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TESTIMONY OF

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And the

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

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Chairman Allard, Chairman Bunning, Ranking Member Reed, Ranking Member Schumer, and members of the Subcommittees, I appreciate the opportunity to appear before you today to discuss nontraditional mortgage products and the proposed interagency guidance on those products. My testimony this morning will focus on a brief overview of the nontraditional mortgage market, the OCC's perspective on factors that precipitated the need for policy guidance, the key elements of the proposed guidance, and a brief discussion of public comments received on the proposal.

Overview

Historically, residential mortgage lending has been a conservatively managed business with low loss levels and reasonably stable underwriting standards. In the past few years, low interest rates and an appetite by lenders for greater acceptance of credit risk has increased housing demand and access to credit; though at the same time contributing to rapid housing appreciation in a number of large regional markets.

Rapid appreciation, coupled with the recent rise in interest rates, has challenged housing affordability and made the payment structure and loan terms of traditional mortgage products less attractive to borrowers. In addition, competitive pressures to maintain origination volumes have provided strong incentives for lenders to promote continued access to credit through product evolution and streamlining costs and underwriting practices.

This environment has led to growing consumer demand, particularly in high priced real estate markets, for residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest. These products, often referred to as nontraditional mortgage loans, include "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan, and “payment option” adjustable-rate mortgages (ARMs) where a borrower has several payment options each month, including one with the potential for negative amortization.

Traditional mortgage loans, both fixed and adjustable rate, typically require that the borrower’s monthly payment cover both interest and a reduction in principal, allowing for a reasonably predictable amortization over the life of the mortgage. Alternatively, nontraditional mortgages allow borrowers to exchange lower payments during an initial period for higher, less predictable payments during a later amortization period.

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage products – once used relatively sparingly by more creditworthy and affluent borrowers as a cash-management tool – are now offered by more lenders to a wider spectrum of borrowers, who may not otherwise qualify for traditional mortgage loans and may not fully understand the associated risks. Increasingly, they are being mass marketed as “affordability products” to borrowers who appear to be relying on the initial low payments to afford the often sizeable mortgages necessary to buy homes in many housing markets across the country. According to data from *Inside Mortgage Finance*, an industry trade publication, approximately 30 percent of all mortgages originated in 2005 were interest-only mortgages or payment-option ARMs.

Many of these nontraditional mortgage loans are being underwritten with less stringent income and asset verification requirements (“reduced documentation”) than in the past. They are also increasingly combined with simultaneous second-lien loans to reduce down payment requirements and avoid private mortgage insurance (PMI). Such risk layering, combined with the broader marketing of these products, exposes financial institutions and borrowers to increased risk when compared to traditional mortgage loans.

The growth in nontraditional mortgage products and easing of underwriting standards is especially important to the OCC, since national banks have significant involvement in the residential mortgage markets - a market that has become increasingly dominated by a handful of very large lenders. According to data from *Inside Mortgage Finance*, the top five lenders produced approximately 47 percent of all residential mortgages originated in 2005, and three of the top five were national banks.

The Need for Policy Guidance on Nontraditional Mortgage Products

At the OCC, we have identified three primary reasons we believe it is essential to provide clear supervisory expectations to financial institutions that offer nontraditional mortgage products. First, we are concerned that the risks associated with nontraditional mortgage products are no longer limited to a small, homogenous population of borrowers, but rather now apply to a wider spectrum of borrowers, including some who may not fully understand the financial risks they are assuming.

In the past, lenders limited these products to more creditworthy borrowers for use as a cash-management tool. For example, payment option ARMs allowed borrowers to manage uneven cash flows, common for individuals paid on commission, or self-employed, or to cushion the blow of a temporary rise in interest rates, by exercising the option to make a smaller monthly payment. Of course, any unpaid interest would be added to the underlying principal balance of the mortgage, thereby increasing the total amount of the underlying loan.

During the spike in mortgage lending over the past few years, banks and other lenders began marketing nontraditional mortgage products as a type of "affordability product" – which is to say that potential borrowers could use these products as a method to qualify for a larger mortgage. This was accomplished by structuring the payment terms to reduce the monthly payment in the early years of the mortgage. But the trade-off for these much lower monthly payments in the present is the requirement to make much higher monthly payments in the future.

During this initial payment deferral period – typically five years but sometimes longer – an interest-only mortgage reduces the monthly payment by allowing the borrower to pay only the interest due on the loan each month. A payment-option mortgage goes one step further. In addition to forgoing monthly principal payments, it allows the borrower to pay back only *part* of the interest that is accrued each month, with any unpaid interest being added to the underlying principal of the loan. In other words, the mortgage "negatively amortizes," so that with each monthly payment, the borrower's mortgage debt increases.

After the limited initial period ends, the monthly payment for the holder of a nontraditional mortgage must increase – sometimes substantially - even if interest rates stay flat. This occurs because the borrower must now amortize the entire amount outstanding over the shorter remaining term of the loan. In the example that I've attached to my testimony, we assume a modest rise in interest rates of only two percent, and yet the monthly payment literally *doubles* in the first month after the payment deferral period ends and the loan is required to amortize. This is a major, if not unmanageable, stretch. How borrowers will respond – and how these new products will perform under such circumstances – remains an open question.

