American Securitization Forum (ASF) Annual Meeting
Remarks of
FDIC Chairman Sheila C. Bair
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I would like to acknowledge up front the leadership of the American Securitization Forum in working with us to address some of the problems in the subprime market. I thank you for stepping up to the plate – especially your Chairman, Greg Medcraft, and your Executive Director, George Miller. It hasn't been easy for any of us. This is a very complicated market. There's a lot of money at stake, and millions of people whose homes are on the line.

But I think we're making good progress in developing solutions that promote a stable secondary market, and that benefit most market participants and borrowers. The immediate task is to sustain homeownership by ensuring that servicers have the flexibility they need to make prudent loan modifications, if it is reasonably foreseeable that a loan may default. The next thing we need to do is to come up with national standards for all subprime lenders.

Strong underwriting standards will bring stability to this market going forward. It will help keep families in their homes and help others buy homes in the years ahead. The market also needs to know when and how troubled loans are modified. Transparency promotes market stability.

Subprime mortgages have benefited Wall Street, and boosted homeownership across the country. The trick now is getting all the actors working together -- from Main Street to Wall Street to Washington -- to get this market on track as an engine for sustainable homeownership.

Positive Benefits

With little doubt, mortgage securitization has been a net positive for many middle- and lower-income communities, as well as the broader economy. Homeownership is at record levels. And lenders have an effective tool for managing and diversifying risk. The liquidity provided by private label mortgage-backed securities (MBS) has been a significant factor in the growth of nontraditional and subprime mortgage lending.

Let me give you a couple of numbers:

- The share of U.S. mortgage debt held in private label securities doubled between 2003 and 2006, from 9 percent to 18 percent.
- This increased liquidity allowed lenders to make these mortgages more widely available.

As a share of all mortgage loan originations, subprime loans more than doubled from 8 percent in 2003 to 20 percent in 2005.
Problems

While this market-driven process has evolved in remarkable ways over the years, the process is now clearly under stress. Significant changes in the subprime mortgage market in recent years have substantially complicated the relationship between borrowers and lenders. Mortgages have become commodities, involving multiple players. As a result, it may be easier to get credit but it's much harder to resolve troubled loans. When the market turns as we've seen in recent months, workout strategies for troubled loans in securitized structures are much tougher to put together.

Further complicating the situation is the fact that the investors may see their interests differently, with each other, or with the borrower. As all of you know, the problems in this market are a major concern for the FDIC. In March, the FDIC and other federal bank regulators jointly proposed new guidelines for underwriting and marketing subprime mortgages. We've received over 100 public comments on the guidelines. And we hope to finalize them later this month.

Protecting Current Borrowers

These proposed rules are designed to assure strong underwriting and consumer protection for subprime mortgage lending by banks. I am hopeful that Congress or the Fed will act to impose comparable requirements on nonbank lenders to prevent future abusive lending practices. There remains the urgent issue of how to address an estimated 2 million loans that will reset over the next 18 months. Almost three-quarters of securitized subprime mortgages originated in 2004 and 2005 were "2/28 and 3/27" hybrid loan structures. These loans have lower payments during the first two to three years but then reset to higher interest rates that impose payment "shocks" of 30 percent or higher. Those are huge increases. Most subprime borrowers will be unable to make the payments on these loans after they "reset."

Further compounding this problem is that fewer and fewer of these borrowers are able to refinance because of the slowing rate of housing appreciation, and the financial difficulties facing subprime lenders. Many borrowers could avoid foreclosure if they were offered alternatives that allow for affordable mortgage payments. Restructuring their loans would bring them back to good standing, allow them to repair their credit histories and dampen the impact that foreclosures have on the broader housing market. Most important, people would be able to stay in their homes.

In April, I testified before Congress on the subprime market and the difficulties that exist in developing practical solutions for troubled borrowers whose loans are in securitization structures. The FDIC, along with the other federal regulators and industry, including your own George Miller, have been talking regularly about how to deal with this problem, most recently last week in Washington. We have focused mainly on how market participants could help resolve the difficulties in modifying the mortgages that

are locked into securitized pools. Our goal is to facilitate an exchange of ideas and industry-led consensus on ways to help struggling borrowers avoid foreclosure, while maintaining the integrity of the secondary market.

One of the clear messages we heard is that loan modifications that provide sustainable mortgages for borrowers are generally the best option for investors and borrowers. Foreclosure rarely is. Sustainable mortgages help give the markets stability both for current borrowers and investors, and for those in the future as well. This is an issue I hope we address squarely and not just end up kicking the can down the road.

Another important message from the industry, not surprisingly, is that more and better information is needed. As loans are modified, investors need to know. They need to see the details. This ties in very closely to our goal of sustainable mortgages. If a loan modification puts a borrower into a loan that he or she can afford, and the details about that modification are disclosed, we believe this will create additional market pressure for sustainable loan restructuring. Sustainable loan modifications avoid ongoing financial distress for borrowers, help keep them in their homes, ease demands on servicer resources and help assure stable income flows for investors. This, too, will give greater stability to the market.

