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on Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions;
before the
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Congresswoman Maloney, Congressman Gillmor and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding subprime mortgage lending products and predatory lending.

Today's hearing focuses on an important topic. We can all agree that there are social and financial benefits to home ownership. Because homeowners have an investment in their community, home ownership promotes neighborhood stability and civic involvement. In addition, for most homeowners, their residence is their most valuable asset. Traditionally, residential real estate has been a sound, stable investment providing a means to build wealth. Government policies, ranging from tax incentives to the formation of government sponsored enterprises, have long encouraged home ownership.

In recent years, many consumers took advantage of low interest rates and new mortgage products to push the home ownership rate to almost 69 percent. Product innovation and the expansion of mortgage credit have been generally positive social developments. Yet, for a significant segment of the subprime market, we have seen a troubling trend. Many of these borrowers have accumulated debt obligations that put their financial health at risk even after years of positive economic growth. Subprime borrowers spend nearly 37 percent of their after-tax income on mortgage payments and other costs of housing – roughly 20 percentage points more than prime borrowers spend, and 10 percentage points more than subprime borrowers paid in 2000.[1] The obligations of subprime borrowers with adjustable rate mortgages (ARMs) are likely to increase further as rates reset. Of ARMs originated in 2006, a full 24 percent have negative home equity.[2]

To be sure, many subprime borrowers have benefited from the expansion of mortgage credit. However, rather than building wealth, many other borrowers are struggling to keep their homes. Many subprime borrowers have little financial cushion in the event of personal emergencies or economic downturns. In addition, many subprime borrowers have been the targets of practices that are highly troubling, if not predatory. Repeat refinancings have taken equity from their homes and adjustable rate features have challenged their ability to continue making payments. In previous years, many of these borrowers could have refinanced their mortgages or sold their homes at a profit to repay their debt in full. Now, as home prices have stagnated or even declined in many areas of the country, more borrowers find themselves trapped in mortgages they cannot afford to pay. Abusive lending practices that result in home ownership that builds debt rather than wealth harm not only individual consumers, but undermine the important societal benefits of home ownership.

My testimony today will discuss recent practices in the mortgage market that have raised concerns at the FDIC, especially with regard to subprime lending. I also will review actions the FDIC has taken to address issues in the subprime market, including the proposed statement on subprime lending. Finally, I will articulate some of the options and challenges we see as Congress considers further steps to address predatory practices. We believe that the time has come for national anti-predatory lending standards applicable to all mortgage lenders, including nonbanks as well as banks.

Clear, common sense standards regarding the underwriting and marketing of subprime adjustable mortgages will reinforce market discipline and preserve an adequate flow of capital to fund responsible lending. It will be important for regulators and Congress not to overreact in developing the standards. Overly rigid rules or introduction of unfamiliar new concepts could create heightened uncertainty and confusion in the market.

Contrasting Subprime Lending and Predatory Lending

Subprime lending involves providing credit to individuals and households with poor or limited credit histories who pose a higher risk of default and foreclosure. The FDIC recognizes the value and benefits of responsibly underwritten loans to consumers with less than perfect credit profiles, provided that institutions have the necessary expertise and capital support to manage them in a safe and sound manner. This does not mean, however, that lenders should make loans that borrowers will inevitably have difficulty repaying, or impose terms that will exacerbate borrowers' credit problems.

While some of the leading originators of subprime loans are banks and thrifts (or their subsidiaries or affiliates) these loans also are offered by thousands of independent mortgage lenders not regulated by the financial institution regulatory agencies. Because of their higher risk, subprime loans carry higher interest rates and, until recent years, more stringent collateral requirements and other risk mitigants.

There is no universally accepted definition of predatory lending. Determining whether a subprime loan product is predatory involves looking at both the loan and the borrower -- and, typically, the whole course of the transaction. Products that may be appropriate for one type of borrower in a particular circumstance may be inappropriate under different facts or circumstances.

In 2001, the financial institution regulatory agencies identified the characteristics most often associated with predatory lending:[3]

- Making unaffordable loans based on the collateral 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
- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Predatory lending can impose significant financial harm on consumers. Rather than providing an opportunity for building individual or family wealth, predatory lending extracts wealth from consumers, and can severely impact their future financial prospects. In addition to being extremely damaging to consumers, predatory lending is inherently an unsafe and unsound banking practice. Thus, the FDIC has a vested interest in ensuring that predatory lending practices do not take root in the banking system.

