

Remarks by
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Before the
Neighborhood Housing Services of New York
May 23, 2007

It's a pleasure to be here with you this morning, and not just because I serve on the board of directors of NeighborWorks America. At a time of rising delinquencies and foreclosures, I'm grateful for the opportunity to address an organization that has done so much, not just to help families buy homes, but to help them keep those homes. Under the outstanding leadership of your president, Sarah Gerecke, Neighborhood Housing Services of New York helped 462 first-time homebuyers obtain affordable mortgages last year, which is a significant accomplishment in its own right. In addition, your very important financial literacy efforts gave many people the skills they needed to participate in the housing boom without falling prey to its excesses. I know that your delinquency and foreclosure prevention program helped nearly 1,800 people last year alone, and in my view, helping a family avert a foreclosure is just as important – maybe even more important – as helping them obtain the mortgage in the first place.

Despite the significant recent problems with subprime mortgages, it's important to remember that the huge growth in the housing market has been good for many people – and not just speculators and developers. Millions of lower-income Americans who might not have been able to make it through the door of a mortgage broker's office ten years ago are walking through the front doors of their own homes today, thanks in large part to innovations in subprime lending that helped fuel the housing boom.

Nevertheless, many of the subprime loans originated in the past few years – too often made in haste, without regard to reasonable underwriting standards – have not been good for either borrowers or lenders. The large resulting problems have rightly attracted much attention from lenders, regulators, policymakers, and advocacy groups. That certainly includes the OCC, even though national banks and their operating subsidiaries originated just 10 percent of all subprime mortgages in 2006 – a period in which such loans had some of their weakest underwriting standards – and even though the default and foreclosure rates on subprime mortgages originated by OCC-regulated institutions have been well below the national average. Our agency is currently working with the other federal banking regulators to finalize important guidance on subprime mortgage lending and disclosure standards. We are also working with our colleagues in the states, including the Superintendent of Banks here in New York, to extend that guidance to state regulated subprime lenders throughout the country.

One specific issue has arisen in this context that I would like to focus on today, because it has bothered me for some time now: the widespread acceptance by lenders of unverified, “stated income” from borrowers – especially subprime borrowers – as an appropriate measure of the borrowers’ capacity to repay their loans. While stated income underwriting practices are by no means limited to subprime mortgages, the impact of such practices on safety and soundness and on individual borrowers has been most pronounced in the subprime market.

Let me state at the outset that there are times when accepting stated income makes good underwriting sense and is better for the customer. The simplest example is a straight refinancing that doesn’t involve a cash take-out, and is underwritten by the same lender who

provided the original mortgage: there, the lender has experience with the borrower and knows that the new loan will be more affordable and therefore more secure than the one it replaces. It may also make sense for individuals who are self-employed or who work on commission and have understandable difficulty in documenting income.

But, what may be suitable in limited circumstances has now become acceptable as general practice. For subprime loans, stated income has become the rule rather than the exception, and in a very brief span of time. While this practice was relatively rare just a few years ago, last year nearly 50 percent of all subprime loans relied on stated income.

How can this be? Sound underwriting – and, for that matter, simple common sense – suggests that a mortgage lender would almost always want to verify the income of a riskier subprime borrower to make sure that he or she had the means to make the required monthly payments. Most subprime borrowers are salaried employees for whom verifying income by producing copies of W-2 forms is just not that difficult. So why would these borrowers pay the higher interest rate that lenders charge for stated income loans?

Two reasons jump to mind, neither of them reassuring. First, in their zeal to get their loan applications approved quickly, borrowers may not fully understand how much more they are paying for the limited convenience of not producing their W-2s or providing any other form of income verification. That lack of understanding provides a tempting target for brokers who typically have a financial incentive to skip the verification process and get the loan approved at a higher interest rate.

As disconcerting as this first reason is, however, the second is even more troubling. Evidence is mounting that borrowers are frequently inflating their incomes, often substantially, to qualify for larger mortgages. For example, the Mortgage Asset Research

Institute examined a sample of stated income loans and found that 90 percent of borrowers reported incomes higher than those found in IRS files. Even more disturbing, almost 60 percent of the stated income amounts were exaggerated by more than 50 percent. Those findings are not unique: a nationwide survey of 2,140 mortgage brokers, reported in *Inside Mortgage Finance*, found that 43 percent of brokers who use low documentation loan products know that their borrowers can't qualify under standard debt-to-income ratios because they don't have enough income for the loan.

Let's not sugar-coat what's going on here. The practice of inflating income is at best misleading, and at worst, fraudulent. Yet if the studies are to be believed, it's a practice that has become widespread in the riskier loans in the mortgage market.

Now it's easy to see why borrowers are tempted to inflate their income on loan applications, because it permits them to qualify for bigger loans and more expensive houses. And it's also easy to see why brokers are tempted to push such practices, since their fees increase if the borrower qualifies for a bigger loan at the higher interest rate that comes with stated income mortgages.

But why would so many subprime lenders and investors in subprime mortgage-backed securities – the ones who bear the credit risk if these loans go bad – why would they be willing to make so many loans where the borrowers' real incomes would appear to be insufficient to service the debt over time? Why wouldn't they have serious reservations about borrowers who elect to pay significantly more in interest rather than save money by simply producing their W-2s?

I've heard several reasons. Some lenders argue that income is not as good a predictor of default as credit scores and loan-to-value ratios; that some borrowers have other factors in

their credit applications that make current income less important; and, that borrowers are willing to pay more to avoid the delays and hassles associated with verifying their income, and lenders can offset the increased risk of those loans by charging a higher interest rate.

