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TESTIMONY OF

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OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

March 27, 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.

INTRODUCTION

Chair Maloney, Ranking Member Gillmor, and members of the Subcommittee, my name is Wayne Rushton, Senior Deputy Comptroller and Chief National Bank Examiner for the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to appear before you today to discuss developments in mortgage underwriting and marketing practices, particularly in the subprime market, that have been the focus of attention by the OCC and the other federal banking agencies. Before discussing subprime mortgage lending and the OCC's supervision of national banks, I think it is important at the outset to make the following observations:

First, it is clear that some subprime lenders have engaged in abusive practices – including making loans that borrowers cannot realistically repay -- and we share the Subcommittee's strong concerns about them. But, it would be wrong to equate all subprime lending with predatory lending. Subprime loans have helped to provide mortgage financing for millions of first-time homebuyers with few credit options, and this segment of the population is important to the economy. No one wants to see creditworthy consumers shut out of the credit markets, and so we need to work together to ensure that they are treated fairly and responsibly without cutting off their access to credit.

Second, the vast majority of subprime loans are not originated in the national banking system or supervised by the OCC. While some national banks and their subsidiaries help to serve the credit needs of the subprime market, their subprime lending last year amounted to less than 10% of the total of subprime mortgage originations by all lenders. Subprime lending is a specialized business that must be carefully managed to maintain safety and soundness, to mitigate risks, and to ensure fair treatment of borrowers. National banks and their subsidiaries that engage in subprime lending are subject to extensive oversight by OCC examiners and must operate in close compliance with the OCC's rigorous safety and soundness and consumer protection standards. Unsound underwriting standards and abusive lending practices have no place in the national banking system. Some have said, perhaps not surprisingly, that there is a direct connection between the rigor of the OCC's supervision of subprime mortgage lending and the low level of this activity in national banks. Indeed, there have been recent instances in which banks have decided against converting to a national charter for this very reason.

Third, we are now confronting adverse conditions in the subprime mortgage market, including disturbing but not unpredictable increases in the rates of mortgage delinquencies and foreclosures. These conditions can be attributed to a variety of factors, including changes in local economies that affect borrowers' creditworthiness and home values; the willingness of investors -- and borrowers -- to assume greater levels of risk; fraud in the application process; intense competition; and a relaxation of lending standards. With regard to matters that are within the purview of the bank regulatory agencies, let me assure you that we will work together, in the institutions we supervise, to obtain appropriate corrections to underwriting practices that cause us concern. Given the importance of the housing sector to our economy and to our national policy goals, however, it is imperative that we all use the right degree of pressure when "applying the brakes" to avoid putting in jeopardy the segments of the market that are working well and that have helped to raise homeownership rates to historic levels.

Finally, as we seek to address the concerns that have been raised about subprime mortgage lending, we need to recognize the predominant role played by nonbank companies in providing financing to subprime borrowers. Almost half of all subprime loans originated in 2006 were made by nonbank lenders, and this is due to several factors. First, insured depository institutions, whether nationally- or state-chartered, are the most heavily regulated of all financial institutions, and they also tend to have the most conservative underwriting standards. This may account for the fact that banks have the smallest share of the subprime market. Nonbank affiliates of bank and thrift holding companies have a larger share of subprime originations than do banks. However, as noted above, state-regulated nonbank lenders and brokers that originate these loans have captured the largest share of the subprime market recently -- primarily because hedge funds and private equity investors provided extraordinary liquidity to fuel this growth by purchasing loans originated by nonbanks, as well as securities backed by these loans, in the secondary market. Given the complexity of subprime mortgage finance, and the variety of companies engaged in the activity, adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

My testimony today will describe these developments in the mortgage market, as well as recent interagency guidelines on mortgage lending. I will also discuss the OCC's supervisory process to describe how we seek to prevent national banks and their subsidiaries from engaging in unfair and deceptive, predatory, or unsafe and unsound mortgage lending practices. In this regard, I will describe supervisory and regulatory standards that the OCC has issued relating to mortgage lending by national banks and their mortgage lending subsidiaries, how we examine these institutions for compliance with these standards, and relevant enforcement actions.

Developments in the Subprime Mortgage Market

Throughout most of the 1990s, mortgage origination volumes remained steady at around $1 trillion per year. Beginning in 2001, however, interest rate reductions by the Federal Reserve Board had a substantial impact on the mortgage market. As interest rates declined, many borrowers refinanced existing loans, often lowering their interest rates and extracting cash at the same time. The result was a three-year rapid expansion of the mortgage market that peaked in 2003 with just under $4 trillion in new originations. When the Federal Reserve began raising interest rates in 2004, the impact on mortgage markets was almost immediate. By the end of 2004, originations volume declined to just under $3 trillion, a 26% drop from 2003.

As one might expect, the 2001-2003 surge in demand prompted mortgage lenders to expand their operations to boost capacity. These conditions also attracted new market participants, often lenders with little business experience or financial strength. When loan demand slowed in 2004, the market was left with overcapacity. To maintain production levels, and satisfy continued strong investor appetite, mortgage originators shifted to "innovative" products, often designed to help borrowers cope with rising home prices or continue to tap idle home equity. Some of these "innovations" included relaxed underwriting standards and temporary payment reductions that increased risk for both borrowers and lenders.

