Remarks by
John C. Dugan
Comptroller of the Currency
Before the
Pittsburgh Community Reinvestment Group
Pittsburgh, PA
November 16, 2006

Thank you for inviting me to join you here today. It's always good to meet with friends and allies as we work together to sustain and strengthen America's neighborhoods. The groups represented in this room testify to the pioneering role Pittsburgh has played in this effort.

The Pittsburgh Community Reinvestment Group began nearly 20 years ago to help foster the Community Reinvestment Act by working with Pittsburgh's major lending institutions and public agencies to develop innovative reinvestment programs targeted to low- and moderate-income neighborhoods. Your member organizations have helped to bring over $4 billion of investment to Pittsburgh's low-income neighborhoods and in the process, proven that neighborhood organizations can have lasting and mutually beneficial relationships with bankers and other community stakeholders.

You have done this by building consensus among nearly 30 neighborhood organizations and collaborating with Pittsburgh's community leaders and financial institutions. You have also delivered essential services to community residents by providing homebuyer education, helping to secure home rehabilitation financing, and counseling individuals who run into temporary difficulties making their mortgage payments.

Pittsburgh is also distinguished as the birthplace of a very important organization. Dorothy Mae Richardson, the founder of the first Neighborhood Housing Services group, was an activist in the Central North Side community who convinced local bankers and government officials in 1968 to join her block club in battling neighborhood blight. Her efforts led to the creation of what is now the NeighborWorks® America network – on whose board I serve – which today boasts 250 affiliates in over 4,400 communities across the country. Last year, these organizations collectively leveraged $2.8 billion of investments in the communities they served.

Since at least the 1930s, home ownership has been a national priority – key not only to upward mobility, but also to the creation of neighborhoods that are stable, safe, and vibrant. Today our national home ownership rate stands at an all-time high of 69 percent, and the home is often an individual's most valuable financial asset. As the Joint Center for Housing Studies reported in 2004, the median net wealth of a homeowner with an annual income in the $20,000 to $50,000 range was $118,000, compared to only $6,000 for a renter with similar income.

Home ownership is also a sparkplug for economic development. It helps the broader community through many documented social benefits, ranging from better schools to reduced crime – all natural results of residents taking citizenship seriously as a means of protecting their investments.

The challenge I want to discuss today involves preserving our successes in bringing homeowners back to the neighborhoods you're trying to revitalize. A changing mortgage market has helped promote home ownership, which on the whole is a very good thing. But recently, in providing new opportunities, the mortgage market has also created some new challenges and risks to sustaining the gains that have been achieved.

Just think of the changes in mortgage products over the past two decades. Twenty years ago, a typical mortgage involved a down payment of between ten and twenty percent.

Today, some mortgages allow residents in your communities with steady incomes, but limited savings, to become homebuyers without making any down payment at all. In addition, the subprime mortgage market has grown from less than five percent of mortgage originations in 1994 to about 20 percent in 2005. This expanded market offers financing, albeit at a higher cost, to those with blemished credit or sparse credit histories who would not have qualified for loans in the past.

More recently, payment deferral products – so-called “interest only” and “payment option” mortgages – have emerged. These products were originally designed to help borrowers who had irregular income streams or were likely to experience significant future increases in income. But over time, they have come to be marketed, sometimes inappropriately, as a way to lower monthly payments to make mortgages more affordable – at least in the short term.

Not surprisingly, in an era of rising house prices and bigger mortgages, the market for products that lower monthly payments has taken off like a rocket. In 2000, interest only and payment option mortgages amounted to only two percent of the market. However, by the first half of 2006, the Mortgage Bankers Association estimates these types of nontraditional mortgage products represented over 40 percent of all loan originations. While these products have had the salutary effect of making financing available to many who otherwise would not have qualified for a home mortgage, there is a catch: the lower monthly payments are limited to the early years of the mortgage, and are offset by monthly payments that are higher in the later years – sometimes much higher. And that, in turn, is why they are called “payment deferral” products.

As its name suggests, interest-only mortgages lower monthly payments in the early years of a mortgage by requiring the borrower to pay only interest on the loan, without any repayment of principal. When the borrower begins repaying the principal – typically after five years – monthly payments increase significantly because the same amount of principal must be repaid in the shorter remaining period of the loan.

