RECENT EVENTS IN THE CREDIT AND MORTGAGE MARKETS AND POSSIBLE IMPLICATIONS FOR U.S. CONSUMERS AND THE GLOBAL ECONOMY

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RECENT EVENTS IN THE CREDIT AND MORTGAGE MARKETS AND POSSIBLE IMPLICATIONS FOR U.S. CONSUMERS AND THE GLOBAL ECONOMY

Wednesday, September 5, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:33 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank, [chairman of the committee] presiding.

Present: Representatives Frank, Kanjorski, Waters, Maloney, Velazquez, Watt, Ackerman, Sherman, Meeks, Moore of Kansas, Capuano, Hinojosa, Clay, McCarthy, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Moore of Wisconsin, Davis of Tennessee, Sires, Hodes, Ellison, Klein, Perlmutter, Murphy, Donnelly; Bachus, Baker, Castle, Biggert, Miller of California, Capito, Feeney, Hensarling, Garrett, Pearce, Neugebauer, Price, Davis of Kentucky, McHenry, Campbell, Roskam, and Marchant.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order. I'm going to make an opening statement, but then I'm going to leave temporarily. There is a hearing before the Committee on Education and Labor on a bill that would ban discrimination in employment based on sexual orientation. I trust people will understand why I will temporarily absent myself. You notice that given these two important issues today, I am wearing pinstripes and a lavender tie.

[Laughter]

The CHAIRMAN. I did not want to indicate any set preference for which issue I was going to deal with. But I will make my statement. There will be other opening statements, and we will then get back.

Before I get into the substance, I just want to say that I apologize: we originally had been scheduled for a two-panel hearing. I apologize to my colleagues on the other side because they helped us to prepare, and I apologize to those who were asked to testify. We will get to them. But there was some miscommunication and I take responsibility for that. I was not able to do what I thought we should be doing.

But secondly, and this is another important reason for the change. On Friday, as you know, the President announced a new initiative in connection with the subprime issue. That would have been part of our second panel. And so, since the President announced that proposal, we will not be getting into that issue today.

We will be focusing today on the question of what happened in the market situation, and my concern is this: For some time now, we have seen the subprime crisis. I believe that those in charge were a little bit surprised that the subprime crisis spilled over as much as it did into other parts of the mortgage market. And more specifically, you know, you are supposed to pretend that you don't like to say, "I told you so." But as I have said before, I find that to be one of the few pleasures that come with age.

In other words, there was an underestimated extent to which the subprime crisis would spill over into the rest of the mortgage market. But I think the far greater surprise was the extent to which the residential mortgage crisis had a negative impact on the market in general. I don't know anyone who was predicting that a failure in subprime was going to lead to a problem in selling commercial paper, and yet it has.

It doesn't seem that any of us charged with responsibility for knowing what was going on anticipated this. Now I hope this is containable, and we will be working together to try to deal with the subprime part of it and other parts of it. But what we have to address, what I want to focus on today, is an important question.

I guess my initial view of it, in the subprime market, it is clear that financial innovation outstripped regulation. Twenty years ago mortgage loans were made by institutions that were regulated by the Comptroller, by the FDIC, and by the OTS. They have been doing a good job, and I have acknowledged that the institutions represented here and the OTS have done a good job.

We then developed a new model for mortgages. Mortgage brokers and people who sold to the market, what Ben Bernanke called in his Jackson Hole speech last Friday, the "originate-to-distribute model." That was the innovation. And it was an innovation that brought a lot of good, that increased funding in the market, that helped a lot of people buy homes.

But it was largely unregulated. And I think we have had a test case recently about regulation, sensible and intelligent regulation, which is I think what we get from the Comptroller, from the FDIC and the OTS, and from the Federal Reserve. Part of our job is to see if we can extend that sensible regulation, not overdoing it, but regulating.

Similarly, I think there is some consensus now that what's gone on in the secondary market without any regulation at all is problematic. And again, Chairman Bernanke, who is rarely confused with Ralph Nader, said in his Jackson Hole speech that the originate-to-distribute model must be modified, is being modified, to include more investor protection and disincentive for irresponsibility.

I read today in the Financial Times, Martin Wolf, again, people who have come from a generally more conservative perspective, say, mortgages by the stricter regulation—talking about securitization. The second objective of regulation is to insulate financial markets from the sort of panic seen in recent weeks. The only way to do that may be to re-regulate them comprehensively. Restrictions would have to be imposed on products sold or the ability of institutions to engage in transactions.