In recent years, 15- and 30-year fully amortizing conventional loan products have declined from 62% of total originations in 2003, to just 33% by the end of 2006, while originations of loans to subprime borrowers, and originations of interest only (IO) and payment option adjustable-rate mortgage (ARM) loans to prime or near-prime borrowers, have increased. For example, loans to subprime borrowers increased from just 8% of total originations in 2003, to 20% in 2005. Subprime originations peaked in 2005 at a total of $625 billion in originations, and declined to about $600 billion in 2006, with a 20% market share in both years. Originations of loans to the so-called Alt-A market, including nontraditional products such as IOs and payment option ARMs, grew from only 2% in 2003 to 13% by the end of 2006.

In contrast to their share of the mortgage market generally, and their share of commercial banking assets, national banks have not been significant players in the subprime loan market. Roughly two-thirds of commercial bank assets are held by national banks. In addition, almost one-third of the approximately $3 trillion in total mortgages that were originated in 2006 were originated by national banks or their subsidiaries. However, as I noted earlier, subprime lending by national banks and their subsidiaries in 2006 amounted to less than 10% of the total $600 billion in subprime mortgage originations by all lenders.

In response to the question posed in your letter, subprime loans originated by national banks have been performing better than subprime loans in the general market. Moreover, given this performance, as well as the very limited holdings of subprime loans by national banks noted above, the current problems affecting the subprime market do not threaten the viability of any national bank.

However, loan performance in the subprime sector generally, as we have been seeing, is deteriorating. Recent statistics reported in a nationwide survey by the Mortgage Bankers Association (MBA) showed that 14.44% of subprime borrowers with ARM loans were at least

60 days delinquent in their payments in the fourth quarter of 2006.[1] This was an increase of 122 basis points from the third quarter delinquency rate for such mortgages of 13.22%. According to the MBA survey, foreclosure start rates for subprime loans increased 18 basis points (from 1.82% to 2%) during the fourth quarter of 2006.

The OCC has carefully monitored these changes in the mortgage market over time, with particular focus on developments affecting the national banking system, and taken preventive steps as appropriate to address safety and soundness and consumer protection concerns as they have been identified. The OCC has addressed the liberalization of mortgage underwriting and the need for caution in four consecutive Annual Surveys of Credit Underwriting Practices, beginning in 2003. In 2004, we began to take particular steps to assess the risks associated with this activity. These steps included a survey of national bank originations of IO and payment option ARM loans, including underwriting and marketing practices. Based on our preliminary findings, in 2005, we initiated an interagency process to develop guidelines to address emerging risks affecting both safety and soundness and consumer protection. This process culminated in the special guidance on nontraditional mortgages, described below, that was issued in 2006.

Close in time to the interagency work on nontraditional mortgage guidance was our review of subprime mortgage loans, including the so-called “2/28” and “3/27” hybrid ARM products. We determined that these loan products, although not technically covered by the nontraditional mortgage guidance, raised underwriting and consumer protection concerns that are similar in several respects to those raised by IO and payment option ARM products. In particular, the agencies, as well as members of Congress and the public, became concerned that

[1] National Delinquency Survey, Mortgage Bankers Association, March 2007.

lenders are not appropriately underwriting these loans and have loosened their borrower qualification standards too far in response to increasing competition for loan volume. For example, with respect to more recent vintages of subprime hybrid ARMs, the agencies are particularly concerned about the potential for increased levels of delinquencies and potential defaults and foreclosures after the payments reset.[2] Based on our assessment of these trends, we developed the proposed interagency statement on subprime lending, which also is described below.

OCC Supervisory Guidance Relating to Mortgage Lending

In addition to on-site examinations and extensive public outreach, an important component of the OCC's oversight of national banks is our provision of written supervisory guidance. We use the guidance process to alert national banks to practices that may raise legal, compliance, safety and soundness, and consumer protection risks and concerns, and to try to prevent such risks from taking hold in the national banking system. Our examiners then apply the principles articulated in guidance in their ongoing bank supervision activities. Over the past several years, the OCC has issued supervisory guidance to national banks on a wide range of matters involving potentially abusive, unsafe and unsound lending practices, providing both general guidelines and more targeted directives where appropriate.[3]

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[2] According to a Special Report by Moody's (March 3, 2007), serious delinquencies increased dramatically for subprime loans originated in 2006, in contrast to delinquency patterns for subprime loans originated in the years 2002 to 2005.

[3] *See* Attachment A.

In October 2006, the OCC and other federal banking agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) issued final guidelines addressing a variety of supervisory issues raised by nontraditional mortgages (NTM guidance), such as IO mortgages and payment option ARMs.[4] Nontraditional mortgage products have frequently been marketed as "affordability" products, and they have been structured to reduce monthly payments in the early years of the loan to make the loan more attractive to borrowers. The agencies were concerned that underwriting standards had eroded to the point that some lenders were paying too little attention to the borrower's ability to make the higher payments that would be required later in the loan term. The agencies also were concerned that such "back-loaded" repayment structures may cause borrowers to commit to substantial increases in required monthly payments that they may not understand or be able to afford. This potential for payment shock, which can be severe given the non- or partially-amortizing nature of these products, is the most significant consumer protection concern related to nontraditional mortgage products.

The NTM guidance directs financial institutions to address and mitigate the risks inherent in nontraditional mortgage products. This includes ensuring that loan terms and underwriting standards are consistent with prudent lending practices, which require a credible analysis of a borrower's repayment capacity. In this regard, the NTM guidance provides that

[4] 71 Fed. Reg. 58,609 (October 4, 2006). We published proposed guidance addressing these concerns in December 2005, and asked for public comment on the proposal. After evaluating the public comment we received on the proposal following the end of the 90-day comment period, the agencies issued the final NTM guidance in October 2006. Most lenders strongly objected to what were deemed to be "overly prescriptive" borrower qualification and consumer protection standards in the proposed guidance. However, the agencies adopted this guidance, essentially as proposed, including the strong borrower qualification and consumer protection standards, in order to address the concerns we had about these practices.

such loans should be underwritten based on a borrower's ability to make fully-amortizing payments at the fully-indexed interest rate. For products like payment option ARMs that permit negative amortization, the guidance provides that a lender's underwriting analysis should be based on the initial loan amount plus any balance increase that may accrue over time based on the maximum potential amount of negative amortization that the loan permits.

