For Release Upon Delivery
10 a.m., December 6, 2007

TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

DECEMBER 6, 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, today's hearing focuses on recent developments to enhance the pace of mortgage loan modifications that may help troubled borrowers remain in their homes, and to explore two proposals that arose in connection with consideration of H.R.3915, the "Mortgage Reform and Anti-Predatory Lending Act of 2007." Both proposals raise important points for consideration. But they also highlight other, broader issues that are raised by subprime resets and by provisions of H.R. 3915 that are intended to prevent similar subprime mortgage problems in the future.

Approaches to Deal with Impending Mortgage Interest Rate Resets

Subprime adjustable rate mortgages (ARMs) typically provide for a relatively low starter interest rate that resets to a significantly higher rate over a 2- to 3-year period – the so-called 2/28s and 3/27s. The volume of such mortgages increased substantially beginning in 2004 and extending through the first part of 2007. As a result, with the passage of time, the nation's mortgage markets are now contending with a large volume of subprime ARMs that reset each month, a process that will continue through at least the end of 2008. Because the monthly payment on these loans can increase substantially at reset – by 25 percent or more – borrowers almost always refinance into new mortgages at the time of reset, assuming they are able to do so.

During the recent years of significant house price appreciation in many parts of the country, the vast majority of subprime ARM holders were able to refinance at reset into new mortgages, due largely to the increased value of the underlying homes. Conversely, with house prices becoming flat or declining in many parts of the country during 2007, it has become increasingly difficult for many subprime ARM borrowers to refinance at reset. While many such borrowers remain current on their loans or are still able to refinance at market rates or into FHA products, an increasing number have either fallen behind on their existing payments, or face the prospect of falling behind when rates reset and they are unable to refinance into new mortgages. Many forecasters project unprecedented levels of delinquencies and foreclosures with the sharply increased volume of resets expected to occur in a climate of flat or declining house prices.

There has been a vigorous and very healthy debate about how best to address the widespread subprime ARM interest rate resets and the prospect of large numbers of defaults and foreclosures. The outcome of this debate is obviously critically important to subprime borrowers and their creditors, typically investors who hold interests in securities backed in whole or in part by pools of subprime ARMs. But another critical stakeholder in the process is the mortgage servicer, part of whose job it is to implement foreclosure when necessary, or any loan modifications that may be appropriate for keeping mortgage borrowers in their homes while mitigating the substantial losses that would accrue to mortgage lenders from foreclosure.

In this regard, banks supervised by the OCC have a significant role to play. As I have previously testified, national banks did not originate subprime mortgages to the same extent as other market participants – for example, only about 10 percent of subprime loans issued in 2006, with default rates significantly lower than the national average. They do, however, occupy a more significant role as subprime servicers, with several large national banks currently servicing approximately $175 billion of subprime loans, constituting nearly 18 percent of the subprime servicing market.

In their role as servicers, these banks are working to balance the sometimes competing interests of borrowers and investors. As borrowers become delinquent and face the prospect of loan modification or foreclosure, the servicer's job becomes much more time consuming and labor intensive. As a result, given the large number of resetting ARMs and the potentially large number of borrowers who may be unable to afford the higher monthly payments at reset, there is good reason to explore new approaches to handling the attendant issues on a broader scale. Under these circumstances, identifying a programmatic approach – that is, an approach that would facilitate modifications of large numbers of mortgages in a short period of time using a common set of criteria – could make very good sense. Of course – and this is important – any programmatic approach would not foreclose the possibility that borrowers who do not qualify under the programmatic criteria might still qualify for loan modifications based on a case-by-case evaluation of their ability to repay under modified terms. Indeed, for the many borrowers who are already delinquent on their payments, have already entered foreclosure proceedings, or will not qualify for the programmatic approach, the loan-by-loan approach will continue to be the best hope for avoiding foreclosure.

As we look for solutions, it is important to recognize that, although the volume of subprime ARMs facing interest rate resets is large, it is divisible into distinct segments, only some of which are realistic candidates for loan modifications. At one end of the spectrum, there unfortunately will be a significant number of borrowers who are overextended, delinquent on their payments even at the starter rate, and face no realistic alternative other than foreclosure. At the other end is a substantial portion of borrowers with the capacity to refinance their mortgages into new mortgages at market rates or pursuant to programs administered by the Federal Housing Administration (FHA).

