STATEMENT OF

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on

MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

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Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the residential housing mortgage market.

My testimony will discuss developments in the mortgage market that concern the FDIC, including the impact that the nontraditional and subprime hybrid adjustable rate mortgages (ARMs) are having on consumers and on FDIC-supervised institutions. I also will discuss supervisory standards the federal banking agencies have imposed and enforcement actions the FDIC has taken to address issues in the nontraditional and subprime mortgage markets, as well as action the FDIC takes to combat predatory lending. We also have provided responses to the Committee's specific data requests based on the best information available to us, and this material is attached to my statement.

The Evolution of Today's Mortgage Market

The current U.S. mortgage market reflects the confluence of trends that came together in 2004 and 2005 to substantially change the marketing and funding of mortgage lending. These factors included rising home prices, declining affordability, historically low interest rates, intense lender competition, innovations in the structure and marketing of mortgages, and an abundance of capital from lenders and mortgage securities investors.

In 2003, U.S. home price appreciation began to intensify, far outpacing the growth of disposable personal income. While disposable incomes have grown slightly faster than average home prices during most years, home prices had begun to grow faster than incomes beginning in 2001, much the same as they had during previous boom periods in 1978-79 and 1986-87. The difference in the recent housing boom was the very rapid acceleration of home price growth to double-digit rates by 2004 and 2005. Average U.S. home prices grew more than three times faster than disposable incomes in 2005.

From 2001 to mid-2004, prime borrowers with a preference for fixed-rate mortgages refinanced in record numbers as long-term interest rates fell to the lowest rates in a generation. As interest rates began to rise in 2004 and the pool of potential prime borrowers looking to refinance shrank, lenders struggled to maintain or grow market share in a declining origination environment, and did so by extending loans to subprime borrowers with troubled credit histories. Between 2003 and 2005, the prevalence of subprime loans among all mortgage originations more than doubled from 9 percent to 19 percent.[1]

In addition, new homebuyers with both prime and subprime credit profiles migrated toward the lower monthly payments associated with ARMs to cope with rapidly rising home prices and declining affordability. Over 30 percent of all conventional mortgages made in 2004 and 2005 were ARMs.[2] The percentage of ARMs among

[1] See "Mortgage Originations by Product," *Inside Mortgage Finance*, February 25, 2005.
[2] Federal Housing Finance Board.

subprime borrowers was even higher – nearly 80 percent of securitized subprime loans were ARMs by early 2006.[3]

Lenders accommodated these borrowers by diversifying mortgage offerings and easing lending standards as they competed to attract borrowers and meet prospective homebuyers' financing needs. Because of the affordability aspect already noted, borrowers increasingly turned to products such as payment option and interest-only (IO) loan structures in 2004 and 2005. These "nontraditional" mortgages are specifically designed to minimize initial mortgage payments by eliminating or relaxing the requirement to repay principal during the early years of the loan. Although it is difficult to measure the use of these mortgage structures across all mortgage originations, payment option and interest-only loans appear to have made up as much as 40 to 50 percent of all subprime and Alt-A loans securitized by private issuers of mortgage-backed securities during 2004 and 2005, up from 10 percent in 2003.[4] The majority of subprime originations over the past several years were "2/28 and 3/27" hybrid loan structures. These hybrid loans provide an initial fixed-rate period of two or three years, after which the loan converts to an adjustable rate mortgage and the interest rate adjusts to the designated loan index rate for the remaining 28 or 27 years of the loan.[5] The 2/28 and

[3] See "ARMs Power the Subprime MBS Market in Early 2006," *Inside B&C Lending*, July 21, 2006.
[4] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-Agency securitized mortgage originations. Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.
[5] For example, the underlying adjustable loan index rate could be 6 month LIBOR plus some spread. The spread between the initial fixed rate of interest and the fully-indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

3/27 loan products accounted for almost three-quarters of subprime securitized mortgages in 2004 and 2005.[6]

The mortgage market was further fueled by significant mortgage backed securities (MBS) liquidity, with investors increasingly seeking yield through higher risk. Securitizations allow financial institutions to access the capital markets to fund mortgage operations, while simultaneously transferring credit risk away from the institutions and to securitization investors. The share of U.S. mortgage debt held outside the government-sponsored enterprises by private mortgage-backed securitizations doubled between 2003 and 2005, helping to fuel the growth of subprime and nontraditional mortgages. The ability to include these mortgage products in securitization pools facilitated their availability to borrowers through both FDIC-insured and non-bank lenders. Many of these lenders would not have found these products to be attractive absent the funding and credit risk transfer features available through securitization.