The NTM guidance also addresses the increasingly common practice of institutions to rely on reduced documentation, particularly unverified income, when they qualify borrowers for nontraditional mortgage loans. This practice essentially substitutes assumptions and alternative information for verified data in analyzing a borrower's repayment capacity and general creditworthiness. Because this practice can present significant risks, including the risk of fraud, it should be used with caution. Accordingly, the NTM guidance provides that the use of reduced documentation, such as unverified, stated income, should be accepted only if there are other mitigating factors that minimize the need for direct verification of repayment capacity. Further, the NTM guidance notes that institutions generally should be able to readily document income for many borrowers using recent W-2 statements, pay stubs, or tax returns.

Finally, the NTM guidance addresses the need for financial institutions to provide timely, clear, and balanced consumer information about nontraditional mortgage products, including information about the potential adverse consequences of these loans, such as payment shock and negative amortization. This information should be provided to consumers when they are shopping for a loan. In addition, the guidance provides that information that will allow consumers to make informed choices concerning payment options should be provided with any monthly statement on a payment option ARM.

The NTM guidance took effect immediately upon its publication on October 4, 2006, and it applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. We are now in the process of ensuring that national banks that offer nontraditional mortgage products perform a self-assessment to determine whether their operations comply with the guidance and, if not, to bring their operations into conformity. And, of course, we will confirm this information, and monitor compliance, through our on-site examination process.

At the same time the agencies issued guidance on nontraditional mortgage product risks, we published for comment proposed illustrations of the consumer information contemplated in the guidance. Commenters, including community banks, generally favored the issuance of these illustrations as a simple "compliance aid" in implementing the disclosure recommendations contained in the NTM guidelines. The agencies have carefully considered the comments we received and we expect to be able to finalize the illustrations in the next several weeks.

Proposed Statement on Subprime Mortgage Lending

A number of questions also have been raised concerning the underwriting and marketing of certain hybrid ARMs that are being made to subprime borrowers, commonly known as 2/28 and 3/27 ARMs, and sometimes referred to as "credit repair" loans. These products make up a significant portion of the subprime mortgages being originated today.[5]

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[5] The 2/28 and 3/27 hybrid ARM products represented more than 60% of all subprime mortgages originated in 2006.

Hybrid ARM products feature fixed initial payments of principal and interest that reset in two or three years based on a variable interest rate plus margin formula. The reset margins on subprime hybrid ARM products are typically much higher, and interest adjustments more frequent, than on comparable prime loans. These circumstances, especially when they are combined with high periodic caps on how much the interest rate may increase and lower than normal initial payments, mean that a subprime borrower's payment may increase significantly and quickly, causing payment shock. The agencies are concerned that some lenders are not prudently evaluating the repayment capacity of borrowers by failing to consider the borrower's ability to service the debt when payments increase and to make housing-related tax and insurance payments. With some subprime mortgages, the terms of a prepayment penalty also can be onerous, which can make it very difficult or expensive for the borrower to refinance the loan in order to avoid unaffordable increases in monthly payments. These products present serious concerns that they are being offered to borrowers who may not understand the associated risks and who do not have the capacity to repay the loan as structured.

As noted above, the consequences of these loan structures can include an inability of the borrower to make payments after the initial rate adjustment, adding to the risk of default. Thus, these loan products raise some of the same concerns about appropriate underwriting, consumer protection, and the risks of payment shock that the agencies addressed with respect to nontraditional loan products in the NTM guidance. However, because hybrid ARM products generally provide for fully amortizing payment schedules, they were not specifically covered by the NTM guidance. [6]

[6] Depending upon the terms of a particular loan, the degree of payment shock for a payment option ARM can be greater than for a hybrid ARM, because payment option ARMs permit negative amortization.

The agencies determined that guidance was needed to address the specific concerns that had been raised with respect to certain subprime mortgage loans such as hybrid ARMs.[7] The proposed "Statement on Subprime Mortgage Lending" published by the agencies earlier this month addresses appropriate underwriting standards, measures to prevent predatory lending, and consumer disclosure practices for subprime ARM products that raise the concerns summarized above.

Like the NTM guidance, the proposed subprime mortgage lending statement specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal explains that an institution's analysis of repayment capacity should include an assessment of the borrower's ability to repay total monthly housing expenses including real estate taxes and property insurance, in addition to principal and interest payments on the loan. The statement also provides that, in making its assessment of the borrower's income and ability to repay the loan, a lender generally should not rely on reduced documentation or stated income procedures. It further notes that most institutions should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

The proposed statement also describes the consumer protection principles that are fundamental to the underwriting and marketing of hybrid ARMs to subprime borrowers. These principles include providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select products and choose among payment options. Therefore, the guidance provides that consumers should

[7] Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (March 8, 2007).

receive clear and balanced information about the relative benefits and risks of the products, including information on:

- Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires;
- The existence of any prepayment penalty, how it will be calculated, and when it may be imposed;
- The existence of any balloon payment;
- Whether there is a cost premium attached to a reduced documentation or stated income program; and
- The requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

The proposed statement strongly encourages institutions that impose prepayment penalties to provide borrowers with sufficient time immediately prior to the reset date to refinance without penalty. And, it provides that institutions should not directly, or indirectly, through broker compensation systems, steer consumers to subprime mortgage products to the exclusion of other products offered by the institution for which the consumer may qualify.

