Remarks
By
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Good morning. It's a pleasure to be here with you as you celebrate your 30th anniversary of making a real difference in our communities. Thank you for the work that you do. I'm here today to talk about an issue that concerns us all - predatory lending. I'm also here to talk about what the FDIC is doing about it.

There is room for legitimate debate on how best to differentiate between subprime and predatory lending. At the same time, there is no question that predatory lenders are doing a brisk - and profitable - business among vulnerable segments of the population.

These lenders reach into low-income and minority neighborhoods through aggressive marketing that promises homeowners access to credit to fund home repairs or consolidate debts. Often the promises are false or misleading, and borrowers learn too late that they have entered a cycle of indebtedness that is almost impossible to escape. In extreme cases, borrowers have lost the homes that they have owned for years - sometimes for generations. This kind of thing is devastating for the borrower -- and bad for the communities you work so hard to develop.

While the problem does not involve most banks, it reflects badly on the banking industry.

More importantly, while banks may not engage in direct predatory lending, banks may participate in it unknowingly through loan purchases, syndications and securitizations from, and credit lines provided to, predatory lenders - or by providing other banking services to them. The FDIC is trying to address that potential problem.

Our goal is to curb lending with predatory or abusive features without curtailing responsible lending.

To effectively combat predatory lending, we must sever the money chain that replenishes the capital of predatory lenders and allows them to remain in business.

The financial money chain has, in many ways, become institutionalized. Over the past 10 years, Wall Street investment firms have provided over $300 billion in liquidity to the subprime market. Homeowners borrow money - often using mortgage brokers, who

shop the loan for a fee to the subprime mortgage or finance companies that will make the loan. That fee often is tied to the interest rate that the broker charges the borrower - the higher the rate, the more the broker is able to charge the originator for the loan. The originator receives the remaining fees at closing - often including fees for "optional" products, such as credit life insurance - and services the loan. When the lender has originated a sufficient volume of loans, the loans are pooled by an investment bank, which sells securities, backed by the pooled portfolio, to private investors - including institutional investors, such as pension funds, insurance companies, and banks.

Many of the securities that are backed by subprime loans help to provide funding for much needed credit with responsible risk-based pricing. The market for mortgage-backed securities has undoubtedly expanded access to credit. Unfortunately, it may also have supported the activities of lenders that have been cited for their predatory practices - such as First Alliance and Delta Funding.

A way to break the "money chain" that supports predatory loans is to be able to distinguish between securities backed by loans that are responsibly underwritten and priced and those that include loans with abusive or predatory features.

An underwriter's due diligence is normally sufficient to identify loans with predatory characteristics, and most underwriters have enough experience to recognize loans that "don't make sense" for the borrower, but may have been made because of deceptive sales tactics or borrower confusion. Yet, based on our discussions with the securities industry, it is apparent that underwriters see their primary responsibility as selling the mortgage-backed securities on behalf of the issuer. Securities must be attractive and marketable to investors, and the underwriter's compensation is based on a percentage of the sales proceeds. Accordingly, the underwriter's motivation appears to be to receive the highest price and best execution possible on behalf of the issuer - not to help curb predatory loans. We must ask if that should change.

The incentives presented to securities underwriters could change if prospective purchasers of mortgage backed securities were to begin to ask underwriters about the origination of the underlying loans. If they were to ask about the extent to which measures are taken to ensure the underlying loans do not contain any predatory characteristics, and made their purchase contingent upon receiving satisfactory answers to those questions, the underwriters' incentives could change. They might begin to specifically screen for, and eliminate, predatory loans from securitization transactions.

With that goal in mind, the FDIC is drafting advice for banks - which we hope to make public by the end of October -- based on what we have learned during our "fact-finding" discussions with Wall Street firms, government sponsored entities, bond rating agencies, and other state and federal regulators. The purpose of this advice is to assist banks in protecting themselves from legal and reputational risks posed by association with predatory loans. Taken together, four steps will help banks avoid the unwitting purchase of asset backed securities backed by predatory loans.