Detecting Problems in the Mortgage Market

The FDIC routinely monitors the mortgage markets on a systemic basis, and compiles information on subprime lending activity in insured institutions using examination data. As part of this process, the FDIC published research that discussed the changing role of subprime lending in the mortgage market in recent years. In 2004, the FDIC noted the prevalence of ARMs among subprime borrowers. In 2005, the FDIC

[6] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-Agency securitized mortgage originations.

raised the possibility that increased use of subprime and nontraditional mortgages was contributing to the expanding U.S. housing boom.[7]

Although our research showed that subprime loan volume began increasing in 2004, clear indications of problems in the subprime market did not begin to surface until the latter part of 2005. Delinquency rates for subprime loans 60 days or more past due began falling in 2002 and continued to fall until the third quarter of 2005. It was not until the fourth quarter of 2005 that severe delinquencies and foreclosures in the subprime market began to rise noticeably (this data did not become available for review until the end of the first quarter of 2006). Total subprime delinquencies rose from 10.33 percent in the fourth quarter of 2004 to 13.33 percent in the fourth quarter of 2006.[8] In the same period, foreclosures rose from 1.47 percent to 2.00 percent. For subprime ARMs, the total loan past due rose from 9.83 percent to 14.44 percent, and foreclosures rose from 1.50 percent to 2.70 percent.[9]

Supervisory Response

The federal banking agencies strive to maintain consistent regulatory policies by developing any significant policy changes on an interagency basis. The interagency policymaking process is both collaborative and deliberative, and often involves the public. Although the interagency collaboration and public comment process invariably

[7] *FDIC Outlook*, Spring 2004 and "FYI Revisited – U.S. Home Prices, Does Bust Always Follow Boom?," *FDIC FYI*, May 2, 2005.
[8] Mortgage Bankers Association National Delinquency Survey
[9] Source: Mortgage Bankers Association / Haver Analytics

slow response time, these comments help to identify the diversity of viewpoints about the issue at hand, as well as any potential unintended consequences that a proposed supervisory action may pose to market activities or to the availability of credit. It also raises awareness among the industry and the public about the concerns of the federal banking agencies, which often triggers the beginnings of corrective action in the financial marketplace even before the final rules or guidance are enacted.

Because the policymaking process is so intensive, the federal banking agencies work to make supervisory guidance principles-based, not product specific. Our experience has shown that product-specific guidance quickly becomes obsolete, while principles-based guidance can remain relevant for many years.

With respect to mortgage lending, over the past two years the federal banking agencies have published a number of examiner and industry guidance documents warning about deteriorating underwriting standards. As early as May 2005, the agencies issued *Credit Risk Management Guidance for Home Equity Lending*[10] in response to the strong growth in home equity lending. This guidance described specific product, risk management, and underwriting standards that warranted supervisory attention, including interest-only features; limited or no documentation of borrower’s assets, employment and income; higher loan-to-value and debt-to-income ratios; lower credit scores; and increased use of third-party or brokered transactions.

[10] FIL-45-2005 (May 24, 2005).

In December 2005, the federal banking agencies followed up with proposed *Interagency Guidance on Nontraditional Mortgage Product Risks* (NTM Guidance).[11] The proposed *NTM Guidance* sent a clear message to the marketplace that bank regulators were concerned about these products. The agencies' concerns with nontraditional mortgage products were similar to the ones identified with home equity lending, but were compounded by the lack of principal repayment and the potential for negative amortization, as well as risk-layering features such as simultaneous second-lien loans and reduced documentation. The *NTM Guidance* was finalized in October 2006 following careful consideration of comments from the industry, consumer groups, and others. The *NTM Guidance* not only reminded bankers to carefully manage the risks associated with these products, it also emphasized that consumers should be provided with clear and accurate information about these products at the point in time at which they are choosing a loan or deciding which payment option to select. To help the industry provide necessary information to borrowers, the federal banking agencies also proposed model illustrations that institutions may use to assist consumers as they select products or choose payment options.[12]

The FDIC also published borrower-focused articles in 2005 ("Mortgages: More Choices, New Risks for Borrowers") and 2006 ("Avoid Costly Banking Mistakes: No Trivial Pursuit") in our *FDIC Consumer News*, a quarterly publication with more than 35,000 mail and electronic subscribers and an average of about 28,000 Internet visits each month. The articles emphasized the importance of obtaining and carefully

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[11] FIL-90-2006 (October 5, 2006).
[12] See Proposed Illustrations for Nontraditional Mortgage Products, 71 FR 58672 (October 4, 2006).

reviewing complete information about loans when choosing among the increased varieties of mortgages available.