The agencies have issued the Statement on Subprime Mortgage Lending as proposed guidance, and we are seeking public comment during the 60-day comment period that ends on May 7, 2007. We recognize that the market for providing mortgage loans to borrowers with impaired credit records has evolved rapidly in recent years, as have subprime mortgage products, in response to expanding home ownership opportunities, higher home prices in certain areas, competition by lenders for loan volume, developments in the secondary mortgage market, and investor and borrower risk tolerances. Not all of these product developments have been benign, and thus there is a need for the agencies to address the concerns we have noted above. We believe that the underwriting and consumer protection principles contained in the proposed statement are responsive to the legitimate concerns that have been raised.

However, it is also important to note that we do not issue prescriptive underwriting standards lightly. In such cases, the government is effectively substituting its judgment on how institutions may assess credit risk for the judgment of market participants and the borrowers themselves. Moreover, in formulating underwriting standards, it can be very difficult to draw lines that will restrict "bad" credit without unintentionally restricting the availability of "good" credit. The subprime market presents unique issues and particular challenges in this regard, as has been noted in a number of recent news articles about deteriorating conditions in the subprime market.

Given the level of concern about the subprime market, questions have been raised about whether or not the agencies have responded with appropriate speed and diligence. We have also been asked why we did not apply the NTM guidance to subprime loans, since a characteristic common to both nontraditional mortgages and subprime hybrid ARMs is the risk of payment shock. I would like to address those questions now. The agencies ultimately decided to propose guidance on subprime hybrid ARM products as separate guidance, to focus public comment on the particular issues raised by this type of lending. In doing so, we hope to be able to evaluate how the application of borrower qualification standards like those contained in the NTM guidance will affect subprime borrowers in particular, and whether other standards should be considered that may be more appropriate or effective in some circumstances. As noted earlier, loan performance data for subprime loans originated in 2006 show a sharp increase in delinquencies, as compared to subprime loans originated in the preceding four years. With respect to whether or not the agencies are reacting with appropriate speed to address underwriting deficiencies suggested by the performance of recent vintage hybrid ARMs, it is true that our course of action to issue separate guidance following a public comment process has the disadvantage of not immediately responding with final guidelines affecting new originations. However, it will permit us to proceed in a better informed manner in addressing issues that may be unique to subprime borrowers and their access to credit.

For example, in recent years, lending institutions have been encouraged to reach out to the subprime market to provide greater access to credit, in connection with their obligations under the Community Reinvestment Act, and in a manner consistent with safe and sound lending principles. As noted earlier, these efforts have been instrumental, and highly effective, in expanding homeownership for these borrowers and in fueling economic growth. In this regard, it is important to note that the borrower qualification standards contained in the proposal are likely to result in fewer subprime borrowers qualifying for home loans, and there is no guarantee that such borrowers will be able to qualify for other loans in the same amount if the standards are adopted. Thus, as compared to the standards for prime and near-prime loans contained in the NTM guidance, imposing strict borrower qualification standards on subprime loans has the inherent risk that borrowers could be denied access to types of credit that represent their only way to finance a home purchase. The application of these standards to existing subprime borrowers with hybrid ARMs, who want to refinance their loans in order to avoid unaffordable payment increases, can raise particular challenges and questions of fairness if they are unable to do so.

We also recognize that some products have been introduced that are intended to serve as temporary credit accommodations, rather than long-term financing vehicles. At origination, these loans may involve terms that exceed the borrower's present ability to service the debt. The motivations for these arrangements vary, but sometimes they include providing a home purchase loan to a borrower who intends to use the property only temporarily, for whom there is expected future earnings growth, or for whom there is a need for affordable payments in the short term, in order to improve the borrower's credit history. Indeed, a recent survey involving an admittedly small sample of these loans found that a number of the products have been used for credit repair, enabling at least some borrowers to refinance their subprime hybrid ARMs to either prime loans or subprime fixed-rate products. Thus, these loans can operate as de facto balloon payment loans that may be appropriate in certain circumstances.

In light of these considerations, we are particularly interested in public comment on whether the proposed statement appropriately balances the need for changes in underwriting standards with the need to prevent an undue constriction in credit availability for creditworthy borrowers. Therefore, we have asked for comment on whether the loans described in the statement always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances they may be appropriate. In addition, as noted above, we are concerned about the impact of the proposed standards on borrowers who currently hold such loans, and we seek comment on whether the standards, if adopted, will unduly restrict the ability of these existing borrowers to refinance their loans and avoid payment shock.

We are also concerned about the possibility of an "unlevel regulatory playing field" if already highly-regulated, federally-regulated institutions are subject to stricter standards on subprime mortgage lending, but state-licensed nonbank lenders are not. This is a particular concern because, as noted earlier, state-licensed nonbank lenders and brokers play a predominant role in the subprime market. In this regard, we appreciate the recent announcement by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) of their intention to seek adoption by state regulatory agencies of comparable subprime lending standards when the federal agency guidance is finalized. This approach is consistent with the undertakings by the CSBS and AARMR in connection with state-by-state adoption of the federal agency NTM guidance. Many states have not yet applied the NTM guidelines to state-licensed lenders and brokers -- including several states with major real estate markets. However, we are encouraged that agencies in a number of states *have* adopted them.[8] Similarly, we think that it is important that the basic principles embodied in our subprime lending guidance are also adopted by secondary market participants who purchase such loans. We note that Freddie Mac recently issued guidance comparable to the proposed Statement on Subprime Mortgage Lending concerning the eligibility of hybrid ARM products for purchase,[9] although to date, there have not been similar moves by other major securitizers. As mentioned at the outset, we believe that adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