Overview of the Subprime Mortgage Market

A number of factors, including intense lender competition, historically low interest rates, rapid home price appreciation, and, crucially, investor demand for mortgage paper, facilitated the dramatic growth in the subprime market between 2003 and 2005. After many prime borrowers obtained loans during the refinance boom of 2003, mortgage originators struggled to maintain or increase market share in the declining origination market. Many of these lenders operated large origination platforms that needed mortgage paper to remain viable. Borrowers with blemished credit histories, many of whom were not able to obtain financing during the refinance boom, began to represent a larger portion of potential customers. As a result, the subprime share of all mortgage loan originations jumped from 7.9 percent in 2003 to 20 percent in 2005.[4] As of third quarter 2006, subprime mortgages accounted for approximately 12.8 percent of all mortgage debt outstanding.[5]

Some mortgage originators offered new types of mortgage products that were specifically designed to attract borrowers with low initial rates. These "affordable" payments would then reset to carry above market interest rates for the remainder of the loan term. The reset trigger was usually after one or two years, although some loans reset after as little as one payment. These types of loans were simultaneously attractive both to borrowers, who could obtain larger loans at lower cost for at least a short time, and to investors in mortgage loan pools, who were attracted to the above-market yields possible following the reset period. Lenders expanded the use of nontraditional mortgage products -- interest-only mortgage loans[6] and payment-option ARMs[7] to prime borrowers -- and began offering new hybrid ARMs, such as the so-called "2/28" or "3/27" mortgage loans[8]to subprime borrowers.

Prior to 2000, the majority of subprime mortgages were fixed rate loans. But during the first half of this decade, as intense competition led lenders to seek out less qualified borrowers, there was a transformation in the subprime market toward more complex products that can have a combination of risk factors, such as increasing debt-to-income

(DTI) ratios, minimal documentation, and high loan-to-value ratios. In 2006, almost three-quarters of non-agency securitized subprime mortgage originations were adjustable rate mortgages, primarily 2/28 and 3/27 hybrid loans.[9] Estimates are that at least 2.1 million subprime hybrid ARMs are outstanding today.[10] This would mean that approximately 1.7 percent of U.S. households have 2/28 or 3/27 loans.

In addition, the low- or no-documentation share of subprime lending has grown significantly since 2001, from about 25 percent to over 40 percent. Furthermore, prepayment penalties are more prevalent among subprime loans than among Alt-A or prime mortgages. In 2006, 68 percent of subprime mortgages included in non-agency securitizations had prepayment penalties, compared to 51 percent of Alt-A[11] loans and only 1.5 percent of prime mortgages.[12] Finally, average loan-to-value ratios for both fixed and adjustable rate subprime loans have increased.

Consumer Protection Concerns

As the Committee is well aware, poorly underwritten or predatory lending carries with it a number of significant consumer protection concerns.

Disproportionate Impact on the Financially Vulnerable

While it is not possible to directly measure the demographic characteristics of subprime hybrid ARM borrowers, the 2005 Home Mortgage Disclosure Act (HMDA) data indicate that higher priced loans are disproportionately made to minorities and lower income households. As you know, the HMDA data do not contain all the information needed to ascertain whether a higher-priced loan is a predatory loan. For example, the HMDA data do not identify nontraditional loans, or even whether a loan has a variable rate. Nonetheless, the fact that African-Americans were three times more likely than non-Hispanic Whites to receive higher-priced home purchase loans during 2005 and evidence that minorities disproportionately borrow from higher-priced lenders[13] raise concerns about fair access to home mortgage loans.

Misaligned Interests of Borrower, Broker, Lender and Investor

Reputable mortgage brokers can be a tremendous help to borrowers, offering them access to options they have difficulty finding on their own. However, mortgage brokers generally do not have a duty to find the most appropriate loan for a borrower, and they are not directly compensated based on benefits to the borrower. Moreover, mortgage brokers have no financial risk if the loan eventually defaults because they are compensated by lenders who in turn offer incentives based on the lender's preference for products it wishes to hold or sell. For example, a broker compensated with yield spread premiums (YSPs) -- the difference between the par rate for a loan (the minimum acceptable interest rate) and the interest rate actually paid by the borrower -- has an incentive to encourage a borrower to take a product with a higher interest rate.

