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**TESTIMONY OF**  
**JOHN C. DUGAN**  
**COMPTROLLER OF THE CURRENCY**  
**BEFORE THE**  
**COMMITTEE ON FINANCIAL SERVICES**  
**OF THE**  
**U.S. HOUSE OF REPRESENTATIVES**  
**OCTOBER 24, 2007**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to testify on H.R.3915, the “Mortgage Reform and Anti-Predatory Lending Act of 2007.” The OCC supports several key goals of the legislation, especially the establishment of national standards for subprime mortgages, which have been the source of so many recent problems in credit markets. We also support the bill’s goal of enhanced regulation of all mortgage brokers, whether used by banks or nonbanks.

As the OCC and others have testified, the lower underwriting and sales practice standards at non-federally regulated mortgage providers was a significant cause of the subprime loan problems we face today. This is not to suggest that banks and their affiliates had no part in the current problems, although, as we have previously testified, national banks and their operating subsidiaries originated only about 10 percent of subprime loans issued in 2006, and the rates of default on these loans have been significantly lower than the national average. In recognition of pervasive problems in the subprime market generally, the federal banking agencies tightened mortgage standards by issuing the *Statement on Subprime Mortgage Lending*, which followed the previously issued *Interagency Guidance on Nontraditional Mortgage Risks*. We believe these federal banking agency standards addressed fundamental concerns about underwriting and marketing practices for subprime and nontraditional mortgages.

Of course, these standards apply only to federally regulated institutions. They do not and cannot address similar practices at state-regulated institutions that are not banks, even though, by nearly all accounts, such institutions engaged in some of the most aggressive mortgage practices. As a result, the federal banking agency standards cannot

be truly effective unless they extend to non-federally regulated institutions as well, to create truly national standards. Such national standards could be achieved through state action, such as through uniform state legislation or rulemaking that adopts the federal banking agency standards, as has been done in some, but not all, of the states. They could also be largely achieved by regulation through Federal Reserve Board rulemaking under the Home Ownership and Equity Protection Act (HOEPA). Or they could be achieved through federal legislation, such as the bill that is the subject of today's hearing. Regardless of the path chosen, the OCC supports national standards for subprime mortgages that are similar to the federal banking agency standards.

From our initial understanding of the bill, which we have only had limited time to review, it intends to establish national mortgage standards for three different categories of mortgages.

- For all mortgages, the bill would establish national sales practice standards for “mortgage originators” through licensing and registration requirements, a federal duty of care, and anti-steering provisions. The bill would also prohibit single premium credit life insurance and mandatory arbitration for all mortgages, and would impose restrictions on all negative amortization mortgages provided to first time homebuyers.
- For subprime mortgages, the bill would – through the use of “safe harbor” provisions – establish national underwriting standards that are similar to, but more stringent than, the underwriting provisions in the federal banking agency

standards.<sup>1</sup> These new national underwriting standards would be enforced through, among other mechanisms, creditor and assignee liability provisions. In addition, the bill would prohibit prepayment penalties for all subprime mortgages.<sup>2</sup>

- For HOEPA mortgages, the bill would lower the APR and fee triggers and add additional categories of fees, including prepayment penalties, to count toward the fee triggers. These changes would make less costly mortgages subject to the enhanced HOEPA regulatory regime.

Taken together, these three categories of changes plainly go beyond the federal banking agency standards. That is, some of the new national standards apply to mortgages other than subprime mortgages, and some of the bill's national subprime standards are more stringent. While we support some of these broader standards, others raise significant questions and concerns that we hope will be addressed as the process moves forward.

In particular, the application of some of the new and extensive national mortgage standards to banks that do not provide subprime mortgages raises significant issues of regulatory burden and fairness. In addition, the more stringent standards for subprime mortgages would by definition restrict the availability of credit to subprime borrowers more than the federal banking agency standards. This would increase the likelihood that some creditworthy subprime borrowers would be denied credit, and would also make it more difficult for some existing subprime borrowers to refinance their loans. These and

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<sup>1</sup> While the safe harbor provisions focus the bill's underwriting restrictions to subprime mortgages, the underwriting provisions nominally apply to all mortgages and could affect prime loans in certain circumstances.

<sup>2</sup> The "subprime" restrictions in the bill would actually apply to all non-prime mortgages, including so-called "Alt-A" mortgages.

other concerns are addressed in more detail below, in more specific comments concerning the bill's provisions.