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[8] *See* www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

[9] *See* News Release, Freddie Mac, "Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default; Company Also to Develop Model Subprime Mortgages" (Feb. 27, 2007), *available at* www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html; *see also* Letters from J.B. Lockhart, III, Director, Office of Federal Housing Enterprise Oversight to R.F. Syron, Chairman and CEO, Freddie Mac, and D.H. Mudd, President and CEO, Fannie Mae (Dec. 8, 2006) (requesting a report on the steps taken in response to interagency guidance on nontraditional mortgage products), *available at* www.ofheo.gov/media/pdf/ NontraditionalMortgage121306.pdf. Another important improvement in the secondary market would be enhanced investor disclosures that state whether or not mortgages in the pools backing the securities are in compliance with federal banking agency guidelines on nontraditional mortgage products and subprime lending, as applicable.

There is evidence that some lenders are already revising their underwriting practices in response to deteriorating market conditions and increasing risks, delinquencies, and foreclosures involving subprime mortgage loans. In light of these developments, it is imperative that the agencies develop final guidelines on subprime mortgage lending that are carefully calibrated to try to ensure that consumers are protected against undue risks while avoiding unintended adverse consequences both to credit availability *and* to mortgage markets.

In this regard, we received a letter from twenty-three members of the House Committee on Financial Services expressing concern about rapidly rising foreclosure rates involving nontraditional and subprime loans, and encouraging lenders to exercise flexibility in dealing with delinquent borrowers who seek to work out, or refinance, these loans in order to avoid unaffordable payment increases. The OCC believes that it is in the best interests of both lenders and borrowers to work together to bring a loan current and to avoid foreclosure whenever possible. Reasonable workout arrangements are an appropriate and productive way to assist borrowers who have encountered financial difficulties. Let me assure you that national banks are encouraged to engage in responsible loan workout and recovery activities in order to avoid a foreclosure and they will not face regulatory criticism for such activities. [10]

Moreover, the OCC recognizes the need for all lenders to engage in foreclosure prevention efforts and we have been very proactive in communicating our views to national banks on this issue and on "best practices" for foreclosure prevention.[11] Among the best practices for effective foreclosure prevention is having a full-cycle approach to borrower

[10] See letter, dated March 14, 2007, from John C. Dugan, Comptroller of the Currency, Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, John M. Reich, Director, Office of Thrift Supervision, and JoAnn Johnson, Chairman, National Credit Union Administration to Barney Frank, Chairman, Committee on Financial Services, United States House of Representatives, responding to these concerns.

[11] *See* "Homeownership: Preserving the American Dream," by John C. Dugan, Comptroller of the Currency, *Community Developments*, Spring 2006.

financial counseling -- before, during, and after taking out a mortgage, and at the first sign of repayment problems. In this regard, the OCC issued guidance to national banks on strategies for effective delinquency intervention activities in affordable mortgage portfolios held by national banks.[12] The OCC, along with the U.S. Department of Housing and Urban Development (HUD) and the other bank regulators, serves on the board of NeighborWorks America, a national non-profit organization. The NeighborWorks Center for Foreclosure Solutions, its national foreclosure center, has developed very effective foreclosure prevention strategies and foreclosure intervention programs in communities across the country. The OCC has encouraged national banks to work to reduce foreclosures through partnerships with nonprofit organizations, like the NeighborWorks Center. We have also advised national banks that when they participate in foreclosure avoidance counseling programs targeted to low- and moderate-income borrowers in their assessment areas, they will receive Community Reinvestment Act credit.

Finally, the OCC is joining with other federal bank regulatory agencies in holding a forum on April 16th to discuss current issues in the mortgage market, including the need for foreclosure mitigation strategies.

OCC Regulations and Federal Laws Relating to Predatory Lending Practices

OCC Regulations

There is scant evidence that national banks or their subsidiaries are engaging in predatory lending practices. Nevertheless, the OCC has taken a number of significant steps

[12] *See* OCC Advisory Letter 97-7, Affordable Mortgage Portfolios.

directed at ensuring that national banks do not become involved in unfair, deceptive, or predatory practices. Through the issuance of supervisory guidelines and regulations, and through enforcement actions, we have acted to deter abusive lending practices and ensure fair treatment of national bank customers.

The OCC was the first federal banking agency to issue comprehensive anti-predatory lending guidance and anti-predatory lending regulations specifically applicable to the institutions we supervise -- national banks and their operating subsidiaries. Early in 2004, the OCC adopted regulations that address a fundamental characteristic of predatory lending – equity stripping.

For example, under OCC rules, national banks are *prohibited* from making mortgage loans based predominantly on the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms.[13] In addition, while the OCC does not have the authority to issue regulations defining the specific acts and practices that are unfair or deceptive, and therefore unlawful under the Federal Trade Commission Act (FTC Act),[14] OCC regulations do prohibit national banks from engaging in any lending practice that would be unfair or deceptive within the meaning of the FTC Act.[15]

In 2005, the OCC issued additional regulatory standards for national banks to avoid potentially predatory lending practices in direct loan originations, loan purchases, and brokered transactions. These standards are entitled "Guidelines Establishing Standards for Residential

[13] 12 C.F.R. §§ 7.4008(b) and 34.3(b).
[14] The Federal Reserve Board has exclusive authority to issue regulations that define the practices that are unfair or deceptive for banks under the FTC Act. 15 U.S.C. 57a(f)(1).
[15] 12 C.F.R. §§ 7.4008(c) and 34.3(c).