Lenders that retain the mortgages they originate have interests more aligned with those of borrowers in the products offered and in the structuring of loans, because they bear a substantial financial risk if the borrower defaults. However, in the case of loans sold on the secondary market, as I will explain in more detail later, the lender's preferences are heavily influenced by what market investors want to buy, which may not match what is appropriate for the borrower.

Aggressive and Misleading Marketing

Aggressive or misleading marketing can have a negative impact on the ability of borrowers to make informed credit decisions. Marketing that promises the ability to "Buy more house!" or "Repair your credit!" often obscures critical features of the loan product. Without countervailing information, consumers may not realize that they may be unlikely to afford the required monthly payments -- particularly when a loan includes an initial teaser interest rate that will expire. In addition, because negative information can be part of consumer credit records for seven to ten years, consumers may not realize that repairing their credit may take much longer than the marketing promises,[14] and that positive performance on one loan will not materially improve their credit standing if they fail to repay other loans on time.

To demonstrate the impact on subprime borrowers, Table 1 illustrates the results from a February 12, 2007, publicly-available rate sheet from a typical large-volume subprime lender. A borrower with $38,000 in gross income and a 620 Fair Isaac and Company (FICO) risk score could obtain a $200,000 stated income, 2/28 hybrid ARM. With the loan's introductory fixed interest rate of 8.30 percent, the borrower would have a monthly principal and interest payment of $1,510 for the first two years based on a 30-year amortization period. The borrower's DTI ratio is 48 percent, so the monthly mortgage payment would represent approximately half of the borrower's monthly gross income. Real estate taxes and property insurance would add to this debt burden.

After the initial fixed rate period, the variable interest rate would be the six-month London Interbank Offered Rate (LIBOR), which is 5.375 percent at origination, plus 6.99 percent. The interest rate would begin to rise, initially by 3 percent, and then a 1.5 percent increase every six months until the fully-indexed rate or the lifetime interest rate cap is reached. Thus, the fully-indexed rate at the time of loan origination (12.365 percent) would result in a monthly principal and interest payment of $2,092, representing two-thirds of the borrower's monthly gross income (66 percent DTI ratio). The underlying index rate would be subject to change and could further increase the monthly payment amount and DTI ratio.

From this same lender, published rate sheets suggest that the borrower could have received a stated income, 30-year fixed rate mortgage with an interest rate of 8.80 percent (8.30 percent + 0.50 percent adjustment for fixed rate option).[15] The monthly principal and interest payment for this mortgage loan would be $1,581, resulting in a DTI ratio of 50 percent. Although the borrower would have had to pay $71 more each month, the borrower's payment would be fixed for thirty years with no risk of payment shock. Furthermore, if the borrower could fully document his/her income, **the interest rate would have been lower than even the start rate of the 2/28 product.**[16] This suggests that many borrowers who opt for this product today either do not understand or are not being told the other options available to them -- or they cannot afford an additional $71 per month for a fixed-rate product, which indicates a severe affordability problem at the 2/28 loan's inception.

Table 1.
Comparison of Mortgage Products

Product Type	"2/28" Hybrid ARM (Stated Income)	30-year Fixed Rate (Stated Income)	30-year Fixed Rate (Full Documentation)
Balance at origination	$200,000	$200,000	$200,000
Interest rate for Year 1 & 2	8.30%	8.80%	8.10%
Payment for Year 1 & 2	$1,510	$1,581	$1,482
DTI ratio for Year 1 & 2	48%	50%	47%
Interest rate for Year 3	11.25%	8.80%	8.10%
Payment for Year 3	$1,928	$1,581	$1,482
DTI ratio for Year 3	61%	50%	47%
Interest rate for Year 4	12.37%	8.80%	8.10%
Payment for Year 4	$2,092	$1,581	$1,482
DTI ratio for Year 4	66%	50%	47%

Safety and Soundness Concerns

In addition to being potentially harmful to borrowers, the current conditions in the subprime mortgage market may pose unacceptable risks to both insured institution and non-bank lenders.

