply for an EIN. You can get Forms W-7 and SS-4 from the IRS by calling 1-800-TAX-FORM (1-800-829-3676) or from the IRS Web Site at **www.irs.gov.**

If you are asked to complete Form W-9 but do not have a TIN, write "Applied For" in the space for the TIN, sign and date the form, and give it to the requester. For interest and dividend payments, and certain payments made with respect to readily tradable instruments, generally you will have 60 days to get a TIN and give it to the requester before you are subject to backup withholding on payments. The 60-day rule does not apply to other types of payments. You will be subject to backup withholding on all such payments until you provide your TIN to the requester.

Note: *Writing "Applied For" means that you have already applied for a TIN* **or** *that you intend to apply for one soon.*

Caution: *A disregarded domestic entity that has a foreign owner must use the appropriate Form W-8.*

Part II—Certification

To establish to the withholding agent that you are a U.S. person, or resident alien, sign Form W-9. You may be requested to sign by the withholding agent even if items 1, 3, and 5 below indicate otherwise.

For a joint account, only the person whose TIN is shown in Part I should sign (when required). Exempt recipients, see ***Exempt from backup withholding*** above.

Signature requirements. Complete the certification as indicated in **1** through **5** below.

1. Interest, dividend, and barter exchange accounts opened before 1984 and broker accounts considered active during 1983. You must give your correct TIN, but you do not have to sign the certification.

2. Interest, dividend, broker, and barter exchange accounts opened after 1983 and broker accounts considered inactive during 1983. You *must* sign the certification or backup withholding will apply. If you are subject to backup withholding and you are merely providing your correct TIN to the requester, you must cross out item **2** in the certification before signing the form.

3. Real estate transactions. You must sign the certification. You may cross out item **2** of the certification.

4. Other payments. You must give your correct TIN, but you do not have to sign the certification unless you have been notified that you have previously given an incorrect TIN. "Other payments" include payments made in the course of the requester's trade or business for rents, royalties, goods (other than bills for merchandise), medical and health care services (including payments to corporations), payments to a nonemployee for services, payments to certain fishing boat crew members and fishermen, and gross proceeds paid to attorneys (including payments to corporations).

5. Mortgage interest paid by you, acquisition or abandonment of secured property, cancellation of debt, qualified tuition program payments (under section 529), IRA or Archer MSA contributions or distributions, and pension distributions. You must give your correct TIN, but you do not have to sign the certification.

Privacy Act Notice

Section 6109 of the Internal Revenue Code requires you to give your correct TIN to persons who must file information returns with the IRS to report interest, dividends, and certain other income paid to you, mortgage interest you paid, the acquisition or abandonment of secured property, cancellation of debt, or contributions you made to an IRA or Archer MSA. The IRS uses the numbers for identification purposes and to help verify the accuracy of your tax return. The IRS may also provide this information to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia to carry out their tax laws.

You must provide your TIN whether or not you are required to file a tax return. Payers must generally withhold 30% of taxable interest, dividend, and certain other payments to a payee who does not give a TIN to a payer. Certain penalties may also apply.

What Name and Number To Give the Requester

For this type of account:	Give name and SSN of:
1. Individual	The individual
2. Two or more individuals (joint account)	The actual owner of the account or, if combined funds, the first individual on the account [1]
3. Custodian account of a minor (Uniform Gift to Minors Act)	The minor [2]
4. a. The usual revocable savings trust (grantor is also trustee)	The grantor-trustee [1]
b. So-called trust account that is not a legal or valid trust under state law	The actual owner [1]
5. Sole proprietorship	The owner [3]
For this type of account:	**Give name and EIN of:**
6. Sole proprietorship	The owner [3]
7. A valid trust, estate, or pension trust	Legal entity [4]
8. Corporate	The corporation
9. Association, club, religious, charitable, educational, or other tax-exempt organization	The organization
10. Partnership	The partnership
11. A broker or registered nominee	The broker or nominee
12. Account with the Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison) that receives agricultural program payments	The public entity

[1] List first and circle the name of the person whose number you furnish. If only one person on a joint account has an SSN, that person's number must be furnished.

[2] Circle the minor's name and furnish the minor's SSN.

[3] **You must show your individual name,** but you may also enter your business or "DBA" name. You may use either your SSN or EIN (if you have one).

[4] List first and circle the name of the legal trust, estate, or pension trust. (Do not furnish the TIN of the personal representative or trustee unless the legal entity itself is not designated in the account title.)

Note: *If no name is circled when more than one name is listed, the number will be considered to be that of the first name listed.*

'NO MONEY DOWN' FALLS FLAT

The Washington Post, Wednesday, March 14, 2007

By Steven Pearlstein

Today's pop quiz involves some potentially exciting new products that mortgage bankers have come up with to make homeownership a reality for cash-strapped first-time buyers.

Here goes: Which of these products do you think makes sense?

(a) The "balloon mortgage," in which the borrower pays only interest for 10 years before a big lump-sum payment is due.

(b) The "liar loan," in which the borrower is asked merely to state his annual income, without presenting any documentation.

(c) The "option ARM" loan, in which the borrower can pay less than the agreed-upon interest and principal payment, simply by adding to the outstanding balance of the loan.

(d) The "piggyback loan," in which a combination of a first and second mortgage eliminates the need for any down payment.

(e) The "teaser loan," which qualifies a borrower for a loan based on an artificially low initial interest rate, even though he or she doesn't have sufficient income to make the monthly payments when the interest rate is reset in two years.