Step One: Assess the reputation of the originating lender. A prospectus supplement will identify the seller and master servicer of the loans backing the securities being sold. Prospective purchasers should inquire whether complaints or lawsuits have been filed against the originator of the mortgages for predatory lending practices.

Step Two: Review the originator's mortgage loan statistics for characteristics that in combination may raise predatory "red flags." For example, a prospectus supplement could reveal a high percentage of refinance loans with a first lien position, low loan-to-value ratios, and unusually high interest rates. In combination, those features could be a sign that borrowers with significant home equity may be unnecessarily refinancing their loans. Other red flags would include a high percentage of loans with unusually high prepayment penalties, non-standard indices used in the calculation of adjustable rate mortgages, and a high percentage of loans subject to negative amortization.

Step Three: Understand the credit enhancements used to market the securities being sold. Those credit enhancements protect purchasers of securities from the underlying portfolio risk. Before investing in subprime mortgage-backed securities, prospective purchasers should compare the extent of the credit enhancements to the level required in other securitizations.

Step Four: Ask about the record of the issuer's previous securitizations. Most loan originators are not first-time securitizers. By reviewing the history of past securitizations by the same loan originator, prospective purchasers may be able to detect lenders that are relatively more likely to have engaged in predatory origination practices. These practices could be indicated by the prepayment speeds, delinquencies, and loss rates from earlier securitizations.

Taking all four steps will allow banks to utilize market mechanisms to combat predatory lending.

But curbing predatory lending will not be easy. Therefore, I have decided that it would be best to get input - from banks, trade associations, consumer organizations, and federal and state regulators - to ensure that we get things right. To ensure that our efforts - our collective efforts - to combat predators do not inadvertently choke off other sources of credit to low- and moderate-income, elderly, and minority borrowers.

We will be seeking this input not only because so much is at stake for these types of borrowers, but because so much is at stake for banks. By this I mean that the last several years have seen an increase in both class action lawsuits and state and federal enforcement activity against finance companies based upon fraud and other deceptive acts and practices in connection with real estate related loans. Many of these legal actions seek refunds for borrowers or to permit borrowers to cancel their loans and return the borrowed principal minus the interest and fees they have paid. To the extent that such suits involve loans that were pooled and sold to private investors, any legal

requirement to refund or rescind loans could compromise such securities and hurt investors, including many banks that have invested in such mortgage-backed securities.

In addition, banks might incur direct liability for predatory lending practices. In one recent case, a finance company was required to pay more than $7 million to compensate borrowers who were discriminated against in paying disparate broker fees that had been set by the mortgage brokers that had referred the loans. Insured depository institutions might similarly be held liable because of predatory or discriminatory loan practices engaged in by brokers or others involved in the lending process.

This increased -- and increasing -- risk of litigation is a cause for concern and offers one more reason we need to "get it right" the first time.

In particular, I would like to hear from you and others on a number of issues, specifically:

- Are current disclosures in a prospectus supplement comprehensive enough to permit a potential purchaser to discern accurately whether any of the loans backing the security contain predatory features? If not, what specific disclosure requirements should be added? Would the inclusion of additional information in a prospectus supplement have a chilling effect on the legitimate subprime market?

- How costly would it be for a bank, particularly a small bank, to carry out the steps that I have outlined? Would those steps have a material effect on the market for asset-backed securities? Could those steps have a chilling effect on the legitimate subprime market?

- Are there additional steps (or alternative steps) that buyers of asset-backed securities could take to combat predatory lending?

- We will soon be posting these questions on our website - www.fdic.gov -- and inviting comment from all concerned parties. We want to provide banks with the tools they need to distinguish between the kind of loans or securities that ultimately give borrowers a "leg up" in achieving financial security and those that are likely to result in financial disaster for the vulnerable or the naïve.

We welcome your input and experience as we seek to strike a balance on this complex and important issue.

The organizations represented here today have done so much to rebuild inner city and rural communities. You have succeeded in making many communities work more effectively with affordable housing, economic development, and job creation. We all have too much at stake to let predatory lending threaten those gains. I invite your assistance in our efforts to curb predatory lending.

Thank you.

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