Remarks by
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It's a pleasure to be with you this morning, to speak to such a broad cross-section of the housing and mortgage finance industries. Your invitation letter said that the members of the Council were interested in hearing about the OCC's request for comment on proposed guidance for non-traditional mortgage lending products. This somewhat cumbersome designation suggests that our concern with these products may be to preserve the sacred traditions of mortgage lending – bank supervisors in the role of Tevye in "The Fiddler on the Roof."

Let me assure you that is not the case. We are delighted when the industry finds new and creative ways to put people into homes. Our concern is ensuring that new products and new features are marketed and unerwritten properly, bringing promised benefits to banks and homeowners alike.

Your letter's reference to <u>OCC's</u> request for comment prompts me to point out that the guidance we are discussing today is not just an OCC initiative but a collaborative effort of the Federal Reserve, the FDIC, the OTS, and the NCUA. This is not an attempt to spread the blame – in case you have found fault with some aspect of the guidance – but rather to underscore the reach of the guidance. The document released on December 29, 2005 applies to all insured financial institutions, their affiliates and subsidiaries.
And the reach of the guidance looks to be extended even farther, as the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are developing companion guidance aimed at state-licensed residential mortgage brokers and lenders.

So we have proposed guidance that should eventually apply to the widest possible range of lenders and brokers, raises concerns about an entire class of mortgage products, yet which we believe supports the national homeownership goals all of us share. How the guidance serves those apparently conflicting goals – and I recognize that the connection may not be intuitively obvious – is one of the subjects I'll touch on today.

Let's start with a summary of what the guidance contains and the circumstances that gave rise to it. The guidance was a response to evolving trends in the mortgage and housing markets, trends with which I know you're familiar. Although house prices nationwide have been very strong for more than a decade, 2002 and 2003 saw really dramatic increases in many U.S. housing markets, fed by (among other things) low interest rates and investors fleeing a sluggish stock market.

Inevitably, though, these price increases squeezed potential buyers, whose incomes were growing much more slowly. Between 2002 and 2005, the median home sale price nationwide increased from $158,000 to $212,000, an increase of 34 percent. More importantly, median family income grew only 12 percent during the same period. Expressed differently, in that same period, the median home cost grew from about 3.1 to 3.7 times median income. In the hottest housing markets, such as California, home prices were up to 5.3 times median income by 2005. At those prices, according to the National Association of Realtors, only 17 percent of California households were able to afford the median-priced single family home.

This situation forced lenders to get creative in what was becoming an increasingly competitive mortgage market. Non-traditional products such as interest-only or payment-option arms – once used relatively sparingly by more creditworthy and affluent borrowers as a cash-management tool – gave a wider range of potential buyers what seemed to be a painless way to reduce their monthly payments and qualify for a mortgage larger than their incomes would otherwise support.

In the priciest markets, non-traditional products came to account for a significant share of new originations – more than 50 percent in California by 2004. And, when even one of *these* products was not enough to bridge the affordability gap, lenders proved willing to combine them with other aggressive underwriting practices, such as simultaneous first- and second-lien mortgages and reduced documentation requirements. In this way, lenders were able to stabilize and even grow loan volume, although at the cost of rising credit risk for banks, with potential implications for their loan loss reserves and capital adequacy.

At the same time, these products raised important consumer protection concerns. The fixation on getting one's foot in the door before house prices climbed still further blinded many borrowers to the longer-term realities of negative amortization and escalating payments. Lenders might have been expected to bring these realities to their customers' attention, but in conducting our supervisory reviews, we found that they were not nearly as forthcoming as we might have hoped. We've had consumers tell us they didn't know that after making 60 minimum payments on an option ARM, they would owe more than they did when the loan was brand-new. They should certainly understand the basic bargain: the price of a low payment now is a much higher payment later. I think it goes without saying that someone, at some point, should have explained this point.

Whether they knew it or not when they signed the loan agreement, interest-only and most payment-option borrowers will eventually face a major challenge in the form of payment shock when their loans start to amortize and reprice, especially if interest rates are higher then than they were at the loan's inception. We calculate that the holder of a 6 percent, $360,000 payment-option ARM who makes the minimum payment during the typical five-year negative amortization period, would see her monthly payment increase by nearly 50 percent once the loan started amortizing in year six. If interest rates climbed to 8 percent in year six, the payment increase would exceed 100 percent – a major, if not unmanageable, stretch. Unless borrowers have had the improbable good fortune to see their income increase proportionately, the day of reckoning could bring some painful lifestyle choices, even if mortgage payments remain manageable. How borrowers will respond – and how these new products will perform under such circumstances – remains an open question.

All these concerns – concerns relating to loan terms and underwriting standards, portfolio and risk management practices, and consumer protection – led us to the December 2005 proposed guidance. It stipulates that loan terms and underwriting standards should be based on a disciplined analysis of the borrower's capacity to repay in an orderly and systematic manner by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. If monthly payments are likely to jump because of negative amortization or reduced amortization periods, the guidance directs lenders to take these likely increases into account in demonstrating a borrower's capacity to meet the terms of the loan. In other words, repayment analysis must include the initial loan amount, plus any balance increase that may accrue from the negative amortization provision.