(f) The "stretch loan," in which the borrower has to commit more than 50 percent of gross income to make the monthly payments.

(g) All of the above.

If you answered (g), congratulations! Not only do you qualify for a job as a mortgage banker, but you may also have a future as a Wall Street investment banker and a bank regulator.

No, folks, I'm not making this up. Not only has the industry embraced these "innovations," but it has also begun to combine various features into a single loan and offer it to high-risk borrowers. One cheeky lender went so far as to advertise what it dubbed its "NINJA" loan—NINJA standing for "No Income, No Job and No Assets."

In fact, these innovative products are now so commonplace, they have been the driving force in the boom in the housing industry at least since 2005. They are a big reason why homeownership has increased from 65 percent of households to a record 69 percent. They help explain why outstanding mortgage debt has increased by $9.5 trillion in the past four years. And they are, unquestionably, a big factor behind the incredible run-up in home prices.

Now they are also a major reason the subprime mortgage market is melting down, why 1.5 million Americans may lose their homes to foreclosure and why hundreds of thousands of homes could be dumped on an already glutted market. They also represent a huge cloud hanging over Wall Street investment houses, which packaged and sold these mortgages to investors around the world.

How did we get to this point?

It began years ago when Lewis Ranieri, an investment banker at the old Salomon Brothers, dreamed up the idea of buying mortgages from bank lenders, bundling them and issuing bonds with the bundles as collateral. The monthly payments from homeowners were used to pay interest on the bonds, and principal was repaid once all the mortgages had been paid down or refinanced.

Thanks to Ranieri and his successors, almost anyone can originate a mortgage loan—not just banks and big mortgage lenders, but any mortgage broker with a Web site and a phone. Some banks still keep the mortgages they write. But most other originators sell them to investment banks that package and "securitize" them. And because the originators make their money from fees and from selling the loans, they don't have much at risk if borrowers can't keep up with their payments.

And therein lies the problem: an incentive structure that encourages originators to write risky loans, collect the big fees and let someone else suffer the consequences.

This "moral hazard," as economists call it, has been magnified by another innovation in the capital markets. Instead of packaging entire mortgages, Wall Street came up with the idea of dividing them into "tranches." The safest tranche, which offers investors a relatively low interest rate, will be the first to be paid off if too many borrowers default and their houses are sold at foreclosure auction. The owners of the riskiest tranche, in contrast, will be the last to be paid, and thus have the biggest risk if too many houses are auctioned for less than the value of their loans. In return for this risk, their bonds offer the highest yield.

It was this ability to chop packages of mortgages into different risk tranches that really enabled the mortgage industry to rush headlong into all those new products and new markets—in particular, the subprime market for borrowers with sketchy credit histories. Selling the safe tranches was easy, while the riskiest tranches appealed to the booming hedge-fund industry and other investors like pension funds desperate for anything offering a higher yield. So eager were global investors for these securities that when the housing market began to slow, they practically invited the mortgage bankers to keep generating new loans even if it meant they were riskier. The mortgage bankers were only too happy to oblige.

By the spring of 2005, the deterioration of lending standards was pretty clear. They were the subject of numerous eye-popping articles in The Post by my colleague Kirstin Downey. Regulators began to warn publicly of the problem, among them Fed Chairman Alan Greenspan. Several members of Congress called for a clampdown. Mortgage insurers and numerous independent analysts warned of a gathering crisis.

But it wasn't until December 2005 that the four bank regulatory agencies were able to hash out their differences and offer for public comment some "guidance" for what they politely called "nontraditional mortgages." Months ensued as the mortgage bankers fought the proposed rules with all the usual bogus arguments, accusing the agencies of "regulatory overreach," "stifling innovation" and substituting the judgment of bureaucrats for the collective wisdom of thousands of experienced lenders and millions of sophisticated investors. And they warned that any tightening of standards would trigger a credit crunch and burst the housing bubble that their loosey-goosey lending had helped spawn.

The industry campaign didn't sway the regulators, but it did delay final implementation of the guidance until September 2006, both by federal and many state regulators. And even now, with the market for subprime mortgages collapsing around them, the mortgage bankers and their highly paid enablers on Wall Street continue to deny there is a serious problem, or that they have any responsibility for it. In substance and tone, they sound almost exactly like the accounting firms and investment banks back when Enron and WorldCom were crashing around them.

What we have here is a failure of common sense. With occasional exceptions, bankers shouldn't make—or be allowed to make—mortgage loans that require no money down and no documentation of income to people who won't be able to afford the monthly payments if interest rates rise, house prices fall or the roof springs a leak. It's not a whole lot more complicated than that.

Steven Pearlstein will host a Web discussion today at 11 a.m. at *washingtonpost.com*. He can be reached at *pearlsteins@washpost.com*.

Crisis Looms In Mortgages

The New York Times, Sunday, March 11, 2007

By Gretchen Morgenson

NEWS ANALYSIS

On March 1, a Wall Street analyst at Bear Stearns wrote an upbeat report on a company that specializes in making mortgages to cash-poor homebuyers. The company, New Century Financial, had already disclosed that a growing number of borrowers were defaulting, and its stock, at around $15, had lost half its value in three weeks.

What happened next seems all too familiar to investors who bought technology stocks in 2000 at the breathless urging of Wall Street analysts. Last week, New Century said it would stop making loans and needed emergency financing to survive. The stock collapsed to $3.21.