ASF Principles

The ASF has taken a real leadership role in trying to resolve these issues. I commend the ASF and the membership for developing principles and guidelines for modifying subprime loans. Those principles recognize and support many of the key conclusions reached in our discussions with the industry. These include:

- The importance of loan modifications as a loss mitigation tool;
- The importance of establishing early contact with borrowers and taking action prior to default where it is reasonably foreseeable;
- The need for modifications that provide sustainable and long-term solutions;
- The need for amendments to existing securitization agreements that prohibit or restrict servicer flexibility; and
- The need to establish greater clarity and consistency in investor reporting and the treatment of modified loans for purposes of “triggers” that control the release of excess cash flow.

I also want to highlight the principle that specifically encourages servicers to conduct modifications that are in the best interest of the borrower. This principle alone should ensure that the borrower’s needs are not subordinate to the interests of everyone else. Finally, I fully support the ASF’s commitment to develop standard, uniform model contractual provisions governing a loan servicer’s ability to make loan modifications in future securitizations.

I appreciate that ASF has a number of interests to balance. However, I do wish to emphasize my strong belief that modifications should be for the long term. This is an

absolute necessity if we are to stabilize neighborhoods and preserve the homeownership gains of recent years.

So, where do we go from here? The next big step is finalizing our regulatory guidance. As I said, we hope to get these rules out in June. Our new rules focus on two fundamental consumer protection principles. First, a loan should be approved based on a borrower's ability to repay according to its terms, not just at the initial rate.

We say subprime loans should be qualified and underwritten based on the borrower's ability to meet fully-indexed and amortizing terms. In my view, this is simple common sense. I don't think any of us would advise our kids to take out a loan they can't repay. But to make good choices, borrowers need clear, easy-to-understand information.

The proposed guidance provides that mortgage product descriptions and ads should provide clear, detailed information about all costs and features, including payment shock. All the regulators, both federal and state, feel very strongly that clear, common sense underwriting and marketing standards for subprime mortgages are extremely important. So, I believe our current draft will remain largely intact. Without strong rules we can't protect consumers. Nor can we reinforce the market discipline that preserves a steady flow of capital for responsible lending.

Looking to the future, I believe that the ultimate solution is a national standard for subprime mortgages regardless of who does the underwriting. There are two core elements for developing a national standard: One, underwriting standards that truly measure the ability to repay. And two, marketing standards that require upfront, complete, and clear cost disclosures for adjustable rate and non-traditional loans and prohibit deceptive advertising based on teaser rates or misuse of the word "fixed."

A national standard should deal with abusive prepayment penalties and the use of "stated income" loans, issues that are also addressed in our proposed guidance. One way is for the Federal Reserve to use its powers under the Home Ownership and Equity Protection Act (HOEPA). New HOEPA rules could strengthen protections for subprime borrowers. And they would apply to bank and non-bank lenders alike. An additional advantage would be a clearer standard for secondary market liability by allowing it only if the loan was abusive on the face of the loan documents. This feature could provide necessary comfort to the market, while protecting against truly egregious lending. Members of the Senate Banking Committee have urged the Fed to use this authority. The Fed will hold a public hearing next week on HOEPA. The FDIC supports the Fed's efforts and would welcome new rules against abusive subprime or predatory lending practices.

Investors and Good Citizenship

I'd like to end by pointing to the obvious. We're all in this together. All of us bear some responsibility for the turmoil in the subprime market. And all of us need to be a part of the solution. And let's be honest about it. Hybrid ARMs were never made based on the

assumption that the borrowers would be able to make the payment once the loan reset. They were designed as two- or three-year “bullets,” with the assumption that home appreciation would allow the borrower to refinance at or before reset. Given current conditions in the housing market, this business model is no longer viable. But market participants should not now claim to be shocked that borrowers are in distress.

Let me be clear, regulators support subprime mortgage lending. Securitization has injected tremendous liquidity and strengthened the American marketplace. But products such as the 2/28 and 3/27 hybrid ARMs create such a huge payment shock at reset that they cannot be sustained through normal economic cycles. I am hopeful that more secondary market funding can be directed at traditional 30-year fixed-rate loans. These loans are steady and predictable, yet still provide a healthy return. They do not put subprime borrowers in the position of having to gamble on home price appreciation or the direction of interest rates. I think the more subprime borrowers we can put into fixed-rate loans the better off everyone will be. As I told Congress, there is no silver bullet. This problem will take time to work out. But our talks with the industry, the ASF Principles, and reviews of the accounting and REMIC rules are all steps in the right direction.

I would ask that you work with us to support national standards for responsibly underwritten subprime mortgages. I would ask that in making your own investing decisions; you seek out securities backed by responsibly underwritten mortgages. I believe this is in everybody’s best interest -- lenders, investors and homebuyers. And it is in the national interest because it will go a long way to preserving the American dream of owning a home.

Thank you very much.

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