Mortgage Lending Practices" (Part 30 guidelines).[16] The Part 30 guidelines were drawn from principles contained in advisory letters on the same subjects that the OCC issued in 2003,[17] but unlike the advisory letters, are enforceable under section 39 of the Federal Deposit Insurance Act.[18] In issuing the Part 30 guidelines, we recognized that "[f]air treatment of customers is fundamental to sound banking practices."[19] The Part 30 guidelines were designed to protect against involvement by national banks, either directly or through loans that they purchase or make through intermediaries, in lending practices that can injure national bank customers and expose the bank to credit, legal, compliance, reputation, and other risks.

Significantly, the Part 30 guidelines identify particular practices in which national banks should *not* become involved, either directly or through brokered or purchased loans:

- equity stripping and fee packing;
- loan flipping;
- encouragement of default on an existing loan; and
- refinancing of special subsidized mortgages with loans that do not provide a tangible economic benefit to borrowers relative to the refinanced loans.[20]

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[16] 12 C.F.R. Part 30, App. C.

[17] Because of the importance of mortgage lending to the nation's economy and to individual consumers, as well as the devastating consequences of predatory mortgage lending, the OCC issued two detailed advisory letters – one focused upon mortgage origination standards and the other addressing the special problems presented by brokered or purchased loans – that were designed to help national banks avoid ever engaging in predatory practices in their mortgage lending activities. OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003) and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003). These advisory letters expanded upon earlier advisories relating to abusive lending practices and the legal standards the OCC would use in determining whether practices are unfair or deceptive. *See* Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000); Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002).

[18] 12 U.S.C. § 1831p-1; *see also* 12 C.F.R. §§ 30.3 - .6.

[19] 70 Fed. Reg. 6329 (Feb. 7, 2005).

[20] 12 C.F.R. Part 30, App. C at III (A)(1) – (4).

The guidelines also address a second category of loan terms and features that the OCC recognized may in some circumstances be susceptible to predatory, unfair or deceptive lending risks, and yet may be appropriate risk mitigation measures in other circumstances. These practices or features are:

- financing single premium credit insurance;
- negative amortization;
- balloon payments in short-term transactions;
- prepayment penalties not limited to the early years of a loan;
- interest rate increases on default at a level not commensurate with risk mitigation;
- provisions allowing the bank to accelerate payment of the loan in circumstances other than the borrower's default or to mitigate loss;
- the absence of an appropriate assessment and documentation of the consumer's ability to repay the loan in accordance with its terms;
- mandatory arbitration clauses;
- pricing terms that trigger HOEPA;
- extending a loan in which the principal balance exceeds the appraised value of the property;
- payment schedules that consolidate more than two periodic payments and pay them in advance from the proceeds; and
- payments to a home improvement contractor from proceeds of a mortgage loan other than to the consumer, the consumer and contractor jointly, or to a third-party escrow agent. [21]

[21] *Id.* at III(B)(1) – (12).

Pursuant to these mortgage lending guidelines, national banks must prudently consider the circumstances, including the characteristics of the targeted market and applicable consumer protection and safety and soundness safeguards, under which the bank will make residential mortgage loans with the terms and features outlined above. A national bank is expected to exercise enhanced care and to apply heightened internal controls and monitoring when making loans with these features to borrowers who are not financially sophisticated or whose credit choices are limited.[22]

As noted above, the Part 30 guidelines apply to mortgages that national banks and their subsidiaries originate directly, as well as mortgages that they purchase or make through a broker or other intermediary. The guidelines thus address concerns that have been raised about the link between predatory practices and non-regulated lending intermediaries, as well as concerns that a national bank could inadvertently facilitate predatory lending through the purchase of loans and mortgage-backed securities and in connection with mortgage broker transactions.

The Part 30 guidelines provide that indirect lending activities by national banks should reflect standards and practices consistent with those applied by the bank in its direct lending activities.[23] Thus, these guidelines specify measures that banks should undertake, such as establishing criteria for entering into and continuing third-party relationships, underwriting and appraisal requirements, compensation standards, appropriate third-party agreements, and criteria for taking appropriate corrective action in the event the bank's policies are not

[22] *Id.* at III(C). Consistent with the OCC's general emphasis on strong consumer disclosure practices and the avoidance of unfair or deceptive practices, the Part 30 guidelines also establish high expectations for the provision of relevant information to consumers. In particular, the Part 30 guidelines provide that national banks should give "timely, sufficient, and accurate information to a consumer concerning the costs, risks, and benefits of the loan," including information "sufficient to draw their attention to these key terms." *Id.* at III(D).

[23] *Id.* at III(E).

followed.[24] They also provide that national banks should take appropriate steps to ensure that compensation policies for brokers do not provide incentives for originating loans with potentially predatory terms and conditions. In addition, the guidelines provide that a national bank should engage in appropriate monitoring and oversight of its third-party originations to ensure that the bank's residential mortgage lending activities comply with applicable law and the bank's internal standards.[25] This rigorous and detailed OCC guidance will remain applicable to all mortgage lending in national banks and their subsidiaries in addition to the interagency issuances in this area.