This potential payment shock problem is the most fundamental issue regarding nontraditional mortgages. For obvious reasons, the financial implications are significant at the individual borrower level, including questions regarding whether borrowers have a reasonable opportunity to understand the loan terms and make informed decisions. The payment shock issue also extends to risk management issues for lenders.

The second reason we are concerned about the rising volume of nontraditional mortgages is that these products may expose both the borrower and a financial institution to unwarranted levels of risk in a stressed environment. On a portfolio level, the risks of nontraditional mortgages can be masked in an active real estate market characterized by rapid home price appreciation. By the time the typical interest only or low minimum monthly payment periods expires, the mortgage can be refinanced and paid off by extracting the increased equity in the appreciated home.

But what happens if rates rise, or home prices fall, or both occur? A borrower can easily be faced with a mortgage that exceeds the value of their home, making it very difficult to refinance or sell if necessary. Borrowers that started out with little or no equity through the combination of a nontraditional mortgage with a simultaneous second-lien loan or borrowers who experienced erosion in their initial equity due to negative amortization could be in an even worse position. At this same time, such borrowers may face a much higher monthly payment, in some cases higher than they can afford, leading to default and foreclosure. By extension, these same scenarios could expose a lender with a portfolio of such loans to much higher credit risk than a portfolio of traditional mortgage loans. Additionally, such lenders could be faced with potential compliance and reputation risks if faced with the prospect of wide-scale foreclosures in any given community.

Third, we are concerned about the ability of current industry practices to adequately inform nontraditional mortgage borrowers of the risks associated with these products. Our final fundamental concern is: Do borrowers who use these products understand the very real possibility of dramatically increased payments in the future? To help answer this question, we looked at samples of actual marketing materials used by lenders to market payment option mortgages. In many cases we found that such materials focused primarily on the initial low monthly payment and gave relatively little attention to the likelihood of much higher payments later. This exercise led us to conclude, at least initially, that nontraditional mortgages are relatively complex, and borrowers unfamiliar with them — which means most borrowers — would benefit greatly from improvements in both the content and timing of disclosures.

Proposed Interagency Guidance

To address these concerns, the OCC and other federal banking agencies (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) proposed guidelines addressing the fundamental issues raised by nontraditional mortgages – specifically, that, over time, borrowers could experience substantial increases in required monthly payments that they may not understand or be able to afford, and therefore, could be putting their homeownership at risk.

This proposed guidance would apply to all insured financial institutions, their affiliates and subsidiaries.

Key Elements of the Proposed Guidance

The proposed guidance directs financial institutions to recognize and mitigate the risks inherent in nontraditional mortgage products. This includes ensuring that loan terms and underwriting standards are consistent with prudent lending practices, with particular attention to conducting a credible analysis of a borrower's repayment capacity. It also includes ensuring that consumers are provided clear and balanced information about the relative benefits and risks, sufficiently early in the process to enable them to make informed decisions.

Loan Terms and Underwriting Standards

The first fundamental issue addressed in the proposed guidance is that loan terms and underwriting standards should be based on a disciplined analysis of a borrower's capacity to repay mortgage debt in an orderly and systematic manner. This includes borrower qualification standards that consider a fully-indexed interest rate and a fully amortizing repayment schedule (*i.e.*, payment of both principal and interest).

Some banks have offered option ARM products for many years. However, as I noted earlier in my testimony, we see some significant differences in the way these products are offered today. Originally, option arm products were offered as cash-management products marketed to higher income or financially-sophisticated clients. However, now we see increased reliance on mass-marketing nontraditional mortgage products to hard-working people whose increases in household income may lag behind the increases in home prices.

According to a recent performance analysis of non-agency, nontraditional securitized mortgages by *UBS Mortgage Strategist (May 16, 2006)*, 75% of borrowers with option ARMs originated between 2003 and 2005 are making minimum payments.

Reduced to its essentials, a payment option loan with a negative amortization feature is functionally equivalent to a traditional mortgage loan coupled with a separate home equity line of credit. With a traditional mortgage and separate home equity line of credit, the borrower may use a check to draw down the line of credit, thereby increasing the total amount borrowed. With a payment option or negative amortization loan, the borrower has a different way to draw down the embedded line of credit to increase the amount borrowed: he or she can simply choose the minimum payment option so as not to pay the entire amount of interest due for a given monthly payment, and the amount not paid is the additional amount borrowed.

There is, however, a fundamental difference in the way that the two products are underwritten. When a lender underwrites a separate home equity line of credit with a traditional mortgage, the borrower must demonstrate to the lender that he or she has adequate income to service the full amount of additional debt that would be incurred if the borrower drew down the entire line. In contrast, in today's market for payment option loans, lenders do not impose a similar requirement to ensure that a borrower has adequate income to service the full amount of additional debt that would be incurred by electing to make only the minimum monthly payments each month. Moreover, as noted above, the overwhelming majority of recent users of payment option loans have elected to "draw down" on this embedded line of credit by repeatedly choosing to pay only the minimum amount due.