The guidance also addresses the practice of relying on reduced documentation, particularly unverified income, to qualify borrowers for non-traditional products. Because these practices essentially substitute assumptions and alternative information for the waived data in analyzing a borrower's repayment capacity and general creditworthiness, it emphasizes the need to use them with caution. It further directs that the use of reduced documentation, such as 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.

In regard to portfolio issues, the guidance requires that institutions 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. It 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.

Finally, the guidance cautions financial institutions to recognize the complexity of these products, the need for timely, clear, and meaningful disclosure, and how important it is to avoid practices that tend to obscure the significant risks these products pose.

When we say that the disclosure should be "timely," we mean that the information should become 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. 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 it should be "meaningful," we mean that it should spell out exactly what the consequences of the borrower's decisions will be. There should be no equivocation about negative amortization and payment shock, if that's what the product entails.

We anticipated a considerable reaction to the guidance, and that's what we received. Together, the agencies received 88 unique comments -- nine of which asked for more time, which we granted by extending the original 60-day comment period by an additional 30 days. Many industry commenters objected to the specificity of the guidance, arguing that regulators are prescribing too much detail on underwriting criteria – an area traditionally left to lenders. Concerns were also raised that the proposed underwriting procedures assume a worst-case scenario for all borrowers rather than making appropriate assumptions about the individual borrower's ability to manage the potential payment shock.

We acknowledge, of course, that many factors influence borrower performance, and that not all borrowers will make only minimum payments. Still, it is in neither the bank's nor the borrower's best interest to have a mortgage amount, or a payment structure, that a borrower is unlikely to be able to afford in the long run. The guidance proposes that underwriting standards should address this issue at inception – that is, by ensuring that qualification standards encompass any reasonably foreseeable payment requirements possible under the terms of the loan. In contrast, assuming only best-case performance unnecessarily increases risk to both parties.

I should add that a significant number of commenters thought the guidance did not go far enough. This group, which included many community bankers, felt that non-traditional products were contributing to speculation and unsustainable housing appreciation, and could lead to severe problems if and when a housing correction occurred. And consumer groups have pointed out that the market for these products now includes many moderate- and even lower-income borrowers and that the guidance was insufficient to protect these consumers from products that might not be in their best interest.

We've found a lot of merit in these and other comments, and I can assure you that all of them are receiving careful consideration by an interagency task force that is at work right now. We expect the final guidance to be released sometime later this summer.

Yet it's clear that beyond some of the objections we've received lie broader public policy concerns. There are concerns that the promulgation of this 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. There are concerns that borrowers for whom the non-traditional option may have provided access to home ownership may now find that road closed to them. Finally, we've heard it suggested that our guidance may have the unintended effect of reducing demand for housing and contributing to a downturn in values that could ironically wind up hurting existing borrowers <u>and</u> lenders, who have been counting on continued strong equity growth. These are important, legitimate concerns, and I'd like to respond to this line of argument right now.

First, let me state that it is not the intention of our guidance to bring about any wholesale clampdown on the use of non-traditional products as a means to extend homeownership opportunities to more people. Nor are we taking aim at negative amortization per se. Our proposed guidance makes clear that these products and features are appropriate if underwritten properly, and offered with meaningful disclosures. They have a definite – and well established – place in the mortgage market, which has been characterized over many years by impressive expansion and creativity. Through innovation and their drive to succeed, the organizations represented here today have boosted home ownership to record levels. We applaud that, and recognize that developing new and innovative financial products is essential to meeting this challenge.

Our goal in proposing this guidance, instead, is to ensure that non-traditional 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. 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.

For example, in June of last year, after our supervisory surveillance reported rising credit and reputation risk in home equity lending, we issued guidance that addressed underwriting, marketing, and account management practices. Under the prodding of our examiners, banks are moving into conformity with this guidance, and it is happening in a way that's minimizing the impact on individual borrowers and the economy. We expect to achieve very similar results through this guidance, and with it, a more solid and durable mortgage market.

Finally, I'd like to offer a few comments about the impact of our proposed guidance on individual borrowers -- some of whom, as i've said, may no longer be able to qualify for mortgage loans as large as they did once the guidance is fully implemented.

For some small segment of the home buying population, the guidance may eliminate some options that were probably neither sound nor realistic in the first place. It may eliminate the possibility of a more expensive house that would likely prove unaffordable over time or it may point toward a more modest house in a more modest neighborhood. In some cases, it may encourage buyers to temporarily defer their purchase plans while more cash is being accumulated toward a down payment. As i've already said, 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. If the borrower cannot qualify for a loan based on the fully amortized repayment schedule, there's an excellent chance that the borrower would be unable to make those payments when the introductory period came to an end.

The loss of a home is a real tragedy. The spiral into foreclosure causes enormous damage to a family's credit history – damage that can take years to repair – and can put tremendous strain on the family itself. We don't want to set people up for failure, and yet, by encouraging borrowers to assume financial responsibilities beyond their capabilities, that is exactly what some of these non-traditional mortgage products can do.

We embrace the national goal, as you do, to promote homeownership and healthy, stable communities. That's the American Dream. If we are true to that dream, we will take every step to ensure that financial institutions have the means to provide consistent, reliable housing financing to creditworthy borrowers. We believe that our proposed guidance is an important step in that direction, and I appreciate the opportunity to discuss it with you today.

Thank you.