Loosened Underwriting Standards

As investor appetite for more volume and competitive pressures increased in the mortgage market, many lenders loosened their underwriting standards in both the prime and subprime markets. Many of these products required little or no documentation of income or were accompanied by practices such as simultaneous second-lien mortgages that create additional layers of risk for lenders. Reduced documentation increases the risk of loss since institutions are essentially relying on assumptions and unverifiable information to analyze the borrower's repayment capacity. Simultaneous second-lien mortgages ("piggybacks") were designed to circumvent requirements for private mortgage insurance (PMI), which is expensive for the borrower but mitigates the lender's risk in a higher loan-to-value mortgage. However, such structures serve to reduce a borrower's up-front equity in the home and increase monthly debt service, without any corresponding risk mitigation for the lender. When one loan combines several such features, the total risk is compounded.

The industry also has relied increasingly on the use of risk-based pricing, often generated by sophisticated proprietary models, as an underwriting alternative to verifying the borrower's income or collateral protection. The premise of risk-based pricing is to build an additional loss cushion into the price of the credit product to cover the incremental loan losses and overhead costs related to underwriting, servicing and collecting a portfolio of loans. However, a higher interest rate does not improve the credit quality of a higher-risk loan. While such models have been reasonably successful in the prime market, the logic underlying such modeling breaks down as the baseline price of the product increases. In fact, recent experience has shown that the predictive nature of subprime models can be unreliable.[17]

For subprime and Alt-A loans, early payment defaults appear to be much more prevalent in low documentation loans than in mortgages that required full documentation. Available data do not include early payment defaults that have been returned from securitization trusts to the originators. However, it is possible to estimate the frequency of early payment defaults by examining the percentage of loans remaining in pools and in default four months after origination. Among Alt-A non-agency securitized loans used to purchase a home in 2006, 1.09 percent of low-documentation loans defaulted within the first four months – about twice as many as loans that required full documentation (0.56 percent). Among similar subprime mortgages, 4.67 percent of low documentation loans defaulted within four months, while only 3.14 percent of full documentation loans defaulted.[18]

Securitizations

Some financial institutions seek to manage the risks associated with nontraditional and subprime mortgage products by securitizing their mortgage originations and spreading the risks of these products to investors. In fact, the share of U.S. mortgage debt held by private mortgage-backed securitizations doubled between 2003 and 2005, helping to fuel the growth of subprime and nontraditional mortgages. The ability to securitize pools of such mortgages certainly helped to make these loans available to borrowers through both FDIC-insured institutions and through mortgage brokers. Although securitization can spread the credit risks associated with these mortgages to investors, such a strategy may not mitigate the risks caused by poor controls over underwriting or the lack of adherence to representations and warranties made to the investors.

Subprime loans have largely been originated for sale into the secondary market, where they are pooled into securitizations and known as collateralized mortgage obligations (CMOs) or asset backed securities (ABS). Traditional structures of these types, such as real estate investment conduits (REMICs), formerly contained prime loans. Subprime securitizations have increasingly adopted a senior/subordinate structure, where the originating or issuing bank may keep the first-loss piece or tranche of the CMO or ABS after selling the more highly-rated tranches to investors. In some instances, ABS tranches find their way into more complex capital market instruments called collateralized debt obligations (CDOs), which carve up credit risk in ways that are often difficult for the average market participant to comprehend. Securitizing pools of loans in this manner also raises additional risks including liquidity risk and market risk – especially when demand for securitization paper backed by loans intended for immediate sale unexpectedly dries up, forcing the originator to secure long-term funding for these assets.

Further, risks to banks originating prime loans for securitization and acting as seller/servicer, such as defaults and fraudulent documentation, are heightened for subprime loans because of the "easy credit" design of loans frequently marketed to subprime borrowers. The same representation and warranty clauses that allow prime loan investors to put back loans to the originating institution if they fail to meet certain standards are written into subprime securitizations as well. Because these repurchase or replacement demands are typically triggered by borrower delinquency, subprime securitizations are likely to suffer a higher level of put-backs to the originating institution. In addition to put-backs, some banks could suffer liquidity consequences through "triggers" or covenants in securitization or warehouse lien documents. If a loan pool does not perform as desired or if the institution's own financial condition declines, bondholders can sometimes demand replacement loans, higher fees or interest -- or in extreme cases, can even stop providing funding to originating institutions.