The analyst's untimely call, coupled with a failure among other Wall Street institutions to identify problems in the home mortgage market, isn't the only familiar ring to investors who watched the technology stock bubble burst precisely seven years ago.

Now, as then, Wall Street firms and entrepreneurs made fortunes issuing questionable securities, in this case pools of home loans taken out by risky borrowers.

Now, as then, bullish stock and credit analysts for some of those same Wall Street firms, which profited in the underwriting and rating of those investments, lulled investors with upbeat pronouncements even as loan defaults ballooned. Now, as then, regulators stood by as the mania churned, fed by lax standards and anything-goes lending.

Investment manias are nothing new, of course. But the demise of this one has been broadly viewed as troubling, as it involves the nation's $6.5 trillion mortgage securities market, which is larger even than the United States treasury market.

Hanging in the balance is the nation's housing market, which has been a big driver of the economy. Fewer lenders means many potential homebuyers will find it more difficult to get credit, while hundreds of thousands of homes will go up for sale as borrowers default, further swamping a stalled market.

"The regulators are trying to figure out how to work around it, but the Hill is going to be in for one big surprise," said Josh Rosner, a managing director at Graham-Fisher & Company, an independent investment research firm in New York, and an expert on mortgage securities. "This is far more dramatic than what led to Sarbanes-Oxley," he added, referring to the legislation that followed the WorldCom and Enron scandals, "both in conflicts and in terms of absolute economic impact."

While real estate prices were rising, the market for home loans operated like a well-oiled machine, providing ready money to borrowers and high returns to investors like pension funds, insurance companies, hedge funds and other institutions. Now this enormous and important machine is sputtering, and the effects are reverberating throughout Main Street, Wall Street and Washington.

Already, more than two dozen mortgage lenders have failed or closed their doors, and shares of big companies in the mortgage industry have declined significantly. Delinquencies on loans made to less creditworthy borrowers—known as subprime mortgages—recently reached 12.6 percent. Some banks have reported rising problems among borrowers that were deemed more creditworthy as well.

Traders and investors who watch this world say the major participants—Wall Street firms, credit rating agencies, lenders and investors—are holding their collective breath and hoping that the spring season for home sales will reinstate what had been a go-go market for mortgage securities. Many Wall Street firms saw their own stock prices decline over their exposure to the turmoil.

"I guess we are a bit surprised at how fast this has unraveled," said Tom Zimmerman, head of asset-backed securities research at UBS, in a recent conference call with investors.

Even now the tone accentuates the positive. In a recent presentation to investors, UBS Securities discussed the potential for losses among some mortgage securities in a variety of housing markets. None of the models showed flat or falling home prices, however.

The Bear Stearns analyst who upgraded New Century, Scott R. Coren, wrote in a research note that the company's stock price reflected the risks in its industry, and that the downside risk was about $10 in a "rescue-sale scenario." According to New Century, Bear Stearns is among the firms with a "longstanding" relationship financing its mortgage operation. Mr. Coren, through a spokeswoman, declined to comment.

Others who follow the industry have voiced more caution. Thomas A. Lawler, founder of Lawler Economic and Housing Consulting, said: "It's not that the mortgage industry is collapsing, it's just that the mortgage industry went wild and there are consequences of going wild.

"I think there is no doubt that home sales are going to be weaker than most anybody who was forecasting the market just two months ago thought. For those areas where the housing market was already not too great, where inventories were at historically high levels and it finally looked like things were stabilizing, this is going to be unpleasant."

Like worms that surface after a torrential rain, revelations that emerge when an asset bubble bursts are often unattractive, involving dubious industry practices and even fraud. In the coming weeks, some mortgage market participants predict, investors will learn not only how lax real estate lending standards became, but also how hard to value these opaque securities are and how easy their values are to prop up.

Owners of mortgage securities that have been pooled, for example, 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 investors have to mark their holdings to the market value. As a result, traders say, many investors are reporting the values of their holdings at inflated prices.

"How these things are valued for portfolio purposes is exposed to management judgment, which is potentially arbitrary," Mr. Rosner said.

At the heart of the turmoil is the subprime mortgage market, which developed to give loans to shaky borrowers or to those with little cash to put down as collateral. Some 35 percent of all mortgage securities issued last year were in that category, up from 13 percent in 2003.

Looking to expand their reach and their profits, lenders were far too willing to lend, as evidenced by the creation of new types of mortgages—known as "affordability products"—that required little or no down payment and little or no documentation of a borrower's income. Loans with 40-year or even 50-year terms were also popular among cash-strapped borrowers seeking low monthly payments. Exceedingly low “teaser” rates that move up rapidly in later years were another feature of the new loans.

The rapid rise in the amount borrowed against a property’s value shows how willing lenders were to stretch. In 2000, according to Banc of America Securities, the average loan to a subprime lender was 48 percent of the value of the underlying property. By 2006, that figure reached 82 percent.

Mortgages requiring little or no documentation became known colloquially as “liar loans.” An April 2006 report by the Mortgage Asset Research Institute, a consulting concern in Reston, Va., analyzed 100 loans in which the borrowers merely stated their incomes, and then looked at documents those borrowers had filed with the I.R.S. The resulting differences were significant: in 90 percent of loans, borrowers overstated their incomes 5 percent or more. But in almost 60 percent of cases, borrowers inflated their incomes by more than half.

A Deutsche Bank report said liar loans accounted for 40 percent of the subprime mortgage issuance last year, up from 25 percent in 2001. Securities backed by home mortgages have been traded since the 1970s, but it has been only since 2002 or so that investors, including pension funds, insurance companies, hedge funds and other institutions, have shown such an appetite for them.