Some of these explanations have merit. As discussed above, there are times when accepting stated income makes good underwriting sense and is better for subprime customers. But can the percentage of subprime borrowers who fit these seemingly limited circumstances really be so large that it is prudent for stated income in subprime loans to be the rule rather than the exception?

I think not. In fact, I think there is something else going on here.

In a market where house prices are rising, the risks of stated income loans are masked. Borrowers who can't service their debts with their incomes can nevertheless repay their loans by refinancing, using the equity generated by house price appreciation. Of course, refinancing generates another round of fees for both brokers and lenders. As a result, the rapidly rising housing market of 2003-2005 was the perfect petri dish to incubate the widespread practice of stated income loans: at a very fundamental level, it seemed to be a bet that the increasing value of the borrower's collateral would offset any inadequacy of the borrower's income.

Now we are seeing the consequences of stated income loans in a market where house prices are declining or failing to increase, as has been the case in a number of parts of the country this past year. These consequences have been increased delinquencies and foreclosures, with serious costs for families and communities.

Now, I am not suggesting that stated income alone is responsible for these problems. Other factors were clearly at work as well, from other loose underwriting practices such as

low levels of required down payments, to broader adverse economic factors such as the strained economy in the industrial Midwest. But I do find it telling that, when faced with the new housing market conditions, subprime lenders have responded first by tightening standards on stated income. And I also find it telling that one of the first things that loan servicers do in the current environment, when deciding whether to restructure or foreclose on a delinquent loan, is – you guessed it – seek verification of income. Apparently verified income is viewed as a critical factor in determining whether a loan can be saved, which of course begs the question: if loan verification is such an important predictor of the borrower’s ability to repay in the current environment, why wasn’t it equally important when the loan was first made?

So where does that leave us going forward? I believe that stated income is appropriate in some cases, but that it should be the exception and not the rule in subprime lending, for three key reasons.

First, stated income is too great a temptation for misrepresentation and, in its most extreme form, outright fraud. It ought to be a truism that sound underwriting practices minimize this temptation.

Second, stated income undermines transparency. How can lenders seriously talk about “debt-to-income” ratios, for example, if the denominator of “income” is really an unknown variable that can be whatever the borrower says it is? Put another way, stated income is a way for lenders, whether consciously or not, to ease debt-to-income ratios without disclosing that fact to investors or regulators – or without disclosing how much easing has taken place. If lenders believe that higher debt-to-income ratios can be prudent,

then they should be willing to disclose the actual, higher debt-to-income ratios rather than masking them through stated income loans.

Third, it is not a safe and sound underwriting practice to make mortgage loans that substitute future house price appreciation for borrower income as a key source of repayment – and as I said, that is what we fear occurred with the widespread use of stated income in the last several years.

Now, I want to say that I have not come to these conclusions easily. It generally is not the job of bank regulators to set underwriting standards like appropriate levels of down payments, or debt-to-income ratios, or interest rate levels. Lenders and markets do that. Our job as regulators is to make sure that the institutions we supervise understand and are capable of managing the risks associated with particular underwriting choices, and that customers are treated fairly.

But it seems to me that stated income as a prevailing market practice in the subprime market is a different kind of animal, precisely because it invites misrepresentation and potentially fraud; undermines transparency; and relies too heavily on collateral appreciation. While there are legitimate uses of stated income for exceptions, it is much more suspect for such a practice to be accepted as a general rule. As we have said before in other contexts, the higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities – and by definition, subprime loans as a class present elevated credit risk.

In the past, the banking agencies have addressed the use of stated income in interagency guidance on both home equity loans and nontraditional mortgages. Now we must decide whether to address the practice even more strongly in the context of subprime

mortgage lending as we finalize the proposed guidance. For the reasons described above, I believe we should, although how we do so and the extent to which we do it are of course decisions that should only be made after careful consideration of the comments we have received.

What we need to make clear, I believe, is the principle that a lender, in underwriting a mortgage loan, must assess not just a borrower's will to make timely payments on the loan, but also his or her capacity to do so. Credit scores tell a lender about a borrower's willingness to repay a loan, and loan-to-value ratios tell what to expect if the lender is forced to liquidate the collateral. But neither measure tells the lender about the borrower's capacity to repay the debt. For that, the lender generally needs to know the borrower's income – and I mean real, documented income, not a number that the borrower or loan originator can pull out of the air.

All of us have been troubled by the recent spike in delinquencies and foreclosures, and it seems clear that one reason for the trend is the increased reliance on stated income in subprime mortgages. It's true that in many cases it is the borrower who is deliberately inflating his or her income in order to qualify for a loan that he or she can't really afford. But a lender is responsible for its underwriting standards, and it is fundamental that the institution ensure that it has the information it needs to make a sound judgment on the borrower's ability to repay the loan.

On the other side of the equation, it's important that borrowers understand the credit process and have the information they need to choose houses and mortgages they can afford. I think that's one of the most important services that Neighborhood Housing Services of New York offers – the education you provide to prospective homebuyers. The Neighborhood

Housing Services' new not-for-profit "buyers broker" affiliate, NHS Home Loans, is an important innovation for ensuring your clients get the right loan at a fair price. Along with our finalized guidance and other decisions made by public policymakers, these services will be critically important in ensuring that stated income loans are confined to the circumstances in which they make good sense for both subprime borrowers and lenders.

Thank you very much.