In addition, representation and warranty clauses can be extensive in some deals, going beyond the typical error, omission, misrepresentation and fraud conditions, to require the seller to attest that the debt to income ratio on all loans must not be greater than 60 percent at origination. For securitizations backed by low document, no document, and stated income loans, such representations and warranties can provide the investors with plenty of leeway for putting delinquent loans back to the servicer. While representations and warranties serve as a critical safeguard to investors against fraud and misrepresentation, an over-reliance on these provisions could limit the actual amount of credit risk transferred from the seller of assets to the investors -- investors who, in return for the yield earned on the security, are expected to perform an appropriate amount of due diligence prior to purchase.

Banking regulators grant a significant amount of capital relief to securitizations with the expectation that such vehicles transfer credit risk to the capital markets. Banks that are required to repurchase assets under representation and warranty provisions and early default clauses are exposed to an elevated degree of credit risk associated with these often delinquent assets as well as the liquidity risk associated with having to secure immediate funding on these assets. In situations where the regulators determine that certain representations and warranties are too permissive and potentially expose the selling bank to a high amount of loss, additional capital requirements may be considered. A similar review and evaluation of the nature and structure of representations and warranties beyond the banking industry might serve as a useful tool in encouraging the investor community to more closely monitor the underlying assets in ABS structures.

Credit Risk

Although subprime hybrid ARMs are typically marketed as "affordability products," they actually create a payment shock problem when the loan resets and the monthly payment increases. Payment shock is especially serious when lenders qualify subprime borrowers at the lower fixed introductory or teaser rate of interest rather than the fully-indexed interest rate, assuming a fully-amortizing repayment schedule. As the earlier example in Table 1 demonstrates, the increase in monthly payments can be substantial. Lenders that do not qualify borrowers at the fully-indexed interest rate are not appropriately evaluating the ability of borrowers to repay their loans, resulting in possible losses for both lenders and borrowers.

The FDIC is concerned that the subprime borrowers who have taken these loans will face an array of serious problems. They may be unable to afford their monthly payments after the initial rate adjustment, or after subsequent adjustments that occur as often as every six months. Borrowers with limited financial resources often have no choice other than to refinance their loan and incur expensive refinancing fees due to closing costs and prepayment penalties. If refinancing is impossible, delinquencies and other adverse credit indicators are often the result.

Delinquency and Foreclosure Trends

On the whole, mortgage delinquencies and foreclosures fell to historic lows from 2003 through 2005, primarily due to low interest rates and strong levels of home price appreciation that fueled growth in mortgages. As growth has slowed, delinquency and foreclosure rates have increased, but currently remain below the peaks seen after the 2001 recession.

The past due rate on one-to-four family residential mortgages, overall, for the fourth quarter of 2006 was 4.95 percent, up from 4.7 percent a year ago. However, the rate for subprime mortgages is much higher. The past due rate for all subprime mortgages is 13.33 percent, and the rate for subprime ARMs is 14.44 percent.[19] It is estimated that the $1.28 trillion in total subprime mortgages represent 12.8 percent of all mortgages outstanding.[20]

Nationwide, foreclosures started on subprime ARMs were 2.7 percent of loans outstanding in the fourth quarter of 2006. That figure is approaching the levels reached just before the 2001 recession, and is more than double the recent low of 1.3 percent in mid-2004.[21] Data on securitized loans indicate that recently originated subprime hybrid mortgages are performing worse than those originated in prior years. Over 10 percent of non-agency, securitized, subprime hybrid loans originated in 2006 became seriously delinquent or started foreclosure within 11 months of origination. After the same 11 month period of seasoning, only 5.5 percent of similar loans originated in 2005 were performing as badly.[22]

The highest rates of foreclosure among subprime adjustable rate borrowers are currently found in states that have experienced the slowest rates of home price appreciation over the past year. For example, new foreclosures on subprime ARMs were up sharply in Michigan and Ohio, where local economic conditions have been weak in recent years. These are also areas experiencing home price depreciation, which makes it difficult for borrowers to refinance their loans when rates reset. However, subprime ARMs are also showing increased stress, although not as great, in states such as California that have previously benefited from very rapid home price gains and generally good economic performance but where home price appreciation is now slowing.