In between the two are segments of borrowers where loan modifications are possible and in many cases will be the most appropriate course of action. Where borrowers are not current on their loans, and even for some borrowers for whom foreclosure proceedings have begun, a loan modification may still be possible – but given the clear indications of credit problems, the only realistic approach for such modifications is a loan-by-loan approach.

On the other hand, there will also be a significant number of borrowers who are current on their payments at the initial rate, but are projected not to be able either to afford payments at the higher reset rate or to refinance into market or FHA mortgages. It is this segment of borrowers for whom some kind of programmatic approach to modification would make the most sense – and interested stakeholders in the lender, servicer, and investor community have been in intense discussions over the past weeks to develop just such an approach.

The formidable challenge has been to develop criteria for a programmatic approach for this category of borrower so that modifications can be completed quickly, allowing more borrowers to avoid foreclosure in ways that mitigate costs to the mortgage holders. Indeed, I believe it is critical for key stakeholders – lenders, servicers, and investors – to hammer out parameters for a programmatic approach that would strike a balance among their diverse interests and is broadly acceptable.

To be sure, such an approach won't be perfect from any one perspective. But its chances for success will be greatly improved because of the stakeholder participation that allowed all the different interests to weigh in to try to find a workable solution. It is our understanding that the different stakeholders are very close to reaching such an agreement, and although I have not yet seen the details, we very much support the approach in principle.

H.R. 4178: The Emergency Mortgage Loan Modification Act of 2007

For today's hearing, the Committee has particularly asked for our views on H.R. 4178, the "Emergency Mortgage Loan Modification Act," which would provide a safe harbor from liability for mortgage market participants that modify troubled mortgage loans according to certain criteria. H.R. 4178 would amend the Truth-in-Lending Act (TILA) to provide a safe harbor from liability for any creditor, assignee, servicer, securitizer, or any other holder of certain troubled residential mortgage loans that enters into qualified loan modifications and workout plans with respect to a troubled mortgage loan. The safe harbor, which would apply to loan modifications initiated within six months after enactment, covers subprime loans consummated on or after January 1, 2004, and extends to any liability that might be imposed under any law, regulation, or contract.

H.R. 4178 is a timely and important step to facilitate efforts by creditors and servicers to respond to the volume of potential loan modifications that may be needed. It has added to the momentum of achieving this goal. Very recent events – the progress made by key interested stakeholders – lenders, servicers, and investors – to hammer out parameters for a programmatic approach that would strike a balance among their diverse interests – may demonstrate, however, that a legislative solution may not be the optimal approach to achieving the desired results.

Legislating a particular solution or approach to modification of troubled subprime ARMs becomes very challenging in view of the competing interests of different market participants that I just described, and it carries downside risks. Legislation effectively undertakes to referee the different interests of the various parties interested in the transaction, specifying criteria for a single approach. In this regard, while I applaud the goals underlying H.R. 4178, the legislation itself presents several significant concerns.

First, the retroactive application of H.R. 4178 could create additional anxiety in the mortgage markets about the reliability of legal obligations upon which investors' expectations are based. If the legislation is enacted, will investors face new qualms about investing in mortgage-backed securities? A loss – or even a significant diminution – of investor confidence in this market could adversely affect the flow of funds for housing credit for some time to come.

Second, to the extent that it would effectively modify existing contract rights under servicer or investor agreements, the legislation may create a new field of potential litigation that is <u>more</u> challenging and inhibits loan modification efforts just as much, if not more than the legal issues industry participants are facing today.

In light of these potential downside risks, and particularly in view of the progress key stakeholders have made is reaching consensus on a programmatic approach, I would respectfully suggest that, at this time, on balance, the new issues that the bill would raise would outweigh its potential benefits.