As the federal banking agencies reviewed comments and prepared the final *NTM Guidance* during 2006, it became apparent that the loosened underwriting and risk layering in the NTM market had extended to the subprime market. However, the *NTM Guidance* initially was focused on the risks of products that defer the repayment of principal and sometimes interest which were not primarily marketed to prime, rather than subprime, borrowers. With respect to subprime lending, the final *NTM Guidance* cross-referenced the 2001 *Subprime Lending Guidance,* which clearly outlined regulatory expectations for subprime lending programs.

In addition to its general research, the FDIC identified significant underwriting and consumer protection issues via the examination process, which also elevated our concerns. It was clear that some in the industry had collectively reached beyond the level of time-tested prudent underwriting principles. The federal banking agencies recognized the need to provide expanded guidance to the industry.

Earlier this month, the federal banking agencies and the NCUA issued a proposed *Statement on Subprime Mortgage Lending* (*Subprime Statement*).[13] The *Subprime Statement,* which is currently out for public comment, makes it clear that lenders should follow two fundamental principles when underwriting and marketing mortgages: (1) approve borrowers based on their ability to repay the loan according to its terms (not just

[13] FIL-26-2007 (March 9, 2007).

at the introductory rate); and (2) provide borrowers with clear information to help them understand the transaction at a time when they are deciding if the loan is appropriate for their needs. Collectively, the standards articulated in the *Subprime Statement* build on fundamental and longstanding consumer protection and risk management principles.[14]

Enforcement

The FDIC enforces mortgage lending standards through examinations and supervisory actions. When examiners encounter unsafe and unsound lending practices, we take whatever supervisory actions are necessary to effect correction. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including the FTC Act prohibition against unfair or deceptive practices, we take action to ensure that illegal practices cease and that harm to consumers is remedied.

Our examination process has led to the issuance of more than a dozen formal and informal enforcement actions that are currently outstanding against FDIC-supervised institutions that failed to meet prudential mortgage lending standards. In addition, the FDIC uses these standards in screening applicants for new banks and establishing prudential conditions for the granting of deposit insurance charters.

The extensive standards for subprime lending and unfair and deceptive practices give the FDIC strong tools with which to fight unsafe, unsound, and abusive lending

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[14] For example, the *Interagency Guidelines for Real Estate Lending*, issued by the federal banking agencies in 1992, addresses basic underwriting standards for real estate loans. *See* 12 C.F.R. Part 365, Appendix A.

practices. As an example, earlier this month the FDIC issued a significant cease and desist order against an FDIC-supervised institution for operating without effective risk management policies and procedures in place in relation to its subprime mortgage and commercial real estate lending operations. The FDIC determined, among other things, that the institution was operating without adequate subprime mortgage loan underwriting criteria, and that it was marketing and extending subprime mortgage loans in a way that substantially increased the likelihood of borrower default or other loss to the institution. The order, which became public on March 7, 2007,[15] sets forth a variety of specific corrective actions to be undertaken.

Options for Troubled Borrowers

While the federal bank regulators have issued guidance to address the issues raised by nontraditional and subprime ARMs, as well as taking appropriate enforcement action, there remain a large number of borrowers who obtained these loans and face potential economic hardship as the loans reset under current economic conditions. A number of borrowers with loans due to reset may be able to take advantage of the current interest rate environment and refinance into a fixed-rate mortgage. However, this will not be an option for everyone.

In many cases, the loans have been securitized, which makes it more challenging to apply the flexibility necessary to develop solutions for borrowers. The terms of the securitizations can limit the options available for restructuring these loans. The FDIC has

[15] See FDIC Press Release dated March 7, 2007,

already begun discussions with lenders, servicers and other participants in the subprime securitization market to find ways to address the needs of borrowers facing economic hardship.