You don't get operation. I understand. But just as it seems clear now, and I think there's a consensus, and the President essentially became part of that on Friday, there is a consensus that regulation in the mortgage market has not kept up with innovation. And that when innovation greatly outstrips regulation, then regulation should catch up, but regulation has to be sensible. Regulation cannot be too negative. But one of the arguments against regulation, for instance regulation of the secondary mortgage market earlier was, well, if you do that, you impinge on the market. You will kill the market. Well, that market is at least in a deep coma, and the notion that regulation of the secondary mortgage market is somehow going to interfere with a thriving market doesn't seem so persuasive.

And in fact, and I think this is what Martin Wolf is saying, and it is what Chairman Bernanke was saying, it is what we know about mortgages, the right kind of regulation may be able to respond to one of the greatest needs we have today in the market: investor confidence. What we have is a severe lack of investor confidence, even in things where they shouldn't lack confidence.

Giving the investor some assurance of quality in what he or she is being asked to invest in is part of the role of regulation. It's not negative. It can help the market. And so, one, there is some consensus that we need to do that in the mortgage market, and I think the President is saying that and Chairman Bernanke is saying that. The open question for us is, do we now, in the broader market, have to deal with that? And I notice Secretary Steel talks about the proposals that will be coming forward.

I think this is the question before us: Has innovation in the broader financial market been made possible by technology, enhanced by the increased liquidity in the world, with globalization? Yes. It produces a great deal of advantages. I'm a great believer in the capitalist system. I don't think phenomena occur unless they meet some real need and provide some real good. People are not fundamentally irrational. And the question is not whether these innovations were beneficial or not but whether or not allowing the innovations to go forward with no regulation on the innovative sector produces some harm. And can we, if that's the case, can we come up with regulation that will diminish the harm without killing the whole operation? I know there are some who believe that regulation will always just damage the market. And regulation will always just be terrible. And there are people who say, you know what? You may think that there are abuses. There have been abuses. But if you regulate this, you're going to kill it. And if you really want to read those arguments made passionately and openly, go to the Congressional Record and read the debates on the establishment of the Securities and Exchange Commission in the 1930's, because they are similar arguments.

My understanding is that you can have bad regulation. But I do think that the subprime market and what we address today is innovation has come and is useful, but there is a problem. And in particular, as I said, we clearly have a problem with a lack of investor confidence. Maybe that's short term, but I will say this: I know that we have tried to talk the investors out of being nervous, and I don't think that works very well. I don't think trying to bolster confidence by talking to them is enough. There have been steps beyond that. There have been increases by the Fed in money being available. There are other things that we have talked about doing.

I guess the fundamental question I hope we would be addressing today, and going forward, is this, just to repeat. Giving the innovation that we have—and by the way, I should say one other thing. This does not to me focus on the institutions that are doing the innovating. The institutional form, whether it's private equity or a traditional investment bank or a hedge fund, seems to me far less important than the substance of what they are doing, of the great growth of derivatives and the fact that technology has made volatility more of a potential problem, because people can do so much more, leverage.

Those are the issues. And no matter who is engaging in them, and the question is, yes, they have—the innovations that have helped in many ways. But they may well have gone beyond reasonable regulation. And the question is what, if anything, should we do in our regulatory structure to catch up? I will say it does seem to be clear. I was not pleased that so many of us were surprised by the impact that the subprime crisis had on the entire financial system. I don't want to be surprised. I don't want the Federal Reserve to be surprised. I don't want Treasury to be surprised. This is not an individual failing. It may be that there is a systemic problem here and that we at least need more information.

So that is the area on which I want to focus. As I said, I know there will be questions specifically about subprime. Members can obviously ask whatever questions they want, but I do want to reiterate that on September 20th, we will be having a hearing on the President's proposal on subprime and other proposals. We will discuss that in great detail then, so I would hope that today we could focus to a great extent on what the implications of the past few months are for that broader question: Has innovation in the financial system so far outstripped our regulatory system that the time has come to examine that regulatory system and try to come up with ways to catch up without obviously diminishing the advantages?

With that, I am going to leave, and I am going to ask Mrs. Maloney, the chairwoman of the Financial Institutions Subcommittee, to take over. We will finish the opening statements, and I hope to be back in time. I apologize again for leaving.

Mrs. MALONEY. [presiding] The Chair recognizes Mr. Bachus for his opening statement.