Wall Street, of course, was happy to help refashion mortgages from arcane and illiquid securities into ubiquitous and frequently traded ones. Its reward is that it now dominates the market. While commercial banks and savings banks had long been the biggest lenders to home buyers, by 2006, Wall Street had a commanding share—60 percent—of the mortgage financing market, Federal Reserve data show.

The big firms in the business are Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Deutsche Bank and UBS. They buy mortgages from issuers, put thousands of them into pools to spread out the risks and then divide them into slices, known as tranches, based on quality. Then they sell them.

The profits from packaging these securities and trading them for customers and their own accounts have been phenomenal. At Lehman Brothers, for example, mortgage-related businesses contributed directly to record revenue and income over the last three years.

The issuance of mortgage-related securities, which include those backed by home-equity loans, peaked in 2003 at more than $3 trillion, according to data from the Bond Market Association. Last year’s issuance, reflecting a slowdown in home price appreciation, was $1.93 trillion, a slight decline from 2005.

In addition to enviable growth, the mortgage securities market has undergone other changes in recent years. In the 1990s, buyers of mortgage securities spread out their risk by combining those securities with loans backed by other assets, like credit card receivables and automobile loans. But in 2001, investor preferences changed, focusing on specific types of loans. Mortgages quickly became the favorite.

Another change in the market involves its trading characteristics. Years ago, mortgage-backed securities appealed to a buy-and-hold crowd, who kept the securities on their books until the loans were paid off. “You used to think of mortgages as slow moving,” said Glenn T. Costello, managing director of structured finance residential mortgage at Fitch Ratings. “Now it has become much more of a trading market, with a mark-to-market bent.”

The average daily trading volume of mortgage securities issued by government agencies like Fannie Mae and Freddie Mac, for example, exceeded $250 billion last year. That’s up from about $60 billion in 2000.

Wall Street became so enamored of the profits in mortgages that it began to expand its reach, buying companies that make loans to consumers to supplement its packaging and sales operations. In August 2006, Morgan Stanley bought Saxon, a $6.5 billion subprime mortgage underwriter, for $706 million. And last September, Merrill Lynch paid $1.3 billion to buy First Franklin Financial, a home lender in San Jose, Calif. At the time, Merrill said it expected First Franklin to add to its earnings in 2007. Now analysts expect Merrill to take a large loss on the purchase.

Indeed, on Feb. 28, as the first fiscal quarter ended for many big investment banks, Wall Street buzzed with speculation that the firms had slashed the value of their numerous mortgage holdings, recording significant losses.

As prevailing interest rates remained low over the last several years, the appetite for these securities only rose. In the ever-present search for high yields, buyers clamored for securities that contained subprime mortgages, which carry interest rates that are typically one to two percentage points higher than traditional loans. Mortgage securities participants say increasingly lax lending standards in these loans became almost an invitation to commit mortgage fraud. It is too early to tell how significant a role mortgage fraud played in the rocketing delinquency rates—12.6 percent among subprime borrowers. Delinquency rates among all mortgages stood at 4.7 percent in the third quarter of 2006.

For years, investors cared little about risks in mortgage holdings. That is changing.

"I would not be surprised if between now and the end of the year at least 20 percent of BBB and BBB- bonds that are backed by subprime loans originated in 2006 will be downgraded," Mr. Lawler said.

Still, the rating agencies have yet to downgrade large numbers of mortgage securities to reflect the market turmoil. Standard & Poor's has put 2 percent of the subprime loans it rates on watch for a downgrade, and Moody's said it has downgraded 1 percent to 2 percent of such mortgages that were issued in 2005 and 2006.

Fitch appears to be the most proactive, having downgraded 3.7 percent of subprime mortgages in the period.

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. A spokesman for S.& P. said the firm made its ratings requirements more stringent for subprime issuers last summer and that they shored up the loans as a result.

Meeting with Wall Street analysts last week, Terry McGraw, chief executive of McGraw-Hill, the parent of S.& P., said the firm does not believe that loans made in 2006 will perform "as badly as some have suggested."

Nevertheless, some investors wonder whether the rating agencies have the stomach to downgrade these securities because of the selling stampede that would follow. Many mortgage buyers cannot hold securities that are rated below investment grade—insurance companies are an example. So if the securities were downgraded, forced selling would ensue, further pressuring an already beleaguered market.

Another consideration is the profits in mortgage ratings. Some 6.5 percent of Moody's 2006 revenue was related to the subprime market.

Brian Clarkson, Moody's co-chief operating officer, denied that the company hesitates to cut ratings. "We made assumptions early on that we were going to have worse performance in subprime mortgages, which is the reason we haven't seen that many downgrades," he said. "If we have something that is investment grade that we need to take below investment grade, we will do it."

Interestingly, accounting conventions in mortgage securities require an investor to mark his holdings to market only when they get downgraded. So investors may be assigning higher values to their positions than they would receive if they had to go into the market and find a buyer. That delays the reckoning, some analysts say.

"There are delayed triggers in many of these investment vehicles and that is delaying the recognition of losses," Charles Peabody, founder of Portales Partners, an independent research boutique in New York, said. "I do think the unwind is just starting. The moment of truth is not yet here."

On March 2, reacting to the distress in the mortgage market, a throng of regulators, including the Federal Reserve Board, asked lenders to tighten their policies on lending to those with questionable credit. Late last week, WMC Mortgage, General Electric's subprime mortgage arm, said it would no longer make loans with no down payments.