Amendment to Increase Enforcement Authority

The Committee also has asked for our views on a proposal that would add authority to impose civil money penalties on mortgage originators, assignees, and securitizers for a "pattern or practice" of violations of H.R. 3915's core lending standards concerning a borrower's ability to repay and the net tangible benefit standard for refinanced mortgage loans. The proposal would amend TILA to make mortgage loan creditors, assignees, and securitizers liable for civil money penalties (CMPs) if they engage in a "pattern or practice" of originating, assigning, or securitizing loans that violate the "ability to repay" or "net tangible benefit" standards under H.R. 3915. The penalties would be mandated at $1 million for engaging in the pattern or practice, plus at least $25,000 per loan involved. All penalties collected would be paid to a trust fund administered by the Treasury Department. This money would then be awarded through a claims process, governed by Treasury regulations, to consumers who were entitled to relief under the rescission and cure provisions of H.R. 3915, but who have no party against whom to assert these remedies.

These penalties are in addition to the remedies against creditors, assignees, and securitizers already contained in H.R. 3915, and remedies already available under current law. TILA currently authorizes the federal banking agencies to institute administrative enforcement action addressing TILA violations at depository institutions (and their subsidiaries) through the broad enforcement powers afforded to the banking agencies under section 8 of the Federal Deposit Insurance Act.[1] Moreover, TILA currently provides consumers with private civil remedies against creditors and assignees for actual damages and attorneys' fees, as well as statutory damages that will be doubled under H.R. 3915.[2]

The federal banking agencies oversee TILA compliance by the entities subject to their supervision, using comprehensive and ongoing supervisory processes designed to assure compliance with applicable standards. Through supervision, compliance weaknesses can be identified at an early stage and can be corrected before they evolve into significant violations of the law. To address the most serious problems identified through the supervisory process, the banking agencies also may employ a flexible range of enforcement tools available to us under section 1818. These enforcement tools range from a cease and desist order under which the institution agrees to address compliance weaknesses, to CMPs against the institution and individuals involved with the violation, and industry-wide lifelong employment bans on institution-affiliated parties in egregious cases.

There is no comparable system of oversight and enforcement for non-depository institution mortgage market participants organized and operating exclusively under state law.

---

[1] 12 U.S.C. § 1818. *See* 15 U.S.C. § 1607.

[2] 15 U.S.C. §§ 1640, 1641.

While the Federal Trade Commission has authority to take enforcement action against these non-depository institutions under TILA, the FTC does not engage in ongoing supervision of lenders' activities.

In its current form, H.R. 3915 does not address how the application of the legislation's qualitative lending standards to non-depository institution lenders and their employees will be supervised and enforced. Clearly, the new standards established by H.R. 3915 are intended to apply to them. The missing link is – how will they be applied in practice?

Therefore, I am concerned that the additional mandatory "pattern or practice" CMP penalties will serve to magnify the already disproportionate compliance impact of the legislation on federally regulated depository institutions. I would have these same concerns even if the proposed amendment were limited only to securitizers since the same imbalance of supervision and oversight also exists in the case of depository institutions and non-depository institutions that engage in securitization activities.

For example, the legislation establishes certification standards that will encourage states to enact effective licensing requirements for non-bank mortgage professionals, including requiring, as a condition of certification of a state licensing system, that there be a state supervisory authority that provides effective supervision and enforcement of the *licensing requirements.* This licensing system certification mechanism assures minimum standards for state licensing systems by requiring that state systems meet specified minimum criteria to be certified, and in so doing helps to minimize inconsistencies between different state licensing systems. If a state licensing system fails to meet the standards for certification, H.R. 3915 provides for a backstop system for licensing non-depository institution lenders in that state, administered by the Department of Housing and Urban Development.

There is no comparable mechanism in H.R. 3915 to assure minimum standards and a level of consistency in state supervision and enforcement of the bill's *substantive standards* on duty of care, anti-steering, ability to repay, and net tangible benefit and the specific restrictions and prohibitions on mortgage terms – as they apply to non-depository institution lenders and their employees. In practice, achieving this requires two elements: a supervisory system adequate to oversee mortgage loan originators and other parties subject to the bill's standards, and the authority under federal or state law to enforce those standards. Very few states today have both.

The licensing system certification standards do not fill that gap because they do not require that there be a state authority that provides effective oversight and enforcement of the bill's *substantive standards* on mortgage marketing and underwriting. Nor does the bill require any minimum criteria for state supervision or enforcement over the creditors, assignees, or securitizers that employ state-licensed mortgage origination personnel and set the policies under which loans are actually made.