Mr. BACHUS. I thank the lady. And I thank the chairman for convening this hearing. This hearing is really about the mortgage market and the disruptions we've seen in the mortgage market. But as we talk about the mortgage market, we all need to understand that 95 percent of the mortgages in America are being paid. They're in good shape. So what we're talking about is some subprime mortgages, and we're not talking about even a majority or close to a majority of those.

And last week, the President and the Administration and private institutions talked about beginning to work out some of these mortgages. So, for many of these people who are late on paying their mortgages, in fact, all of them who really should have been in loans in the first place, that had an ability to pay, I think in almost all cases, they're going to be given an ability to pay with better terms. So there is some good news, some news that really ought to shore up confidence in the mortgage market.

Now the concerns in the subprime market, as the chairman said, we all know what's happened. They've caused, number one, some liquidity problems. Some people call it a crisis. This hearing is called, "turmoil in the mortgage market." That's a little overdone. Because people who have good credit, people who are paying their bills on time, people who have a downpayment, they're able to walk in right now and get a loan at very low rates, lower rates than I could get when I bought my first home, when the rate at that time was 12 percent. Today the rate is 6 percent. So there's an awful lot of good news out there.

When you look at unemployment, we talk about the markets—is a recession coming? Unemployment is at a 6-year low. Real wages are rising. You look at all the figures; they're all good. I mean, I can remember times when inflation was 10 and 12 and 14 percent. Senior citizens were seeing their money, their buying power disappear. It's very low. It's under control

Exports continue to be up. So we have a sound economy. I know that there are some market challenges. There have been some excesses in the market. There have been some deals that probably shouldn't have been made. Investors listen. Banks have a tendency sometimes to pull liquidity in.

But, if anything, I'd say about the mortgage market, you look at where there are no serious problems, and that's the vast majority of mortgages. There are no serious problems. And those are loans made by banks, thrifts, in some instances credit unions, where they know their customers or they have become familiar with their customers. They've assessed their credit history, and they've made loans according to sound underwriting principles, made loans according to the guidance of the regulators. Those loans are not in trouble.

Where we have problems is where they push the limit. The chairman says where they've used innovative things. I'll use, by "innovative," where they didn't get an appraiser, or they had no documentation on financial information, or the people had no source of income. Now that is innovation. When you make a loan to someone with no income, that's innovation. When you make a loan to someone and they have no income and you tell them they don't have to pay the taxes or they don't have to escrow insurance payments for a year or 2 years, that's innovation. And that was bound to fail.

And I will say this. The chairman and I and some other members of this committee got together a year or two ago and we had really no resistance from the regulators. And we talked about changing some things. We talked about the fact that in 95 percent of these cases, we were dealing with the same mortgage originators, whether they were bankers or brokers. They were being kicked out of one State, moving to another State, making these same bad loans, and yet we have a State system that we could incorporate and call for national registration. We didn't do it. So these bad actors continued to go to community after community and do the same thing over and over, and they left a wake of these bad mortgages.

The Appraisers Association has called for—and I have introduced legislation to call for—better appraisals, for some standards there. We ought to do that. We ought to look at when we don't require people to escrow taxes and insurance, particularly people who have no stream of income or no ability to suddenly come up with taxes and insurance.

But the one thing we shouldn't do is rush out and change a market that is working and working well, and has brought homeownership to historic highs. We should not panic. This morning we got some job figures that are low, but they are coming off very high job creation. We're going to continue to get times of weaknesses and strength, but what we do not want to do, what we can't do, is panic. We need to take a measured approach.

Characteristic of this Congress in the past has been a rush to legislation in times of crisis, which has left us all with a hangover when it was over, because the regulation had unintended consequences. It might have boosted confidence. What do you do, and do something, do something now. And it may have made people feel good, but long-term, it resulted in too much regulation. We found that regulation has costs for consumers, costs for mortgages, and it eliminates some of the choices that people have made. In fact, the majority of people who have used new, "innovative" products, at least where they had an ability to pay, those people are in those homes, they're making those payments, and they have homeownership. And if we cut out some of those innovative products, they wouldn't have homeownership.

We welcome our witnesses. We look forward to hearing from you. But I go out there and I find that basically we have a strong economy. We have some investor confidence problems. We have some liquidity problems. But this economy is strong, and we should not panic ourselves into a recession.

Thank you.