Meanwhile, investors wait to see whether the spring home selling season will shore up the mortgage market. If home prices do not appreciate or if they fall, defaults will rise, and pension funds and others that embraced the mortgage securities market will have to record losses. And they will likely retreat from the market, analysts said, affecting consumers and the overall economy.

A paper published last month by Mr. Rosner and Joseph R. Mason, an associate professor of finance at Drexel University's LeBow College of Business, assessed the potential problems associated with disruptions in the mortgage securities market. They wrote: "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."

Correction: March 20, 2007, Tuesday—A chart with a front-page news analysis article on March 11 about a looming crisis in the mortgage market mislabeled the size of the market that trades mortgage-backed securities. It trades in hundreds of billions of dollars a day, not hundreds of millions.

HOMEOWNERS AT RISK

The New York Times, Thursday, March 15, 2007

Editorial

So far, the housing bust has been mainly about subprime lenders going broke, bankers and investors trying to avoid the fallout, and regulators rousing—too late, apparently—from hibernation. The story yet to unfold involves the millions of American families who are in danger of losing their homes.

Last December, the nonpartisan Center for Responsible Lending estimated that 1.7 million homeowners were in harm's way. Fresh evidence of a meltdown—from the Mortgage Bankers Association—suggests that estimate may be too low. The association reported this week that the share of mortgages entering the foreclosure process in the last quarter of 2006 was at its highest level since the group began keeping track 37 years ago. Borrowers with subprime loans have been hardest hit, but all major loan types have been affected, as the housing market weakens amid upward adjustments in monthly payments on many mortgages.

The personal tragedy is only the start. Borrowers presently faced with losing their homes stand to lose $164 billion of wealth in the process. Whole communities pay the price. Foreclosures tend to cluster in neighborhoods, leading to sharp declines in property values, business investment and tax revenues.

Responding to the mortgage bankers' grim report, Senator Christopher Dodd, chairman of the Banking Committee and a presidential hopeful, broached the possibility of federal help for struggling homeowners. The most plausible relief measures—detailed in a new report by the Center for American Progress, a liberal research and advocacy group—involve federal boosts to existing state and local programs. Those include counseling to help strapped families plan for rising monthly payments and renegotiate their loans, legal aid and short-term loans for eligible borrowers. One study shows that a federal grant of $25 million could replicate proven local programs in other areas now experiencing spikes in foreclosures.

Mr. Dodd and his fellow lawmakers could be particularly effective at this stage in framing the case for federal help. Relief would be a cost-effective, humane response to homeowners trapped by complex, unmanageable—and, in a growing number of cases, seemingly predatory—loans. Time and resources to renegotiate those loans or sell an unaffordable property could save many families and communities from calamity.

SUBPRIME LENDING WORRIES HIT HOME

Chicago Tribune, Sunday, March 18, 2007

By Becky Yerak and Sharon Stangenes, Tribune staff reporters

The national subprime lending calamity first reached the South Side graystone on Greenwood Avenue in November.

That was when the homeowner, a 67-year-old widow named Georgia Rhone, first missed payment on a mortgage that jumped from $974 a month in 2004 to $1,850 a month last year.

Her lender now has begun foreclosure procedures as a result of a deal she realizes she never quite understood but has her in a vise: a mortgage charging 11.625 percent after being refinanced twice in two years.

Across the country, bad news is mounting in the subprime mortgage business.

Once thriving by making loans to millions of spotty-credited consumers who otherwise wouldn't be able to realize the American dream of home ownership, the industry has seen an estimated 30 lenders close shop since late 2006, amid a rise in delinquency and foreclosure rates, felled by their own lax underwriting or by borrowers unable to keep up with mortgage payments from 2 points to 5 points above prime.

In Illinois, the percentage of subprime loans in foreclosure at the end of 2006 was 6.22 percent, up from 5.04 percent a year ago, according to the Mortgage Bankers Association.

And the pain might ripple beyond the subprime lenders or borrowers.

The larger real estate industry could have reason to worry, particularly in an already sputtering market, as subprime mortgages have grown to 16 percent of total U.S. mortgage originations, up from less than 5 percent in 1994.

When loans go bad, the spillover effect on housing prices can be significant.

"With delinquency and foreclosure rates continuing to rise, this will result in more supply hitting the market throughout the year," said a report by Credit Suisse. It estimates that the National Association of Realtors' property inventory figures could jump 20 percent when homes now in the foreclosure pipeline hit the resale market.

"These head winds will be felt throughout the entire market," Credit Suisse said.

The impact begins with next-door neighbors.

In Chicago, a foreclosure started on a home lowered the price of nearby single-family homes, on average, by 0.9 percent, according to a 2006 study by the Fannie Mae Foundation, cited in a recent report from the Center for Responsible Lending. And each additional foreclosure started on the block cut values another 0.9 percent. The impact was highest in lower-income neighborhoods, where each foreclosure dropped home values an average of 1.44 percent.

One housing watcher blames overzealous lenders for the rise in foreclosures.

"Lenders are so scared about losing market share," said Malcolm Bush, president of the Woodstock Institute, a Chicago non-profit that studies housing.

Their subprime underwriting has become so "appalling," he said, that some borrowers are defaulting on adjustable-rate mortgages even before the rates change for the first time.

In Chicago, more than 56,000 high-cost mortgages were originated in 2005, double the number in 2004, according to figures that will be released next month in Woodstock's 2007 community lending fact book.