## **National Standards Applicable to All Mortgages**

### *Licensing and Registration Requirements*

The licensing and registration requirements respond to the need for better regulation of mortgage brokers. For example, the bill would impose new qualitative controls and net worth requirements on non-federally regulated mortgage brokers, including those used by banks. We support this aspect of the bill, which would fill a distinct regulatory void.

We also support the bill's establishment of a new system to track mortgage originators that have been subject to sanctions for their conduct, whether as bank employees or as independent mortgage originators. To ensure that information about "bad actors" is available to both federal and state regulators, the legislation directs the federal banking agencies, and state authorities, to submit information about formal enforcement actions against individuals to a new centralized national database. Such a system would be highly valuable to both federal and state regulators, as well as to lenders and prospective borrowers.

We do, however, have significant concerns about extending the licensing and registration provisions beyond brokers, who clearly need it, to every individual bank employee involved in mortgage origination, where the need is far less clear. In our view, the bill's one-size-fits-all standard for licensing and registering mortgage originators will impose substantial new compliance burdens on banks – especially community banks. We question whether the marginal benefits are worth these burdens, because banks and their

employees (1) are already subject to supervision and federal standards, and (2) have not been the primary cause of recent mortgage problems.

That is, bank regulators conduct ongoing oversight of a bank's mortgage lending standards, operations, systems, and controls, as well as of bank employees engaged in mortgage lending. This supervisory approach obviously can't be used for nonbank mortgage originators. There, greater reliance *must* be placed on a screening and clearance process for entry by individuals into the business, because there is no comparable system of ongoing supervision.

In contrast, national banks are already required to adopt and implement appropriate internal controls and standards for all employees, including those engaged in loan originations. These internal controls include segregation of duties to reduce opportunities for fraud and concealment; prevention of conflicts of interest; safeguards on access to assets and records; documentation procedures; reporting; and reviews of compliance with bank policy. Special written procedures and controls are required for real estate lending functions. Our supervision periodically addresses whether the bank has implemented appropriate internal controls and safeguards for oversight of loan officers. And, the OCC takes enforcement actions to address violations of law, including fraud, by individuals engaged in loan origination functions at national banks and their operating subsidiaries.

The federal banking agency supervisory and enforcement approach would also extend to any new substantive mortgage requirements that Congress chooses to impose on banks, such as the federal duty of care or subprime underwriting standards required by H.R. 3915. As a result, a costly overlay of new and extensive licensing, registration, and

compliance requirements for individual bank employees arguably would be unnecessary, especially for community banks that can least afford the additional compliance burden.

#### *Duty of Care Standards*

The OCC supports the part of the federal duty of care provision that requires full disclosure of key mortgage terms. We are concerned, however, about the part of the provision that requires originators to present borrowers with mortgages that are “appropriate” to the consumer’s circumstances. While appealing in concept, the standard is quite subjective, and therefore could be very challenging to implement and enforce. We believe the provision should be clarified so that it is not interpreted to be a kind of *de facto* “suitability” standard that could expose lenders to substantial litigation risk even when acting in good faith. This might be accomplished by a linkage between the “appropriateness” determination and assessment of the borrower’s ability to repay.

Indeed, based on extensive comments that we received when developing the federal banking agency standards, the agencies decided not to adopt a “suitability” standard. Instead, we opted to rely exclusively on an objective standard based on an assessment of a prospective borrower’s ability to repay. Like Title II of the bill, the banking agency standard focuses on the borrower’s ability to repay the loan according to its terms, based on the fully-indexed, fully-amortizing rate, and describes the factors lenders should consider in making that assessment.

#### *Anti-Steering Provisions*

The anti-steering provisions would prohibit certain incentive compensation. We fully understand the objectives of the bill in seeking to curtail yield spread premiums and similar broker inducements that have been severely criticized. We are concerned,

however, about the breadth of the provision, which could have the unintended consequence of prohibiting a bank from offering incentives to employees to promote certain types of loans based on beneficial features, and not based on higher fees, such as refinances of hybrid ARMs with fixed rate loans, or CRA-eligible loans.