Mrs. MALONEY. I thank the gentleman. Pursuant to committee rules, the Chair will extend the time for opening statements for 10 minutes on the Democratic side, and the Republicans will likewise have an extension of time. And I now recognize Congressman Kanjorski for 5 minutes.

Mr. KANJORSKI. Madam Chairwoman, I commend you for convening this timely hearing. As we begin our fall legislative session, it is very appropriate for us to examine what transpired in the capital markets during the last month or so. The apprehensions of many participants in our financial markets about their exposures to financial products backed by American subprime mortgages helped to trigger significant volatility in our credit markets at home and abroad. This instability affected not only housing markets, but it also seeped over into other commercial sectors.

Today's hearing will help us to understand at least some of the factors that contributed to this turmoil and the response of our regulators to these problems. It will also help us to discern whether Congress needs to take further actions to restore the confidence of investors in America's dynamic capital markets. Although I have not yet arrived at any conclusions, I have already identified at least three concerns I expect we will begin to address today.

First, I would like to learn more about the transparency of our capital markets related to subprime mortgage-backed securities, consolidated debt obligations, credit default swaps, and the parties that package and hold these increasingly sophisticated financial products.

From what I have read, it appears that the participants in our capital markets, as well as their regulators, have had significant difficulties in determining exposures to subprime mortgages that have defaulted or will likely default. We know from past experience that transparency and access to information provide the lubricant for our capital markets to work well.

Second, I, like you, Madam Chairwoman, am very interested in exploring the role that credit rating agencies played in contributing to these events. Many have already criticized their assessments of the creditworthiness of the financial products backed by subprime loans. Some have suggested that their actions may have contributed to engineering the faulty financial products.

While we took action last year to reform the oversight of rating agencies, we may still need to do more. The testimony provided by our witnesses today will help shape the hearings that the Capital Markets Subcommittee will hold on these issues in the coming months.

Third, I am very interested in examining how well the regulators, created in the last century, are responding to the problems of the new century. Our capital markets have significantly evolved since the creation of these overseers. After all, no one had conceived of mortgage-backed securities at the time we created the Federal Reserve and the Securities and Exchange Commission. Moreover, banks traditionally engaged in the role of making mortgages based on the amount of assets they needed on their books.

Today, financial companies accessing our capital markets often help families to buy homes. As a result, the traditional lines between prudent regulation, investor protection, and consumer protection have blurred. Regulators now have multiple missions, such as the Commission's safety and soundness oversight of investment banks.

In other instances, regulators are responding to problems in our capital markets using indirect means such as the decision last month of the Federal Reserve to lower the discount rate in response to marketplace uncertainty. Consequently, I intend to focus increasingly on whether our present regulatory architecture can anticipate and manage the risks of the modern financial system as the Capital Markets Subcommittee proceeds with its business during the remainder of the 110th Congress.

I look forward to working with everyone interested in these issues in the coming months and invite them to share their ideas on these matters.

In sum, Mr. Chairman, we live in an increasingly complex and interconnected financial marketplace. We need to move deliberately and strategically to explore whether we need to update the regulatory architecture of our financial system. If we come to the conclusion that we do need to pursue such a change, we must also move carefully to modify the system in a way that protects investors and ensures the long-term stability and viability of our financial system.

These are complex problems and questions, and I look forward to exploring them. Thank you, Mr. Chairman.

Mrs. MALONEY. Thank you. Mr. Baker, for 4 minutes.

Mr. BAKER. I think the chairwoman for her recognition. I know that it has been made clear that the economic fundamentals are excellent outside the mortgage-impacted sector of the market. The global economy is very strong. Exports are up. There are a lot of good things to talk about, and the aberrant circumstance we now face in the mortgage market is certainly disappointing, but not all that unexpected.

When one looks at the pressure from investors to seek higher rates of return and the diversification of tools to spread mortgage risk across broader sections of the market, and to do so in a global fashion, it created a hunger in the investing world that naturally the provider of product would going to attempt to meet.

At the same time, the ability to acquire a home loan at historically record low cost enabled people to step into that next level of home or that first-time home buying opportunity on the belief that before the adjustable rate trigger was pulled, escalating values would continue and the takeout would come from the realization of profit from that sale before income constraints caused the aberrant result.

It was a good plan. I came from Louisiana in the 1980's. We had a thing called an S&L in those days. And you used to walk across the parking lot and make a deal with your banker on a new development in 20 minutes. It seems like history is repeating itself here to some extent, in that over-aggressive lending fueled the ability for more people to buy, which fueled an increase in home prices, which built the view that this was all very solidly constructed, so investors were comfortable in throwing more money into the market for the chance of a greater rate of return. And somehow we are surprised that we now have a correction.