In contrast, comprehensive and ongoing supervision of depository institutions subjects them to independent scrutiny of their TILA compliance efforts. Failure to address this difference in the oversight of depository institutions and these non-depository institution entities risks creating a gap in actual achievement of the new standards and protections created under H.R. 3915.

Because of this gap, the enforcement remedies in the legislation will fall most heavily on depository institutions, which have not been the major source of subprime lending abuses. This result seems inconsistent with the bill's goal to ensure that mortgage lending is conducted according to uniform standards that are applied consistently regardless of whether the lender or broker is, or is affiliated with, a depository institution.

The amendment's mandate of large CMPs for a "pattern or practice" of violations would amplify the effects of these oversight differences. The existing precedent establishing the level of conduct that constitutes a "pattern or practice" that has been used in the lending context sets a very low threshold for liability. A relatively small number of instances of prohibited conduct could well rise to the level of a "pattern or practice." I have attached to my testimony an appendix briefly discussing the relevant precedent on what may constitute a "pattern or practice" under other statutes. Depository institutions under comprehensive ongoing federal supervision will face constant scrutiny, unlike their non-bank counterparts under state jurisdiction, and thus a heightened prospect that in the examination process, practices could be found that would trip the low "pattern or practice" trigger.

TILA already authorizes the federal banking agencies to seek redress of TILA violations through the very same administrative enforcement actions we can pursue for violations under the banking laws, using the broad array of remedies available to us under those laws against depository institutions and institution-affiliated parties. Thus, the new provisions added to TILA by H.R. 3915 could be effectively enforced by the Federal banking agencies using the same tools we already have available. While the proposed amendment would add to the federal enforcement regime one new penalty applicable on its face to all mortgage market participants, in practice, because of the disparate supervision and enforcement applied to different types of mortgage lenders, the force of the amendment would appear to fall most heavily on already regulated depository institutions.

As an alternative, I would respectfully suggest further exploration of other amendments to H.R. 3915 that could help achieve more consistent oversight and enforcement of the bill's qualitative standards as they apply to non-depository institution lenders and their employees. We would be happy to work with the Committee and other interested parties to further that effort.

###

Appendix: The Meaning of "Pattern or Practice" in Federal Legislation

The Mortgage Reform and Anti-Predatory Lending Act of 2007 (H.R. 3915) would establish licensing requirements and origination standards relating to residential mortgage loans, additional restrictions on high-cost mortgages, and other substantive changes in the law. The bill would also make significant changes to the liability provisions in the Truth in Lending Act (TILA). For example, rescission remedies are extended to circumstances involving violations of the new ability to repay and net tangible benefit requirements, and the civil liability provisions are amended by increasing both statutory damages amounts and class action damages caps.

The amendment offered by Reps. Miller, Watt, and Frank would further enhance penalties for certain TILA violations. In particular, the Miller-Watt-Frank amendment would increase the potential administrative sanctions against violations of the ability to repay and net tangible benefit requirements. The amendment provides that:

> [A]ny creditor, assignee, or securitizer which engages in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate [the new ability to repay or net tangible benefit requirements] shall forfeit and pay a civil penalty of—
>
> (i) not less than $25,000 for each such loan; and
> (ii) $1,000,000 for engaging in such pattern or practice.

Penalties collected under this provision are to be held in trust by the Secretary of the Treasury for the benefit of borrowers with residential mortgage loans that were originated in violation of the ability to repay and net tangible benefit requirements.

The amendment does not define the term "pattern or practice." Similarly, a number of existing federal statutes employ the "pattern or practice" terminology, without definition, in their respective enforcement provisions. For example, the term is used in Title VII of the Civil Rights Act of 1964 (Equal Employment Opportunities),[3] the Fair Housing Act,[4] the Equal Credit Opportunity Act,[5] and federal flood insurance legislation.[6] It is likely that regulators and others would look to interpretations of this language in other statutes for guidance in interpreting the proposed amendment, if enacted in its present form.[7]

Courts and regulators have considered the facts and circumstances of a given case in determining whether a pattern or practice of violations exists. The Supreme Court explained in a Title VII case that the "pattern or practice" language "was not intended as a term of art, and the words reflect only their usual meaning."[8]

---

[3] 42 U.S.C. § 2000e-6(a), (e).
[4] 42 U.S.C. § 3614(a).
[5] 15 U.S.C. § 1691e(g).
[6] 42 USC § 4012a(f)(1).
[7] See United States v. DiMucci, 879 F.2d 1488, 1497 n.11 (7th Cir. 1989) ("pattern or practice" is not "a term of art, but appears in several federal civil rights statutes, and is interpreted consistently therein").
[8] International Bhd. of Teamsters v. United States, 431 U.S. 324, 336 n.16 (1977).