Applicable Laws

In addition to OCC regulations, several federal laws apply to the mortgage lending operations of national banks and can be enforced as necessary to address instances of unfair, deceptive, or predatory mortgage lending practices. These laws, and the agencies responsible for issuing and interpreting related regulations, include:

- The Home Ownership and Equity Protection Act of 1994 (HOEPA)),[26] which provides enhanced consumer protections with respect to certain high-cost mortgages and directs the Federal Reserve Board to issue such additional regulations as necessary to address unfair, deceptive, or abusive mortgage lending practices (Federal Reserve Board);
- Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices and directs the Federal Reserve Board to define by

[24] *Id.* at III(E)(1) – (6).
[25] *Id.* at III(F).
[26] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.

regulation such practices that are unlawful for banks (Federal Reserve Board for banks; Office of Thrift Supervision (OTS) for thrifts);[27]

- The Equal Credit Opportunity Act (ECOA),[28] which prohibits discrimination against applicants based on race, color, religion, national origin, sex, marital status, age, the receipt of public assistance income, or the exercise of rights under the Consumer Credit Protection Act in any aspect of a credit transaction (Federal Reserve Board);
- The Fair Housing Act,[29] which prohibits discrimination based on race, color, religion, sex, handicap, familial status, or national origin in making a residential real estate-related transaction available (HUD);
- The Truth in Lending Act (TILA),[30] which requires creditors to provide disclosures about terms and costs of credit (Federal Reserve Board); and
- The Real Estate Settlement Procedures Act (RESPA),[31] which requires advance disclosure of settlement costs in residential real estate transactions and prohibits kickbacks or unearned fees for settlement services (HUD).

OCC Supervisory Process

The OCC conducts comprehensive examinations of national banks to ensure that they operate in a safe and sound manner and in accordance with the applicable laws, regulations, and supervisory directives described above. Through a network of approximately 1,800 examiners located throughout the United States and in London, we monitor conditions and trends, both in individual banks and in the banking system as a whole. Our supervisory

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[27] 15 U.S.C. § 45. The OCC's ability to enforce this prohibition against national banks and their operating subsidiaries has been upheld in the courts. *See* Roberts v. Fleet Bank, 342 F.3d 260, 270 (3d Cir. 2003); Chavers v. Fleet Bank, 844 A.2d 666, 674-676 (R.I. 2004).
[28] 15 U.S.C. § 1691 *et seq.*; *see also* 12 C.F.R. Part 202.
[29] 42 U.S.C. § 3601 *et seq.*; *see also* 24 C.F.R. Part 100.
[30] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.
[31] 12 U.S.C. § 2601 *et seq.*; *see also* 24 C.F.R. Part 3500.

activities focus on the risks as identified by our supervisory monitoring tools and subject matter experts. At the largest banks, on-site examination teams continuously monitor all aspects of the banks' operations.

The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries.

National banks are regularly examined for safety and soundness and for compliance with applicable consumer protection laws and regulations. The OCC reviews the adequacy of the bank's policies, systems, and controls relative to the character and complexity of the bank's business, and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners sample individual transactions to validate their assessment of the bank's systems, controls, and legal compliance.

Depending on the bank's risk profile and other supervisory information, including consumer complaints, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the institution is engaging in significant new or expanded mortgage lending activities, examiners ordinarily would pay particular attention to those loans during their review. If the sampling process indicates potential issues, examiners will expand their review as appropriate. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis.

As indicated above, consumer complaints filed with our Customer Assistance Group (CAG) may raise red flags concerning potential predatory lending. CAG staff are responsible for assisting customers of national banks and their subsidiaries by answering questions and resolving individual complaints. When CAG receives a written, signed complaint, it requests a response from the bank involved, and may request additional information from the consumer or the bank. Additionally, CAG personnel may, and often do, consult with OCC's bank supervision and Law Department personnel to help ensure that complaints are resolved appropriately and, where applicable, any identified violations of law are fully addressed.[32] After evaluating the information before it, CAG sends the consumer a letter containing its findings. Over the last five years, from 2002 to 2006, national bank customers received more than $3,500,000 in financial relief in connection with resolution of individual mortgage-related complaints filed with CAG.

CAG also provides data to examiners to help flag banks, activities, and products that require further investigation, and to OCC management and others to assist in identifying trends and emerging problems. If predatory or abusive lending issues surface in the course of these examinations or are otherwise brought to examiners' attention through consumer complaints or other sources, examiners and OCC attorneys determine whether the practices in question violate any applicable laws and regulations, including the FTC Act, HOEPA, or the OCC's Part 30, or are otherwise inconsistent with OCC guidelines and mortgage lending standards. In cases where such a determination is made and depending upon the circumstances, the OCC will either obtain appropriate corrective action informally through the supervisory process or formally through an enforcement action, as described below.

[32] Complaints that allege or raise issues of predatory lending or unfair or deceptive practices are generally reviewed by CAG personnel in close consultation with the OCC's Law Department.

The OCC's bank supervision process can result in significant reforms to bank practices and keep banks on a proper course even in the absence of litigation, formal enforcement actions, or other publicized events. The OCC's examiners exert extraordinary authority and influence over the activities of national banks through the supervisory process. When examiners identify an issue, they expect it to be fixed promptly, without having to resort to a formal enforcement action, and the agency can use a wide range of measures short of formal, public enforcement actions to obtain the desired result. Such measures include communications of "matters requiring attention" in confidential examination reports to bank management and boards of directors and informal enforcement actions such as nonpublic memoranda of understanding.

The vast majority of supervisory problems are promptly corrected through informal means. In some cases, however, a formal enforcement action may be necessary based on the nature or gravity of an issue or the nature of the remedies sought to address instances of unfair, deceptive, or predatory lending practices. In such cases, as described below, we do not hesitate to bring an enforcement action when appropriate.