Adds Jeff Metcalf, whose Kaneville-based Record Information Services Inc. tracks foreclosures: "We see instances where people aren't even in their homes for a year."

Rhone is in danger of losing her home after years of caring for her parents and raising two grandchildren.

Because of a financial crunch, she refinanced into a subprime loan in 2005, and had to refinance it again to keep ahead of spiraling payments.

Rhone said she told her broker the monthly payment on the most recent deal he brought her was "very, very steep for my budget."

"They said, 'This is the best deal' available and that we would refinance in a few months," she said.

The South Side widow cared for her parents in the house on Greenwood Avenue, where she is now raising her daughter's children, 10 and 17.

Having trusted her broker and signed for a loan she says she didn't understand, Rhone is one of a growing number of owners trying to hang on to her home.

"More clients are contacting us because they are in foreclosure," said John Groene, associate director for Neighborhood Housing Services of Chicago, a non-profit working for neighborhood revitalization.

NHS' mission has been building and rehabbing properties in struggling Chicago neighborhoods and educating first-time home buyers. But foreclosure prevention now eats up about 40 percent of its time.

Groene supervises NHS programs in eight Chicago foreclosure hot spots: Auburn Gresham, Back of the Yards, Chicago Lawn-Gage Park, North Lawndale, Roseland, South Chicago, West Humboldt Park and West Englewood. Their foreclosure rates average seven times the national figure.

Interest rates on subprime adjustable-rate mortgages often start at 8.99 percent, Groene said. Many have one- and two-year fixed rates that reset to 10.5 percent or higher. The higher rate or a family crisis often leads to a refinance, where the interest rates are higher yet. "They are refinancing two or three times," he said. "Their interest rate is going up each time," often on yet another adjustable-rate mortgage.

But it's not just struggling neighborhoods seeing escalating foreclosures.

"We are seeing it across the board" in all price ranges and in all types of communities, said Jim Rossi, who with his wife, Sue, owns ReMax 2000 in Crete, about 25 miles south of Chicago.

"A lot of lenders who came into business in the last five years applied the wrong product to the wrong buyers," Rossi said. Buyers were "stretched into larger monthly payments than they should have had."

Lending practices "were so loose that it drove prices up," he said. That, in turn, created a "snowball effect." As prices rose, buyers needed larger mortgages to buy the house, and lenders eased standards to do the deals.

"It was keeping up with the Joneses," said Rossi, who expects foreclosures to keep rising based on the paperwork crossing his desk.

Meanwhile, lenders and appraisers are tightening standards and more closely scrutinizing buyers, which, in turn, contributes to slowing sales, he said.

Owners with mortgage problems during the recent housing boom were able to sell a home before losing it, Sue Rossi said.

But, "with the market being down the last 14 to 15 months and with market times lengthening, a lot of people who would have been able to sell haven't been able to sell," she said.

In the past, even as interest rates rose, appreciating home prices could help rescue borderline borrowers, making it easier for them to refinance. But as the housing market lost steam, slowing price appreciation, the increased equity of a home isn't there, reducing refinancing options.

"Weakness in loan underwriting is being exposed by softening housing markets," explained Keith Ernst, senior policy counsel for the Center for Responsible Lending, a non-profit watchdog of the financial-services industry.

More than 19 percent of subprime loans originated in Illinois in 2006 will result in the home being lost to foreclosure, the center estimates. That's up from 13.3 percent of Illinois subprime loans originated from 1998 to 2001 in which the home is expected to be lost.

Some consumers are taking steps now to keep themselves from slipping into the ranks of the delinquent.

Take Chicago semi-retiree Charlene Snow, 69, who pays $1,150 a month for the loan on her Trumbull Avenue home and is working with NHS to refinance her mortgage at a fixed rate. It currently carries a 10.75 percent interest rate and she is worried about it going higher.

"I had refinanced, and it was a fixed rate for two years. And after two years, they said it would be adjustable, but at the time I didn't understand what that meant," said Snow, whose two children and granddaughter live with her.

The broker also told her that they would eventually refinance the mortgage, which started at about $125,000.

Says Snow: "You don't know what tomorrow will bring, so I'd like to be at a fixed rate so I know what I'll have to pay instead of guessing what it might be."

Tips for homeowners facing foreclosure

Ask for help as soon as possible. The longer you wait, the harder it can be to fix the problem.

Beware of anyone who promises to "keep you in your home" or says they'll take care of everything.

Ask for everything in writing. When you get it on paper, have a lawyer, loan counselor or someone you trust look it over and make sure the deal is what you were promised.

The Illinois attorney general's office suggests those falling behind on mortgage payments should:

Look at "Predatory Home Loans: A Guide to Prevention and Rescue Resources," at *www.illinoisattorneygeneral.gov.* The Web site also lists names of reputable mortgage foreclosure counselors.

Call the 311 Homeownership Preservation Campaign, developed by the City of Chicago, Neighborhood Housing Services of Chicago and lender partners. The 311 operator connects you with an accredited housing counselor. Counseling is done over the phone, is confidential and takes about 45 minutes.

——Tribune staff

HISPANICS' AMERICAN DREAM HIT BY MORTGAGE CRISIS

Reuters, Sunday, March 18, 2007

By Adriana Garcia

WASHINGTON, March 18 (Reuters)—Hispanic immigrants across the United States are being hit hard by the subprime mortgage crisis, with many risking their life savings in a failed bet on the American dream of owning their own homes.