With regard to subprime loans held in insured depository institutions, the FDIC is working to reassure financial institutions that they do not face additional regulatory penalties if they pursue reasonable workout arrangements with borrowers who have encountered financial difficulties. Many lenders and loan servicers are today working directly with stressed borrowers to restructure their loans or find other ways to allow them to keep their home and make more affordable payments. Working constructively with borrowers is typically in the long-term best interests of both financial institutions and the borrowers

In addition, programs that transition borrowers from higher cost loans to lower cost loans may receive favorable consideration as a lender's Community Reinvestment Act performance is assessed.[16] The FDIC strongly supports such transition programs. Further, some non-profit organizations have developed programs that counsel struggling borrowers and work with local leaders to create foreclosure intervention programs. For example, the Center for Foreclosure Solutions is sponsored by NeighborWorks America, an organization created by Congress to provide financial support, technical assistance,

[16] See Interagency Questions and Answers on the Community Reinvestment Act, 66 Fed. Reg. 36619, 36631, Sec. 345.22(a)-1 (July 12, 2001), .

and training for community based revitalization efforts and chaired by FDIC Director Thomas J. Curry.[17]

Predatory Lending

In January the FDIC issued its *Supervisory Policy on Predatory Lending*[18] that describes certain characteristics of predatory lending and reaffirms that such activities are inconsistent with safe and sound lending and undermine individual, family, and community economic well-being. The policy also describes the FDIC's supervisory response to predatory lending, including a list of policies and procedures that relate to consumer lending standards.

The federal banking agencies have been concerned about abusive practices for some time. Six years ago, the agencies issued guidance for financial institutions that outlined the specific characteristics most often associated with predatory lending:[19]

- Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and
- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

[17] See NeighborWorks America website at:
[18] See FDIC Financial Institution Letter 6-2007, dated January 22, 2007.
[19] *Expanded Guidance for Evaluating Subprime Lending Programs*, FIL-9-2001, January 31, 2001, .

The federal banking agencies warned lenders that loans with these characteristics would be closely reviewed from both a consumer protection and a safety and soundness perspective. Moreover, they explained that examiners would criticize loans made to borrowers who have not demonstrated the capacity to repay from sources other than the collateral pledged.[20] While these principles were first stated in the context of subprime lending, the FDIC treats them as valid guidance for loans made to all borrowers. As mentioned earlier – and it bears repeating -- when FDIC examiners encounter any loans with predatory characteristics, they take whatever supervisory actions are necessary to effect correction. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including the FTC Act prohibition against unfair or deceptive practices, we take action to ensure that illegal practices cease and that harm to consumers is remedied.

Because many predatory practices can be characterized as either unfair or deceptive, the FDIC communicated to its state nonmember banks in 2002 that the FTC Act prohibition against such practices applies to their activities.[21] Together with the Board of Governors of the Federal Reserve (FRB), the FDIC issued more detailed FTC Act guidance applicable to all state chartered banks in 2004.[22] This guidance explained the standards used to assess whether an act or practice is unfair or deceptive, as well as the interplay between the FTC Act and other consumer protection statutes. It also offered suggestions for managing risks related to unfair and deceptive practices. Two years ago,

[20] Id. at p. 10.
[21] See FIL-57-2002, issued on May 30, 2002.
[22] See FIL -26-2004, issued on March 11, 2004.

the FDIC issued procedural guidance to its examiners to ensure that they have the tools that they need to assess whether unfairness or deception has occurred.[23]

Concern about predatory lending prompted us to amend the Community Reinvestment Act (CRA) rules in 2005 to clarify that credit practices that are discriminatory, unfair or deceptive, involve unearned fees or kickbacks, or fail to meet other significant regulatory standards weigh against an institution when its CRA performance is assessed.[24]

The FDIC also has worked to integrate Home Mortgage Disclosure Act (HMDA) pricing data into its fair lending compliance examination program. Compliance examiners are now required to evaluate racial and gender-related patterns in the HMDA pricing data when conducting compliance examinations of all institutions subject to HMDA reporting requirements. The FDIC also uses the new HMDA pricing data to identify outlier institutions that warrant special scrutiny because of larger pricing disparities for minorities or females in one or more loan product areas than are evident for other FDIC-supervised institutions. Institutions identified as outliers are asked to provide the FDIC with information that explains the channels through which people obtain mortgage loans and the factors the bank considers in making its pricing decisions for the loan product under review. As necessary, comparative analysis is conducted to determine whether those factors were fairly and neutrally applied. In addition, the FDIC

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[23] See "Abusive Practices" section of FDIC Compliance Examination Handbook, published on January 30, 2007 through FIL 10-2007. .

[24] See, e.g., 12. C.F.R. §345.28(c) (CRA rules applicable to FDIC supervised institutions).

considers whether minorities or women have been disproportionately steered to high cost products.