Until early this year, investors searching for higher yields provided ample cash to the mortgage industry. However, rising defaults have curbed investors' appetite for securities backed by subprime mortgages, making it hard for subprime lenders to sell their loans and raise cash to make new ones. Several non-bank private subprime lenders have already filed for bankruptcy protection after having their financing cut by the banks and brokerage firms that were facilitating the securitization of their subprime mortgages. The risk premium demanded by investors in subprime mortgage paper has increased dramatically in recent weeks, weakening the business model of the stand-alone subprime originators.

Response to Lending Practices

Supervisory Statements and Guidance

The FDIC and the other federal financial institution regulatory agencies (collectively, the Agencies) strive to remain abreast of innovations in the marketplace and consider their implications from both a safety and soundness and a consumer protection perspective. For example, in September 2006 the Agencies *issued Interagency Guidance on Nontraditional Mortgage Product Risks* (NTM Guidance) in order to address concerns about offering interest-only and payment-option ARMs to borrowers for whom they were not originally designed.[23] 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 time they are choosing a loan or deciding which payment option to select. FDIC examiners evaluate an institution's processes, policies, and procedures to ensure that its practices appropriately address the risk of these products. To help the industry provide necessary information to borrowers, the federal banking agencies proposed model illustrations that institutions may use to assist consumers as they select products or choose payment options.[24]

Subsequently, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed guidance to state agencies that regulate residential mortgage brokers and companies on the risks posed by nontraditional mortgage products. The CSBS/AARMR guidance substantially mirrors the federal nontraditional mortgage guidance, applying the sections that address non-depository institutions. To date, 26 states and the District of Columbia have adopted the CSBS/AARMR guidance.

On January 22, 2007, the FDIC issued its *Supervisory Policy on Predatory Lending*[25] 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.

Since the subprime market raises additional concerns,[26] the federal banking agencies issued a Proposed Statement on *Subprime Mortgage Lending* on March 2, 2007 (the Statement).[27] The Statement emphasizes that lenders must not allow their mortgage programs to become predatory. As the Statement explains, institutions marketing mortgage loans with predatory characteristics carry an elevated risk that their conduct will violate the Federal Trade Commission (FTC) Act's prohibition against unfair and deceptive practices, which the FDIC and other agencies enforce.[28]

The Statement makes clear that lenders should follow two fundamental consumer protection principles when underwriting and marketing mortgages. First, a loan should be approved based on a borrower's ability to repay it according to its terms (not just at the initial rate, for example). Second, borrowers should be provided with the information necessary to understand a transaction at a time that will help them decide if the loan is appropriate for their needs. The Statement cautions that such communications should not be used to steer consumers to these products to the exclusion of other institution products for which consumers may qualify. Relying on these principles, lenders will be able to offer mortgages that meet the needs of most subprime customers in a safe and sound manner. We look forward to receiving comment on the Statement and will carefully review the commenters' views.

CSBS and AARMR also have strongly endorsed the Statement. They are particularly interested in comments regarding the applicability of the Statement to state-licensed and supervised residential mortgage brokers and companies. CSBS and AARMR intend to develop a parallel statement for state supervisors to use with state-supervised entities.[29]

Examination and Supervisory Actions

The FDIC also aggressively addresses predatory lending through examinations and supervisory actions. When examiners encounter loans with predatory characteristics, the FDIC takes 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.

The FDIC also has worked to integrate the new 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 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 work of the FDIC in this area is ongoing, we have referred two of these matters to the Department of Justice for enforcement action. In addition, credit practices that are discriminatory, unfair and deceptive, involve unearned fees or kickbacks, or fail to meet other significant regulatory standards weigh against an institution when its Community Reinvestment Act (CRA) performance is assessed.[30]

The FDIC also helps financial institutions meet the credit needs of their entire communities, including low- and moderate-income areas by conducting outreach and providing technical assistance to banks and community organizations to foster community economic investment and fair lending. Because well-informed consumers are less likely to be the victims of predatory lenders and are more likely to make informed choices, the FDIC disseminates free consumer information in a variety of forms. For example, the FDIC's Money Smart Financial Education program is widely used to help adults outside the financial mainstream enhance their money management skills and create beneficial banking relationships. When a bank's CRA performance is reviewed, the institution's efforts to provide financial education and other retail services are given positive consideration.