Hispanics hold up to 40 percent of mortgages in the troubled subprime loan market, where higher interest rates are charged to buyers with a damaged credit history or little borrowing experience.

Often new to the country and with limited English, many say they were misled by mortgage brokers and never expected their payments to be so high.

"If we took that loan it was because we didn't understand it," said Maria, a 39-year-old Mexican mother of three who recently lost her home in Kansas City.

She and her husband Francisco, both illegal immigrants, sold a $20,000 home and bought a $114,000 property with the kitchen of her dreams. "This new house had four bedrooms and a bigger kitchen, and that's what interested me, because I like cooking."

Two years later, with interest rates higher, they were missing their monthly payments. Unable to refinance the loan or sell to cover their debts in a depressed market, they gave up and moved to a two bedroom rented apartment in October.

"If we had known, we would never have signed the papers," she said.

About 1.5 million homeowners will face foreclosure this year, an increase of at least 20 percent from 2006, according to housing research firm RealtyTrac.Some mortgage brokers were too aggressive in persuading people to buy homes they could not afford, and Hispanics were especially vulnerable because immigrants have little credit history and are natural customers for subprime loans.

"Their lack of financial education and their overwhelming desire to buy a home makes them the perfect victims of predatory lenders," said Gregory Cahn, from La Fuerza Unida Inc., a housing counseling agency in Long Island, New York.

'CHEATED'

"People call me from all over the country to tell how they've been cheated. There are from 350 to 400 types of loans in the market, but brokers just sell what's convenient for them," said Aracely Panameno, director for Latino issues at the Center for Responsible Lending, a consumer advocacy group.

The Hispanic population in the United States stands at around 42 million, and Latinos also account for most of the country's estimated 12 million illegal immigrants.

Although some brokers went too far, the rapid growth of subprime loans in recent years gave many immigrants a chance to buy homes for the first time. As lenders now abandon the sector, even worthy Hispanic borrowers could now see loans shut off to them again.

Experts say many Hispanics trapped with expensive subprime mortgages are looking for second jobs or renting rooms in their homes to keep up payments.

"You will have families that are working multiple jobs to buy this house," said Janis Bowdler of the National Council of La Raza, a prominent Latino civil rights group. "It's their dream, so they will do everything they can to pay that bill."

Maricela Vargas, a Mexican-American woman in Visalia, California, lives with one of her sons in a three bedroom house she bought for $261,000. When she signed the papers, she was worried about the monthly payment of around $1,600.

"I trusted this woman. She told me I'd be able to refinance after a month, but it didn't happen," Vargas said.

Earning only $1,800 a month, Vargas has already spent more than $40,000 of her savings to pay the mortgage, and she rents a room to a friend. She is also now looking for a second job.

"I didn't want to move because I felt I would lose everything, my identity," she said, explaining why she is trying everything to hold on to her home. "I don't want to think about what could happen."

FED, OCC PUBLICLY CHASTISED FEW LENDERS DURING BOOM

Bloomberg.com, Wednesday, March 15, 2007

By Craig Torres and Alison Vekshin

March 14 (Bloomberg)—The Federal Reserve and the Office of the Comptroller of the Currency took little action in public to police the $2.8 trillion boom in the U.S. mortgage market—whose bust now risks worsening the housing recession.

The Fed, which is responsible for the stability of the banking system, didn't publicly rebuke any firm for failing to follow up warnings on home-lending practices between 2004 and 2006. The OCC, which supervises 1,793 national banks, took only three public mortgage-related consumer-protection enforcement actions over the same period.

Consumer advocates and former government officials say the regulators, by acting behind the scenes rather than openly advertising the shortcomings of some firms, failed to discipline an industry that loaned too much money to borrowers who couldn't repay it.

Now, more lenders are being forced to shut and foreclosures are rising, threatening to scuttle any chance of an early recovery in housing.

"There was tension between the responsibilities not to mess up some banks' businesses and the responsibility to consumers," said Edward Gramlich, a Fed governor from 1997 to 2005 who is writing a book about the mortgage market at the Urban Institute in Washington. The result, he said, is that "we could have real carnage for low-income borrowers."

Private Actions

Officials at the Fed and OCC say their examination process was rigorous and resulted in private enforcement and correction of abuses.

The agencies say they aren't allowed to disclose how many non-public actions they took between 2004 and 2006 that were aimed at protecting consumers from home-loan abuses. Private enforcement action “contains confidential supervisory information,” said Susan Stawick, a Fed spokeswoman in Washington. The OCC considers the information “proprietary and confidential,” said Kevin Mukri, a spokesman in Washington.

“Making sure people understand what they’re getting into is very important,” Fed Chairman Ben S. Bernanke said in Stanford, California, on March 2. “We’ve issued several guidances. We hope that they’ll be helpful.”

Mortgage delinquencies rose to 4.95 percent in the fourth quarter, the Mortgage Bankers Association said yesterday; that’s the highest level since the second quarter of 2003. The trade group said 13.33 percent of “subprime” borrowers—those with poor or limited credit histories—were behind on payments, the highest rate since the third quarter of 2002.

Because borrowers are having difficulty paying in a time of economic expansion and low unemployment, Congress and consumer advocates want to know how regulators allowed lenders to write loans borrowers would never be able to repay.

Prodded by Dodd

After being rebuked for foot-dragging by Senator Christopher Dodd, a Connecticut Democrat who chairs the Senate Banking Committee, federal regulators issued proposed guidelines aimed at subprime lending on March 2.