Moreover, the anti-steering provision would also require federal regulators to prescribe regulations to prohibit mortgage originators from steering any consumer to a mortgage “that is not in the consumer’s best interest.” The regulators would also be required “to seek to ensure that such regulations . . . promote the interest of the consumer in obtaining . . . the best terms for a residential mortgage loan for which the consumer qualifies.” This language is even more subjective than the “appropriateness” language described above, raises even greater challenges to implementation and enforcement, and would potentially expose banks to a greater degree of litigation risk.

### **Provisions Applicable to Subprime Mortgages**

On its face, the bill would impose minimum general underwriting standards to a broad swath of mortgages: an ability to repay standard for all mortgages, and a net tangible benefit standard for any mortgage refinancing. But two important “safe harbor” exceptions apply. First, these general standards would not apply to prime mortgages, leaving them only to apply to subprime mortgages (including Alt A mortgages). Second, the general standards would not apply to “qualified safe harbor mortgages,” *i.e.*, those subprime mortgages that meet certain specific, statutorily defined underwriting standards regarding verified income, debt-to-income ratios, etc. We believe that, to avoid liability, few securitizers would purchase subprime loans unless they were qualified safe harbor mortgages, and the same might well be true of lenders that intend to hold the loans on



their balance sheets. As a result, the likely practical impact of the provision would be that nearly all subprime loans would have to meet the very specific underwriting standards necessary for qualified safe harbor mortgages, while the general standards would seldom come into play. Put another way, the qualified safe harbor mortgage could well become the federal prototype for subprime loans generally.

While the specifically required terms of these qualified safe harbor mortgages are similar to the federal banking agency standards, they are more stringent in a number of significant ways. For example, unlike the federal banking agency standards, a qualified safe harbor mortgage must have a debt-to-income ratio that does not exceed 50 percent; may not have negative amortization at any time; must always be based on income and financial resources that are verified (exceptions are permitted under the federal banking agency standards); and must as a practical matter have a fixed rate for at least the first seven years of the mortgage.<sup>3</sup> In addition, the bill separately prohibits prepayment penalties on all subprime loans, whereas the federal banking agency standards prohibit only those prepayment penalties that extend beyond the reset date of a subprime loan.

Taken as a whole, we believe these more stringent national underwriting standards would have a significant impact on subprime lending over time in that they would restrict the supply of credit. On the positive side, this reduction of credit would help ensure that the borrowers who obtain these loans could truly afford to repay them. On the negative side, the reduction would prevent some creditworthy borrowers from obtaining loans. In addition, the standards would narrow choices for all subprime borrowers (for example, by precluding virtually any form of adjustable rate mortgage). It

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<sup>3</sup> The safe harbor would permit adjustable rate mortgages where the rate is less than three percentage points above an acceptable index, but few subprime (or Alt A) mortgages could satisfy this test as a practical matter.

is impossible to determine *ex ante* the extent to which creditworthy borrowers would be denied loans due to the new and stricter standards. But this is clearly a trade-off in the bill that should be recognized. In addition, the stricter standards would also prevent more existing subprime borrowers with adjustable loans from refinancing such loans.

### **Enforcement Provisions**

Finally, the OCC believes that there is an important point to be made about the bill's enforcement remedies. On their face, the remedies appear even-handed because they apply equally to banks and nonbanks. But the reality is quite different. Because of existing enforcement provisions in federal banking law, application of the same set of bright-line standards to banks, brokers, and nonbanks would expose banks and their employees to a wide range of potential enforcement actions in the application of those standards, with no parallel system for enforcement of the standards applicable to brokers and non-banks. Put another way, banks and their employees would be subject to a stronger enforcement regime than nonbank lenders or mortgage brokers for the very same infractions of the bill's new provisions.

The very real concern is that uneven enforcement of the bill's new standards would result in raising the bar higher for banks than for nonbanks, which is surely not the bill's intent. Changes to the bill's enforcement standards are needed to ensure that the bill's standards are as effectively implemented and enforced at nonbank lenders and brokers as they would be at banks.

### **Conclusion**

I appreciate the opportunity to present the OCC's views today. The legislation is a real start towards establishing truly national standards for subprime mortgage lenders

and borrowers. It addresses a regulatory void by imposing standards for non-federally regulated mortgage brokers, and it would create a national database of mortgage originators who have been subject to sanctions, which would be beneficial to enforcement agencies as well as the public. In its current form, however, it does raise some significant concerns that we believe should be addressed.

We look forward to working with the Committee as its consideration of the legislation progresses, and we will be very happy to discuss these and other comments on particulars of the bill with Committee staff during that process.