At the OCC, we believe that underwriting standards that do not include a credible analysis of a borrower's capacity to repay their entire debt violate a fundamental principle of sound lending and elevate risks to both the lender and the borrower. Accordingly, for products that permit negative amortization, the proposed 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 by repeatedly choosing the minimum monthly payment and the maximum potential amount of negative amortization that the loan permits.

The proposed guidance also addresses the practice of institutions increasingly relying on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and alternative information for the verified data traditionally used in analyzing a borrower's repayment capacity and general creditworthiness, they should be used with caution. The proposed guidance directs that the use of reduced documentation, such as unverified, stated income, should be accepted only if there are other mitigating factors such as lower loan-to-value limits and other more conservative underwriting standards.

Portfolio and Risk Management Practices

We expect institutions to adopt robust risk management practices, including policies and internal controls that address product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. The proposed guidance also discusses the need for institutions to maintain performance measures and management reporting systems that provide early warning of potential or increasing risks.

This includes stress testing of key performance indicators and ensuring that the results are integrated into the process of calibrating reserve and capital levels, as well as future product terms.

Consumer Protection Issues

Finally, the proposed guidance recommends that financial institutions provide timely, clear, and balanced consumer information about nontraditional mortgage products, and avoid practices that tend to obscure the significant risks these products could pose.

When we say that the disclosure should be “timely,” we mean that the information should be available to potential borrowers at crucial decision points — when they’re shopping for the loan and when they face the choice each month on how much to pay. Information provided at these points in time will help to fill in some gaps existing in federal disclosure rules concerning nontraditional mortgages. When we say they should be “clear,” we mean that the information should be delivered in plain English, free of legal and financial jargon. And when we say they should be “balanced,” we mean disclosures should spell out exactly what the consequences of the borrower’s decisions will be – both the benefits and the risks. There should be no equivocation about the risks of negative amortization and payment shock, if that’s what the product entails.

<u>Public Comments Received</u>

The comment period closed on March 29, 2006. Together, the Agencies received approximately 100 unique comments from the public. Not surprisingly, the majority were from financial institutions and trade groups, though comments were also received from a small number of consumer groups and individuals.

The consensus from the banking trade groups and large banks is that the underwriting, portfolio risk management, and consumer protection provisions are too restrictive or unclear, and should be left to individual institutions rather than prescribed by the regulatory agencies. On the other hand, almost all of the consumer groups, individuals, and the majority of community bankers felt the proposed guidance doesn't go far enough. Their general theme was that these products are contributing to speculation and unsustainable housing price appreciation and could lead to severe problems when and if a correction occurs.

The banking groups also expressed concern that the proposed guidance, if applied only to federally regulated institutions, would provide non-federally regulated lenders with a competitive and cost advantage, while putting at risk consumers of their services. Several made the point that unregulated institutions are driving much of the perceived relaxation in underwriting standards. They suggested that the disclosure aspects of the proposed guidance be deferred and addressed through subsequent rulemaking generally applicable to all lenders, such as through Regulation Z (Truth-in-Lending Act) and/or Regulation X (Real Estate Settlement Procedures Act). A recent announcement by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR), that they are considering similar guidance with the expectation that state agencies that regulate residential mortgage brokers and lenders may adopt and issue for use by their respective licensees, should help mitigate these concerns about a level regulatory playing field.

In addition, there are concerns that the promulgation of this proposed guidance, especially at a time of softening real estate markets in many parts of the country, is inconsistent with the goal of increasing home ownership. Let me emphasize that it is not the intention of the agencies to restrict homeownership opportunities in the market today. Rather the proposed guidance is intended to ensure that lenders take steps now to address weak underwriting practices for nontraditional mortgages and potentially misleading product information – to avoid credit and consumer protection problems in the future.

Our goal in proposing this guidance, instead, is to ensure that nontraditional mortgage products and the risks associated with them are managed properly by the banks that offer them, so that they do not compromise the safety and soundness of financial institutions and their ability to continue providing a steady, reliable stream of finance to homebuilders and purchasers. The proposed guidance is predicated on a belief that we do no one any favors – not the buyer, not the lender, and not the community in which the home is situated – to underwrite the purchase of a home that an individual buyer cannot afford in the long run. Supervisory guidance is the key instrument through which we communicate our expectations to bank management and bank examiners, and modulate market behavior in a way that causes the least disruption to existing markets and practices.

I can assure you that all of the comments we received are receiving careful consideration by an interagency taskforce that is at work right now. We expect the final guidance to be released this fall.

Payment Shock: Payment Option ARM

The payment shock for payment option ARMs can be substantial…

	If Rates Stay Flat	If Rates Increase 2%
Loan Amount	$360,000	$360,000
Initial Payment (1.25%)	$2,000	$2,000
Payment Reset after 5th year	$2,495	$3,153
Payment Shock in Dollars (60th – 61st Payment)	**+$893**	**+$1,551**
Payment Shock Percentage (60th – 61st Payment)	**56%**	**97%**
Negative Amortization Amount (at reset)	**$27,274**	**$48,566**