A payment option mortgage goes one step further. Here the borrower is given the option of reducing his or her monthly payment not only by deferring repayment of principal, but also by deferring repayment of part of the interest that is due. The unpaid interest is then added to the original principal amount of the loan – a process called "negative amortization" – so that with each minimum monthly payment the borrower's debt actually increases. When the borrower begins repaying the principal, monthly payments increase even more than they would have with an interest only loan because an even larger amount of principal must be repaid in the shorter remaining period of the mortgage.

How big is that increase? Big enough to earn the name "payment shock" under some very typical circumstances. For example, when a payment option mortgage of $150,000 at 6 percent resets after an initial five-year period, monthly payments can jump from $669 to $1,040, an increase of over 50 percent. If rates rise just two percentage points, to eight percent, the payment would increase to $1,314 – nearly doubling the amount of the initial monthly payments.

Now, such payment deferral products can be fine for borrowers who have the financial wherewithal to handle higher payments in the out-years and really understand the risk. But that class of mortgagor is unlikely to include many subprime borrowers, who are least able to handle or understand the risk of payment shock. Yet these subprime borrowers are the very individuals to whom these payment deferral products are increasingly being marketed. During the first quarter of this year, for instance, nearly one quarter of new subprime mortgages were interest only loans.

The risks of payment shock are exacerbated if, as unfortunately can be the case, the lender offers these nontraditional mortgage products to subprime borrowers through so-called "stated income" programs. In such circumstances, the borrower pays the lender not to verify the borrower's stated income on the loan application, making it possible for the borrower to artificially inflate the size of his or her income in order to qualify for a bigger mortgage. It is disconcerting, to say the least, that stated income loans comprise more than 50 percent of the subprime market, especially when, according to a study by the Mortgage Asset Research Institute, nearly 60 percent of the applications for stated income loans exaggerated income by at least 50 percent.

In a housing market with rapid home price appreciation, borrowers may be able to avoid payment shock – at least temporarily – by refinancing their mortgages and extracting equity gained from the increase in value of their homes. But when interest rates rise and home prices remain stable or fall, this route may be closed to them. Indeed, some recent statistics from First American Real Estate Solutions indicate that more than one payment option ARM in five originated in the past two years is now "upside down" – which means that the loan exceeds the current value of the house. And if home prices drop by 10 percent, about 40 percent of such loans would be upside down according to this report.

If true, such statistics portend potentially higher foreclosure rates on nontraditional mortgages, with an increasing number of people facing the prospect of unmanageable mortgage payments. Such a result could cause severe financial setbacks to the families involved and destabilize their neighborhoods, undermining the objectives so many of you in this room are trying to achieve.

What can be done? Well, as many of you know, the Federal bank regulatory agencies issued guidance in September to address the key risks raised by nontraditional mortgage products. Its purpose is to ensure that loan terms for such mortgages are consistent with prudent underwriting practices, and that consumers have enough information to make informed choices when considering these products.

The guidance makes clear that a bank's underwriting of a nontraditional mortgage must consider the borrower's ability to pay principal and interest as if the mortgage were a traditional amortizing loan. That is, a borrower should not be able to qualify for a nontraditional mortgage with lower initial monthly payments unless the borrower could also qualify for a traditional amortizing loan of the same amount with higher monthly payments.

To help the borrower understand the risk of nontraditional mortgages, the guidance also addresses disclosure: marketing materials should provide clear information about potential payment shock early enough in the marketing process to enable prospective borrowers to make informed decisions about whether to assume the risk of such products. The guidance also calls for financial institutions to provide balanced information that discloses both the benefits and risks of nontraditional mortgages, and to avoid using legal and financial jargon that tends to obscure the significant risks embedded in these products.

In terms of stated income loans, banks should rely on reduced documentation, particularly unverified income, only with caution. Indeed, the use of reduced documentation should be accepted only if it is offset by other factors, such as lower loan-to-value limits and other more conservative underwriting standards.

In sum, we believe our guidance provides an important foundation for the appropriate underwriting and marketing of nontraditional mortgages. Yet, as important as it is, the guidance should be viewed only as the start of a longer and larger process. After all, it applies only to federally regulated institutions – insured depositories and their affiliates. It does not extend to mortgage lenders not affiliated with banks, which are regulated exclusively by the states – even though such lenders constitute a large portion of nontraditional mortgage originators.