Examinations at a handful of the outlier institutions suggest the possibility of discriminatory pricing on the basis of race. In these situations, loan officers typically enjoyed broad, unmonitored pricing discretion. Although the FDIC review is on-going, two of these matters have been referred to the Department of Justice for enforcement action.

Conclusion

The FDIC is very concerned about recent practices in the mortgage markets, especially with regard to subprime lending. Although we have been monitoring this type of lending for a decade and have issued guidance and taken supervisory actions when necessary, we also recognize the need to keep pace with this evolving market. Accordingly, we look forward to the public comments on the recent draft Subprime Statement. In addition, the FDIC will continue to aggressively enforce all laws, rules and guidance regarding subprime lending. Working with our federal and state regulatory counterparts and the Congress, we also are eager to find solutions for borrowers with mortgages they cannot afford.

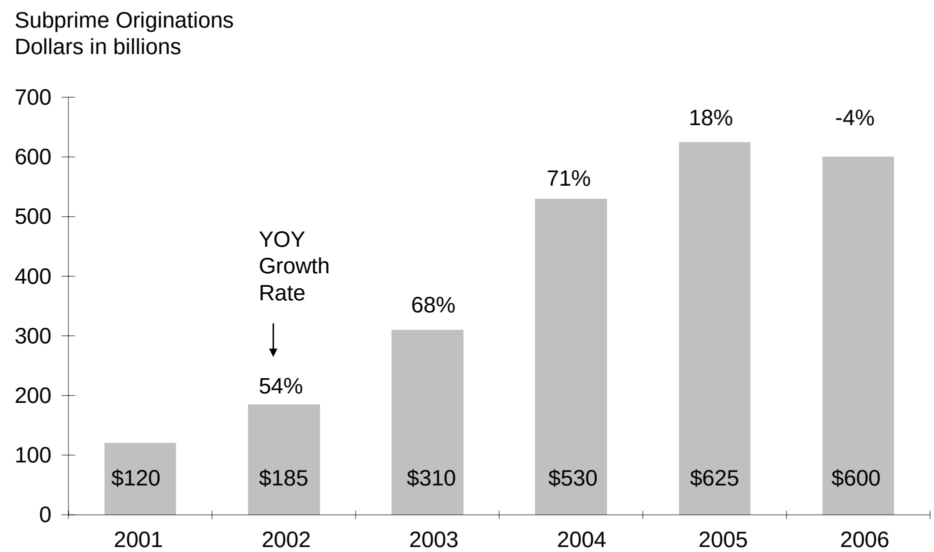
This concludes my statement. I will be happy to answer any questions the Committee might have.

Attachment

Responses to Data Requests from the

Senate Committee on Banking Housing and Urban Affairs

Inside Mortgage Finance reported on mortgage market trends and provided historical data on subprime mortgage originations.



Source: Inside Mortgage Finance.

An analysis of private-label securitization data provides a sampling of subprime loan characteristics from 2001 forward.

Subprime MBS composition

Origination Year	Total subprime MBS ($ in billions)	ARM share	Fixed Share
2001	$72.76	60.8%	39.2%
2002	$118.99	67.7%	32.3%
2003	$215.34	65.2%	34.7%
2004	$357.25	75.7%	24.2%
2005	$429.66	79.7%	20.3%
2006	$197.34	74.0%	26.0%

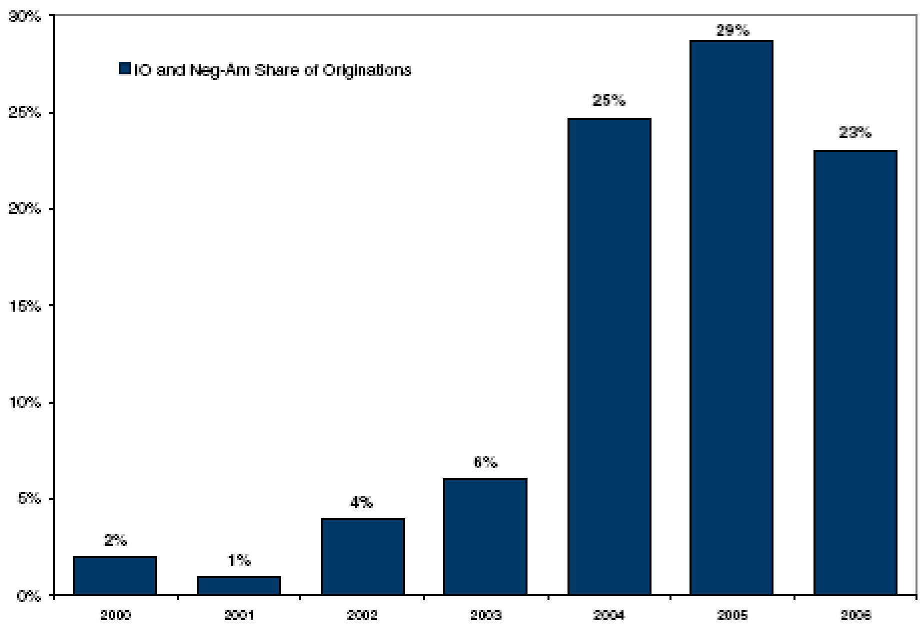
	IO share*	Negative amortization share	2- and 3- year hybrid adjustable rate	5- 7- and 10-year hybrid adjustable rate
2001	0.0%	0.0%	59.5%	0.8%
2002	1.2%	0.0%	65.4%	1.4%
2003	4.1%	0.0%	63.1%	1.4%
2004	16.2%	0.0%	73.5%	1.5%
2005	27.2%	0.0%	72.2%	1.5%
2006	17.0%	0.0%	50.3%	2.0%

