ORAL STATEMENT OF
KATHRYN E. DICK
DEPUTY COMPTROLLER
OFFICE OF THE COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON ECONOMIC POLICY
And the
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION
of the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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.

Mr. Chairman, thanks in large part to a highly competitive, highly innovative mortgage market, we have achieved near record levels of home ownership across our country. Our goal as federal regulators is to preserve -- and expand upon -- this important accomplishment, while avoiding unwarranted risks to financial institutions and to consumers.

In recent years, a combination of market forces – especially the rapid increase in house prices -- has led to the increased popularity of so-called non-traditional mortgage products. This category includes “interest-only” mortgages, where a borrower makes no principal payments for the first several years of the loan; and “payment option” adjustable-rate mortgages, where a borrower has several payment options each month, including one with the potential for negative amortization, which occurs when a certain portion of the interest due is deferred and added back to a rising loan balance.

In addition, many nontraditional mortgages are made under relaxed underwriting

standards – with less stringent income and asset verification requirements, and sometimes in combination with simultaneous second-lien loans to reduce down payment requirements, frequently so that borrowers can dispense with private mortgage insurance.

Nontraditional mortgages have gained a prominent place in the marketplace. According to one trade publication, 30 percent of all mortgages originated in 2005 were interest-only or payment-option ARMs. In the highest-priced housing markets, the number was even higher.

Yet, despite their popularity, these loans pose special risks -- to borrowers and to lenders. Payment-option ARMs expose borrowers to the likelihood of payment shock, which occurs when the payment deferral period ends – usually after five years – and the loan resets to the market rate of interest. At that point, the borrower must amortize the entire amount outstanding over the shorter remaining term of the loan. In the example that is attached to my written testimony, which assumes a modest two percent rise in interest rates, the monthly payment would double.

In an active real estate market characterized by rapid home price appreciation, such a mortgage can be refinanced and paid off by extracting the increased equity from an appreciated property. But what happens if interest rates rise or home prices fall – or both?

Evidence shows that these risks are often not adequately disclosed and even less well understood in the wider population to which these products are increasingly marketed. Marketing materials we have reviewed emphasize the initial low monthly payments -- and gloss over the likelihood of much higher payments later on.

Increasingly, when borrowers opt for a payment option ARM, they aren't thinking

about how much their payment will be five years down the road and whether they will be able to make that payment – or what will happen if they can't. But they should be thinking about it -- and lenders should be thinking about it, too. It's that kind of thinking that our proposed interagency guidance on nontraditional mortgages is designed to stimulate.

It does this by directing financial institutions to ensure that loan terms and underwriting standards are consistent with prudent lending practices, with particular attention to the borrower's repayment capacity. It requires that when banks rely on reduced documentation, particularly unverified income, they do so with caution. It requires that banks adopt vigorous risk management practices that provide early warnings on potential or increasing risks. And it requires that consumers are provided with timely, clear, and balanced information about the relative benefits and risks of these products, sufficiently early in the process to enable them to make informed decisions.

It may be useful to think of a payment-option ARM as the functional equivalent of a traditional mortgage coupled with a separate home equity line of credit – except that, instead of using a check to draw down the credit line, the borrower does so by choosing the minimum payment option. The real difference, for our purposes, is in the underwriting. Whereas an applicant for a home equity line has to show adequate income to service the entire amount of that line, no similar qualification requirement is imposed on the payment option borrower for the additional debt that would be incurred by electing to make only the minimum monthly payment – and the minimum monthly payment is what most payment option borrowers make.

Under the proposed guidance, lenders would be required to conduct a credible

analysis of the borrower's capacity to repay the entire debt – including the potential amount of negative amortization that the loan structure and initial terms permit. That, we believe, is the only approach consistent with the fundamental principles of sound lending.

The comment period on our guidance closed on March 29. 2006. It generated approximately 100 unique public comments, each and every one of which, I can assure you, is receiving very serious and thoughtful consideration. In particular, I would like to express my appreciation to the Conference of State Bank Supervisors for being here today to speak to one of the comments we heard – about the need for comparable guidelines for lenders that may not be supervised by the federal banking agencies. We are delighted that State Banking Commissioners and the Conference of State Bank Supervisors have participated in gatherings, such as the Treasury Consumer Forum, which offer a real opportunity to bring consumer protection consistency and competitive equality to the mortgage market, if states disseminate and implement these principles in the same way as they will be at the federal level. We are expecting to issue final guidance on nontraditional mortgages this fall.

Mr. Chairman, in proposing this guidance, we have had two goals in mind: 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 provide a steady, reliable stream of finance to homebuilders and purchasers; and to ensure that consumers are provided the information they need, and when they need it, to make informed decisions on loan product and payment options.

I appreciate your attention and I look forward to answering your questions.