Indeed, the old paradigm where consumers sought home financing directly from their neighborhood bank or thrift has plainly changed. Under the new paradigm, an increasingly large part of the mortgage market consists of brokers that originate mortgages and deliver them to banks, thrifts, and other financial firms, which in turn package and market them to investors here and abroad. These innovations have made the mortgage market more accessible and efficient. They deserve some credit for the record home ownership rate we have today. But they also introduce new issues and risks into the mortgage lending process.

Often those who initially process such loans are far away when borrowers discover that escalating payments exceed their resources. A mortgage originator's deal-making may center on closing the deal, focusing only on whether a buyer can afford the <u>initial</u> payments, not on whether the prospective borrower is really capable of shouldering the later payments necessary to fully repay the loan.

This is where the states, and organizations like yours, have an especially important role to play. I am very encouraged by the model non-traditional mortgage lending guidance that was released this week by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. This model guidance mirrors the guidance issued by the Federal banking agencies, and these regulatory organizations are strongly encouraging their adoption in every state. We are told that some state regulatory agencies may quickly adopt these guidelines through such administrative processes as guidance to their examiners, policy revisions, or memoranda to the lenders they supervise. Other states will be exploring implementation of the guidance through formal rulemaking or legislative revisions. Here in Pennsylvania, I know that PCRG has been working with the Department of Banking on its mortgage reform initiative, and I hope that the nontraditional mortgage guidance will be quickly adopted in conjunction with these efforts.

I have spoken in the past of the need to apply the key principles of the federal guidance to all mortgage originators, not just those who are federally regulated. Without such a level playing field, a consumer protection gap would exist with respect to a broad segment of mortgage lenders who are regulated only by the states. The model nontraditional mortgage guidance endorsed by the CSBS and AARMR is a very promising step, to be followed, we hope, with effective implementation by each of the states.

Community organizations also have a vital role to play in this arena and are stepping in as important intermediaries when borrowers face threats to sustaining their home ownership. For example, here in Pittsburgh, PCRG has served more than 150 clients faced with foreclosure this year, with successful results in most instances – ranging from facilitating short sales, to renegotiating terms on an existing loan, to helping the borrower obtain a new loan. Providing this type of objective expertise to borrowers facing such a high level of financial stress is critical to helping avoid disruption in the communities which you've worked so hard to restabilize.

Importantly, we see other nonprofit groups around the country shifting their attention to providing foreclosure avoidance assistance. And, as is appropriate for an organization tracing its roots to neighborhood revitalization efforts in this very city, foreclosure prevention is the focus of a national initiative being sponsored by NeighborWorks® America through the NeighborWorks® Center for Foreclosure Solutions.

The Center seeks to preserve homeownership by supporting a coordinated strategy that includes foreclosure intervention programs in communities across the country. The Center also has a national toll free number for borrowers who are having difficulty paying their mortgages – they can call this number to learn more about forbearance options and to speak with a financial counselor.

But I think even more important than providing such fiscal first aid is creating an environment where people avoid the problem in the first place. In our own ways, both your organization and mine are working to achieve this goal. You do it by counseling buyers before they commit to a deal, and by sharing information about unscrupulous mortgage lenders with state and national regulatory and enforcement officials. We do it by providing guidance and regulating national banks, which currently originate about 40 percent of all U.S. mortgages.

In this latter role, let me stress that, if any homebuyer has concerns that any national bank or its subsidiary is engaged in inappropriate or abusive lending practices, we need to hear about it. The OCC's Customer Assistance Group is fully geared up to provide information and take complaints from bank customers or their designated representatives. Information about our Customer Assistance Group and how to make a complaint or referral is available on the OCC's Internet site. Because our commitment to sound and fair lending practices by all the institutions we supervise is steadfast, we can and will take action to address legitimate complaints.

In sum, we need an ongoing cooperative effort among all levels of government and groups closest to the problems of affected neighborhoods. That idea is behind the anti-predatory lending initiative the PCRG has launched, which combines a public service campaign; counseling to potential buyers about the risks of different mortgage products; and the development of a database that can be used to share information with regulators. The basic thrust of these efforts is to make the mortgage market work as it should by supporting transparent lender transactions with borrowers who can make informed choices.

Pittsburgh is in many ways a positive case study for the strategy I have described. You are both aware of the problem and experienced in how to deal with it. Our common goal must be to create a climate where organizations like yours can focus more time on getting people <u>into</u> affordable housing, and less time getting them <u>out of</u> financial distress.

It's been a pleasure to be with you this morning to discuss these important issues. We look forward to working with you in the weeks and months to come.

Thank you very much.