Options/Challenges for Reform

Widespread credit distress in the subprime mortgage market, with especially pronounced problems among independent mortgage lenders, suggest the need for a comprehensive response that assures that all lenders are subject to certain baseline requirements. Guidelines and other supervisory standards promulgated by federal bank regulators apply to only a portion of the market. Moreover, the lack of uniform standards creates negative competitive pressures on insured institutions. A national anti-predatory lending standard would help assure basic uniform protections for all borrowers, as well as create a more level competitive playing field for regulated entities. There are two possible approaches to create and implement an anti-predatory lending standard that would apply across the mortgage lending industry.

First, Congress could articulate a set of anti-predatory lending standards in a statute. A statutory approach to establishing a national anti-predatory lending standard could draw from our current and proposed federal regulatory guidelines, as well as existing state anti-predatory lending statutes. It should raise the bar by strengthening protections available to borrowers. At its core, it should address at least two important areas: 1) the ability of the borrower to repay the loan and 2) misleading marketing and disclosures that prevent borrowers from fully understanding the terms of loan products.
A statutory national predatory lending standard should require underwriting based on the borrower's ability to repay the true cost of the loan, not payments based on an artificially low introductory rate. This requirement would go a long way toward helping borrowers avoid loans that they cannot repay, and would improve the quality of lender portfolios and mortgage backed securities. It also would help balance the role of mortgage brokers by curtailing the incentives to steer customers to high cost products that they cannot afford.

A national anti-predatory lending standard should also address misleading or confusing marketing that prevents borrowers from properly evaluating loan products. Marketing materials are often crafted to induce even cautious borrowers into inappropriate products. One key area of concern is the misuse of the word "fixed" to describe negative amortization products where the rate adjusts though the payment may be "fixed" for a certain period. The term can also be used misleadingly to describe hybrid ARMs where the rate is fixed only for the first few years. In addition, as previously mentioned, some lenders and brokers disclose information about comparably priced 30 year fixed rate mortgages less prominently than more lucrative exotic products with payment shock features.

A national predatory lending standard could require that rate and payment marketing information for nontraditional mortgages or hybrid ARMs include a benchmark comparison of the rate and payment being offered by the same lender for a 30 year fixed rate mortgage. The standard also could require that all rate and payment disclosure information include full disclosure of the borrower's monthly payment at the fully amortized, fully indexed rate, not just the teaser rate -- consistent with the approach of the NTM guidance and the proposed guidance on subprime lending.

Additional provisions for a national anti-predatory lending standard can be found in among the 36 state anti-predatory mortgage laws currently in effect. This menu of state laws include provisions addressing loan flipping, prepayment penalties, escrow of taxes and insurance, the fiduciary obligations of mortgage brokers, and many other areas. States have proven to be innovative laboratories for the development of consumer protections in recent years, especially in the area of predatory lending. Congress should draw from their experience in drafting national standards.

Alternatively, or in conjunction with a statutory process, the Federal Reserve Board (FRB) could exercise rulemaking authorities it has under the Home Ownership Equity Protection Act (HOEPA) to address abusive practices by all mortgage lenders, not just practices that relate to high cost loans. We understand that the FRB is in the midst of reviewing the regulations that implement HOEPA. The FDIC would strongly support the FRB should it decide to make greater use of the authorities provided by HOEPA to address predatory practices. Many abuses might be more effectively addressed by regulation rather than statute, especially in areas such as misleading marketing, in which the manner and types of abuse frequently change.

The Immediate Problem of Loan Restructuring

National standards will help protect future borrowers. However, the task at hand is to find ways to help borrowers currently in financial distress. Many lenders, loan servicers, and other participants in the mortgage market are currently working with stressed borrowers to restructure their loans or find other ways to allow them to keep their home and make more affordable payments. The FDIC understands that regulators can play a role in working with all market participants to explore ways to help troubled borrowers. I am pleased to inform the Subcommittee that the FDIC will jointly host a forum on these issues April 16th along with the Office of Thrift Supervision, the Office of the Comptroller of the Currency and the FRB. The forum will include lenders, servicers and other participants in the subprime market to develop alternatives to foreclosure and consider strategies to implement those alternatives. We look forward to comprehensive discussions and creative approaches at this meeting.