	Investor share	Second home share	Owner occupied share	Purchase share	Refinance share
2001	5.0%	0.8%	93.5%	31.2%	67.2%
2002	5.2%	0.7%	93.8%	31.4%	67.7%
2003	5.7%	0.8%	93.4%	31.6%	67.9%
2004	5.5%	0.9%	93.6%	37.6%	62.4%
2005	5.4%	1.4%	93.2%	42.7%	57.3%
2006	5.2%	1.5%	93.3%	44.1%	55.9%

Source: LoanPerformance, non-agency securitized mortgage originations.
*IO = interest only

Nontraditional mortgages (including interest-only and negative amortization loans) grew substantially as a share of purchase originations in 2004 and accounted for almost a quarter of originations in 2006.

Exhibit 29: Interest-Only and Negative Amortization Share of Total Purchase Mortgage Originations, 2000–06



Note: Based off of origination dollars.

Source: Loan Performance, Credit Suisse analysis.

Detailed data for nontraditional originations is available from 2004 forward.

Inside Mortgage Finance (January 2007)
Mortgage Originations (dollars in billions)

	Interest-Only						
Origination year	Total	ARM	FRM	Option ARM	40 year ARM	Total Originations	Interest only and option ARM share of total originations
2004	$60	$55	$5	$145	$0	$2,920	7.02%
2005	$481	$418	$63	$280	$10	$3,120	24.39%
9M06	$405	$300	$105	$208	$58	$2,260	27.12%

Note: 40-year balloons have initial amortization schedule of 40-50 years with balloon payment due at 30 years.
Source: Inside Mortgage Finance, January 2007.

Analyzing LoanPerformance non-agency MBS data provides a more detailed analysis of securitized nontraditional loans:

Interest-only and negative amortization shares of non-agency MBS

Origination Year	IO share	Negative amortization share
2001	4.2%	0.9%
2002	12.1%	1.1%
2003	16.7%	0.6%
2004	32.2%	6.6%
2005	35.6%	14.3%
2006	31.5%	18.3%

Subsequent shares are calculated as a percent of nontraditional* non-agency MBS

Origination Year	Total nontraditional originations ($ in billions)	ARM share	Fixed Share	2- and 3- year hybrid adjustable	5- 7- and 10-year hybrid adjustable
2001	$12.06	98.8%	1.2%	1.4%	61.7%
2002	$45.03	99.2%	0.8%	4.9%	56.9%
2003	$90.17	97.3%	2.6%	15.0%	51.8%
2004	$296.05	97.0%	3.0%	32.7%	34.2%
2005	$452.81	88.8%	11.2%	28.8%	27.8%
2006	$236.86	84.3%	15.7%	14.4%	32.5%

	Investor share	Second home share	Owner occupied share	Purchase share	Refinance share
2001	1.8%	6.9%	91.3%	31.6%	68.4%
2002	2.0%	5.8%	91.7%	31.0%	69.0%
2003	4.5%	5.8%	89.7%	41.8%	58.1%
2004	7.0%	4.4%	88.5%	54.4%	45.4%
2005	8.7%	4.3%	87.0%	52.0%	48.0%
2006	8.9%	4.7%	86.5%	47.3%	52.7%

Source: LoanPerformance, non-agency securitized mortgage originations.
*Nontraditional refers to interest-only and negative amortization originations