Enforcement Actions

Congress has provided the OCC with a wide range of methods to address unsafe or unsound practices or violations of laws, rules, or regulations. Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to compel compliance with any law, rule, regulation, written agreement or condition imposed in writing. The OCC may initiate cease and desist proceedings, seek civil money penalties, and, as appropriate, seek restitution or reimbursement for affected customers if the OCC determines that a national bank or its operating subsidiary has violated any applicable federal law or regulation or any applicable state law or regulation.[33]

The OCC was the first federal banking agency to take enforcement action against an institution it supervises for violations of Section 5 of the FTC Act. In a groundbreaking case, the OCC asserted section 5 of the FTC Act as a basis for seeking a cease and desist order, as well as affirmative remedies, against a national bank in 2000. Since that time, the OCC has taken several more formal enforcement actions against national banks found to be engaging in unfair or deceptive practices within the meaning of the FTC Act. These cases have involved issues ranging from misleading and deceptive advertising of credit cards and ancillary products to unfair mortgage practices.[34]

To date, the OCC has charged FTC Act violations in two cases to obtain reimbursement for mortgage loan borrowers who were harmed by predatory or unfair practices. In a consent order entered into in 2003, we required a bank to provide restitution to borrowers who were affected by unfair practices in connection with tax lien loans. We found that fees for these loans were imposed for services that were not performed, and that the bank also violated federal legal requirements in TILA, HOEPA, RESPA, and the FTC Act. Consumers who were harmed by the bank's practices were provided restitution in the amount of all fees paid in connection with the loans – whether or not characterized as a finance charge under TILA and whether paid to the bank or to a third party, and all interest charges.

In 2005, the OCC entered into a formal agreement requiring another bank to establish a $14 million fund to reimburse consumers who were harmed by the lack of appropriate controls

[33] 12 U.S.C. § 1818. This statute also permits the OCC to pursue remedies based on unsafe or unsound banking practices.
[34] *See* Attachment B.

in the bank's mortgage lending operations and practices. Consumers entitled to restitution included consumers who: (1) paid origination fees and/or interest rates substantially different from those indicated on good faith estimates; (2) did not have their creditworthiness adequately considered; or (3) held a subsidized loan that was refinanced with a higher cost loan that did not appear to provide the consumer with a tangible economic benefit. The agreement also required the bank, among other things, to ensure that its advertising materials adequately disclose limitations or conditions on various products and to develop a detailed consumer compliance program to ensure compliance with the FTC Act, RESPA, the OCC's Part 30 guidelines, and the OCC's other issuances regarding abusive, predatory, unfair, or deceptive practices.

Conclusion

In conclusion, this hearing is an important opportunity to examine the issues confronting the subprime mortgage market, including the very serious concerns that have been raised about loan underwriting practices, consumer protection, and deteriorating loan performance. Even though subprime lending engaged in by national banks under the OCC's supervision accounts for a small percentage of the overall market for such loans, we nevertheless believe that it is important that the federal banking agencies and state agencies continue to work together to address these concerns to the extent they arise in the institutions we supervise. In going forward, we should all be cognizant of the need to find an approach that not only addresses these concerns without unintended adverse consequences to consumers or to credit markets, but that also is fairly applied and consistently implemented for all of the providers of subprime mortgage finance.

I appreciate the opportunity to present the OCC's views on these issues and will be pleased to answer any questions that you might have.

Attachment A

List of OCC Supervisory Guidance Documents on Abusive Lending Practices

- Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000)
- Advisory Letter 2000-10, "Payday Lending" (Nov. 27, 2000)
- Advisory Letter 2000-11, "Title Loan Programs" (Nov. 27, 2000)
- Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002)
- Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003)
- Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003)
- Advisory Letter 2004-4, "Secured Credit Cards" (April 28, 2004)
- Advisory Letter 2004-10, "Credit Card Practices" (Sept. 14, 2004)
- Joint Guidance on Overdraft Protection Programs (Feb. 18, 2005)
- Interagency Guidance on Nontraditional Mortgage Product Risks (Oct. 4, 2006)
- Interagency Statement on Subprime Mortgage Lending (Proposed March 8, 2007)

Attachment B

List of Public Enforcement Actions under the FTC Act

- Consent order – June 28, 2000. We required the bank to set aside not less than $300 million for restitution to affected consumers and to change its credit card marketing program, policies, and procedures.

- Consent order – May 3, 2001. We required the bank to provide restitution of approximately $3.2 million and to change its credit card marketing practices.

- Consent order – December 3, 2001. We required the bank to set aside at least $4 million for restitution to affected consumers and to change its marketing practices.

- Formal agreement – July 18, 2002. We required the bank to change its marketing practices.

- Consent order – January 17, 2003. We required the bank to set aside at least $6 million for restitution to affected consumers, to obtain prior OCC approval for marketing subprime credit cards to non-customers, to cease engaging in misleading and deceptive advertising, and to take other actions.

- Formal agreement – March 25, 2003. We required the bank to provide restitution in connection with private label credit card lending and to make appropriate improvements in its compliance program.

- Formal agreement – July 31, 2003. We required the bank to provide refunds of approximately $1.9 million to affected consumers in connection with credit card practices.

- Consent order – November 7, 2003. We required the bank to set aside at least $100,000 to provide restitution for borrowers who received tax lien loans, review a portfolio of mortgage loans to determine if similar violations existed, and take steps to prevent future violations.

- Consent order – May 24, 2004. In a second case involving the same bank, we required the bank to set aside at least $10 million for restitution to affected consumers and prohibited the bank from offering secured credit cards in which the security deposit is charged to the consumer's credit card account.

- Formal agreement – November 1, 2005. We required the bank to set aside at least $14 million for restitution to affected customers and to strengthen internal controls to improve compliance with applicable consumer laws and regulations and underwriting standards.