“We ought to let businesses decide how to price their products,” said William Isaac, who oversaw the largest rescue of bank depositors in American history as chairman of the Federal Deposit Insurance Corp. from 1978 to 1986. Still, he said, “if you are putting a whole bunch of teaser loans out there and people aren’t going to be able to afford them when they pop up in three years, the government has the responsibility to look into these institutions and say, ‘What are you going to do?’” The subprime industry’s woes have their roots in the tenure of former Fed Chairman Alan Greenspan. The Greenspan-led Fed cut its benchmark rate to 1 percent in 2003 and kept it there for a year, helping foster a housing bubble.

Philosophically Opposed

At the same time, Greenspan was philosophically opposed to heavy-handed intervention or rule-writing, and favored self- regulation and the primacy of markets. The former chairman declined to comment.

As Wall Street’s appetite for high-yielding mortgage bonds drove demand for high-risk loans, lending standards declined. Subprime mortgages almost doubled to $640 billion in 2006 from $332 billion in 2003, according to the newsletter Inside B&C Lending.

In response, the Fed and other regulators issued non- enforceable warnings, advising bankers and federal examiners about best practices in mortgage lending. Agencies issued guidelines defining unfair and deceptive practices in 2004, on home-equity lending in 2005, and on non-traditional mortgages in 2006.

Shared Responsibilities

While the Fed and OCC regulate the largest banks, some responsibilities are shared with three other federal agencies: the FDIC, the Office of Thrift Supervision and the National Credit Union Administration.

Federal bank regulators say their authority is limited to the institutions they oversee and doesn’t extend to the state- chartered mortgage brokers that represent a large share of the industry.

Consumer advocates say the Fed has expansive authority and could have stopped abuses. The Truth in Lending Act gives the Fed rule-writing authority over disclosures for consumer credit among all financial institutions. The Home Ownership and Equity Protection Act of 1994 also gave the Fed a role in preventing predatory lending, according to consumer advocates.

In addition, federally regulated banks and Wall Street firms are often the financiers standing behind state-regulated mortgage lenders. New Century Financial Corp., the nation’s second-biggest subprime lender, includes Morgan Stanley, Citigroup Inc., and Goldman Sachs Group Inc.—all regulated by federal agencies—among its creditors. Gramlich says the Fed should seek an expansion of its authority to supervise mortgage subsidiaries of bank holding companies.

‘Systematic Fraud’

“There is no question that mortgage brokers are on the street committing systematic fraud on the American homeowner,” said Irv Ackelsberg, a Philadelphia attorney who testified at a Fed hearing last year in the city. He said there is a “lack of will” on the part of the Fed to use its power to stop abuses.

Fed officials defend their approach, saying that over-zealous regulation might cut off credit to people who need it most.

“There is going to be a fraction of people that get the wrong product and that is regrettable,” Richmond Fed President Jeffrey Lacker said in an interview. “Should we do something to limit that probability? Well, we could, but it would also limit credit to people for whom that is the right product.”

Fed and OCC officials say their routine bank examinations, which aren’t disclosed, have enabled them to intercept trouble as they find it. Together, the organizations oversee financial institutions with more than $8.2 trillion in assets.

‘Process Is Working’

“The problem is normally addressed through non-public supervisory and informal actions, and only rarely reaches the point where a formal action is necessary,” said the OCC’s Mukri. “In fact, the relatively low number of formal actions is an indication that the supervisory process is working.”

The Fed’s Stawick said the central bank “has in place a rigorous supervision and examination program and routinely examines the institutions it supervises for compliance with all consumer protection requirements.”

While no enforcement actions resulting from the Fed’s consumer-loan guidelines have been disclosed, “non-public action has been taken,” Stawick added.

Total OCC enforcement actions against banks, both public and private and omitting so-called affiliated parties, averaged 81 a year between 2004 and 2006. Fed banks completed 102 non- public enforcement actions in 2004 and 95 in 2005, including those against affiliated parties. Data for 2006 aren’t yet available.

The Right to a Remedy

Critics say the regulators’ private responses harm consumers by depriving them of information they might need to take action on their own behalf. “Borrowers hurt by an abusive practice have the right to a remedy,” said Alys Cohen, a staff attorney at the National Consumer Law Center in Washington.

The Fed has published some large enforcement orders. CitiFinancial Credit Company of Baltimore, a subsidiary of Citigroup Inc., paid a fine and restitution to customers that totaled $70 million or more under a 2004 order, according to the Fed. The disciplinary action was related to home and personal lending between 2000 and 2001, prior to the mid-decade surge in mortgage lending.

Fed officials last year held lengthy hearings on home lending in four cities, where they were warned about predatory lending and given specific examples of abuses by witnesses.

One witness at a June 9 hearing in Philadelphia was Ackelsberg, who received a 2001 award from that city’s bar association for his work for the public interest.

‘Fundamentally Broken’

Ackelsberg told former Fed Governor Mark Olson and Consumer Affairs Director Sandra Braunstein that the subprime market was “fundamentally broken,” and presented an example of a loan that left a Social Security recipient with about $10 a day to live on after she paid her mortgage.

He and other critics say the lack of public action is symptomatic of a too-cozy relationship between the overseers and the overseen, with consumers and the U.S. economy paying the price. “We have regulators almost competing with one another to be clients of the industry,” said David Berenbaum, executive vice president for the National Community Reinvestment Coalition in Washington “What we need is for regulators to be competing to offer consumer protection.”

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