While isolated, sporadic, or accidental occurrences do not constitute a pattern or practice,[9] there is no necessary minimum number of acts required.[10] As one court has stated, "there is no threshold number of incidents that must occur before the government can bring suit against a party."[11] In cases under the antidiscrimination laws, courts have stated that the number of persons adversely affected is not determinative; rather, the question is whether discrimination is the defendant's usual policy, regular practice, or standard operating procedure. For instance, in a case challenging the use of a written examination for employment, the Fourth Circuit Court of Appeals rejected the argument that the United States had not demonstrated a pattern or practice because the number of black applicants affected was small. United States v. Commonwealth of Virginia, 620 F.2d 1018, 1024 (4th Cir. 1980), cert. denied, 449 U.S. 1021 (1980). The court stated that:

> The question . . . is not the number of applicants which were affected, but rather whether the United States established "by a preponderance of the evidence that racial discrimination was the (Commonwealth's) standard operating procedure rather than the unusual practice."[12]

Thus, courts have found pattern or practice discrimination even where the number of identified victims is as few as two or three.[13] For example, in United States v. Big D Enter., Inc., 184 F.3d 924, 931 (8th Cir. 1999), cert. denied, 529 U.S. 1018 (2000), the court found that evidence of discrimination against three identified victims, along with the testimony of the defendants' employees that they were instructed not to rent apartments to black applicants, demonstrated a pattern or practice of discrimination. Indeed, some courts have stated that the mere existence of a policy that would result in discrimination is sufficient to satisfy the pattern or practice requirement.[14] The focus on the defendant's policies, practices, and procedures does not mean that the defendant must be found to have discriminated uniformly in order to find a pattern or practice.[15]

---

[9] See id. at 336; see also E.E.O.C. v. Federal Reserve Bank of Richmond, 698 F.2d 633, 644 (4th Cir. 1983), rev'd and remanded on other grounds sub nom Cooper v. Federal Reserve Bank of Richmond, 467 U.S. 867 (1983) ("two incidents of failure to promote . . . , even if regarded as discriminatory, . . . would not support the District Court's finding of a pattern of class discrimination in promotions . . . or offer any reinforcement to an inference of discrimination derived from statistical proof").
[10] United States v. Habersham Prop., Inc., 319 F. Supp 2d 1366, 1372-73 (N.D. Ga. 2003).
[11] Id.
[12] United States v. Commonwealth of Virginia, 620 F.2d at 1024, quoting Teamsters, 431 U.S. at 336.
[13] See United States v. West Peachtree Tenth Corp., 437 F.2d 221, 227-28 (5th Cir. 1971) (discrimination against two individuals, in combination with other evidence, established a pattern or practice of discrimination); United States v. Lansdowne, 713 F. Supp. 785, 818 (E.D. Pa. 1989), aff'd, 894 F.2d 83 (3d Cir. 1990) (evidence of discriminatory rejection of three families from swim club membership, along with evidence of discouragement of black applicants, established a pattern or practice).
[14] See, e.g., United States v. City of Parma, Ohio, 494 F. Supp. 1049, 1095 (N.D. Ohio 1980), aff'd in part, rev'd in part on other grounds, 661 F.2d 562 (6th Cir. 1981), cert. denied, 456 U.S. 926 (1982); see also United States v. Garden Homes Mgmt. Corp., 156 F. Supp. 2d 413, 423-24 (D.N.J. 2001) ("[o]nce a discriminatory policy has been established or admitted, the plaintiff does not have to introduce specific instances of discrimination to prove a pattern or practice").
[15] United States v. Lansdowne, 713 F. Supp. at 807, 894 F.2d at 89.