Conclusion

In conclusion, the FDIC recognizes the importance of subprime lending if it is properly underwritten and borrowers are provided with complete and understandable disclosures. However, recent practices in the subprime mortgage markets have often placed borrowers in products that create financial hardship rather than building wealth. The FDIC is committed to finding solutions for borrowers already trapped in mortgages they cannot afford. We look forward to working closely with this Subcommittee to address the many issues raised by recent developments in the subprime mortgage market and look forward to the comments we hope to receive from all sectors on the recent proposed Subprime Statement and the discussions we hope to have at our upcoming forum. This concludes my statement. I will be happy to answer any questions the Committee might have.

1. Eduardo Porter and Vikas Bajaj, "Mortgage Trouble Clouds Homeownership Dream," *New York Times*, March 17, 2007.

2. First American CoreLogic, *Mortgage Payment Reset*, March 19, 2007, p. 11

3. *Expanded Guidance for Evaluating Subprime Lending Programs*, FIL-9-2001, January 31, 2001, http://www.fdic.gov/news/news/financial/2001/fil0109.html.

4. *Inside Mortgage Finance*, December 1, 2006.

5. FDIC-derived estimate based on third quarter 2006 data from *Mortgage Market Update* and the Federal Reserve Board's Flow of Funds data.

6. Interest-only mortgages are loans for which the borrower is required to pay only the interest due for a specified number of years (e.g., three or five years). After the interest-only period, payments include both principal and interest sufficient to amortize the debt. During both the interest-only period and the amortizing period, the interest rate may be fixed or may fluctuate based a prescribed index. The financial institution regulatory agencies consider interest-only mortgages to be non-traditional mortgages.

7. Payment-option ARMs are mortgages that allow the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term. The financial institution regulatory agencies consider payment option ARMs to be non-traditional mortgages.

8. 2/28s and 3/27s are hybrid ARMs typically marketed to subprime borrowers. These ARMs are similar to ARMs that are prevalent in the prime market (known as 3/1 ARMs), in that they have a fixed rate for 2/3 years and then adjust to a variable rate for the remaining 28/27 years. However, 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 on 2/28 and 3/27s, versus 100-250 basis points on prime 3/1 ARMs.

9. Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

10. Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

11. 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.

12. Source: LoanPerformance databases of prime and nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

13. *Higher-Priced Home Lending and the 2005 HMDA Data, Federal Reserve Bulletin*, Table 13A. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, September 2006.

14. See 15 U.S.C. 1681(c) – provisions of Fair Credit Reporting Act that permit adverse information to be included in credit reports for seven years and bankruptcy information to be included for ten years.

15. The interest rate information is based on publicly-available rate sheets from a large volume subprime lender as of February 12, 2007.

16. The interest rate is 8.10 percent, which is based on the introductory fixed interest rate for a fully-documented 2/28 loan of 7.60 percent plus 0.50 percent adjustment for fixed rate option.

17. See *Wall Street Journal article*, "Faulty Assumptions: In Home-Lending Push, Banks Misjudge Risk – HSBC Borrowers Fall Behind on Payment; Hiring More Collectors," February 8, 2007

18. Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

19. Mortgage Bankers Association *National Delinquency Survey* via Haver Analytics. Numbers are seasonally adjusted.

20. FDIC-derived estimate based on third quarter 2006 data from *Mortgage Market Update* and the Federal Reserve Board's Flow of Funds data.

21. Mortgage Bankers Association *National Delinquency Survey* via Haver Analytics. Numbers are seasonally adjusted.

22. Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations

23. See *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006).

24. See *Proposed Illustrations for Nontraditional Mortgage Products*, 71 FR 58672 (October 4, 2006).

25. See FDIC Financial Institution Letter 6-2007, dated January 22, 2007.

26. The NTM Guidance focused on the risk of products that defer the repayment of principal and sometimes interest. Since 2/28 and 3/27 hybrid ARMs are fully-amortizing, these products did not meet the definition of nontraditional mortgages in the NTM Guidance.

27. See *Proposed Statement on Subprime Mortgage Lending*, 72 FR 10533 (March 8, 2007).

28. See Joint Board and FDIC *Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks*, issued through FDIC Financial Institution Letter 26-2004 dated March 11, 2004.

29. Refer to CSBS and AARMR media release dated March 2, 2007.

30. See 12. C.F.R. §345.28(c).

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