I don't come to that conclusion. I recognize that business cycles are cycles, and that at some point, regulatory review or market pressure, and in this case, I am, to some extent, not surprised that it's an international response. Many homeowners are now coming to an understanding of the definition of LIBOR, not even knowing that their rate trigger was tied to the London rate. And there is now for the first time in many years a divergence between treasuries and LIBOR which is uncharacteristic, but to a great extent, it's because European lenders are now worried about counterparty risk. It's whether or not we will be able to pay our obligations back to European lenders.

This is not something I believe should cause a great surprise or frustration with our mortgage market. Certainly we should have the highest standards of disclosure. We should expect nothing but professional conduct from mortgage brokers and other originators, and where we find those practices are deficient, certainly actions should be taken. But I suggest that most of the tools to respond to those crises or problems are well within the hands of the Treasury or the Federal Reserve.

And so I urge great caution in having the Congress ham-handedly interject more risk in the American taxpayer pocketbook or constructing more constrictive rules that will in essence preclude a more logical market-based recovery. Certainly there is risk in the world, and you can't protect everyone from every conceivable risk. You should discuss it. You should disclose it. You should do your best to explain it. But at the end of the day, all you can do is explain it; you can't understand it for people. And as a result of inappropriate risk-taking, if people lose money, that should not come as a big market surprise in a capital market system.

This review, I think, is highly appropriate. But before this Congress acts to take on unwarranted response to a market disappointment, we should be very careful to understand the consequences of our action.

I yield back.

Mrs. MALONEY. Thank you. The Chair recognizes herself for 3 minutes. First of all, I want to thank our chairman, Mr. Frank, for holding this hearing on really the biggest financial story of the year: The turmoil in the credit and mortgage markets, and its impact on consumers and the economy.

After Hurricane Katrina, over 300,000 people lost their homes. About 10 times as many people may lose their homes to foreclosure due to the subprime crisis.

The response from the Administration has been slow. Therefore, I was extremely pleased to hear the President's announcement last week. His proposed changes at FHA to provide refinancing options to more homeowners and to help borrowers by refinancing them into FHA loans is an important first step. I also support his proposed temporary legislative fix to change tax law so that canceled mortgage debt is not treated as income. Individuals facing foreclosure should not get the double whammy of paying taxes on the loss in value of their home.

These are helpful actions that Congress can take immediately, and I support them, but it is not enough. Another item that can be quickly achieved is GSE reform. Fannie Mae and Freddie Mac are providing much needed liquidity in the prime market right now. If there was ever a time when they should expand their activities, even if it's temporary, it is now. We need to raise the ceiling on the amount of mortgage that can be refinanced and raise caps temporarily. We passed a GSE reform bill in the House. It needs to pass the Senate, or the Administration needs to take action to raise the limits.

I have always said that markets depend as much on confidence as on capital. Right now there is a loss of confidence in rating agencies, and they deserve it. Large amounts of debt that are or have been highly rated are headed for default. As with Enron, the rating agencies have been dead wrong. Investment guidelines and capital standards need to be more accurate. We need to review the way rating agencies are compensated by their clients and look for ways to strengthen regulatory oversight of these agencies.

We also need a uniform national standard to fight predatory lending. We need to set a single consumer protection standard for the mortgage market. The Fed has taken important steps in regulation, but we need to do more. We have a great deal to do, and I look forward to the testimony from our distinguished panel.

I now recognize Congressman Miller for 2 minutes.

Mr. MILLER OF CALIFORNIA. Thank you very much. I commend Chairman Frank and Ranking Member Bachus for holding this hearing today. This is a—if we look back at recessions, this is a lot different than the mid-1970's, 1980's recession. Remember prime was in the 20's, so if you could get a 12 percent fixed rate 30-year loan, people would close your house immediately. I mean, you can sell them. The 1990's recession, high unemployment, the same situation. It seems like the press beat this issue to death for several years before they could get a decent housing recession going, and finally it really occurred. It's interesting when you look at buyers. If there's a line forming, they'll get in line to buy a house, yet they'll walk by a house that's a good deal when the bad time occurs and never even make an offer.

But the situation we're facing today in the subprime marketplace, we've talked about defining subprime and predatory in recent years. And I think today is a good example of what predatory is when you see it in reality. When you make a subprime loan and you lend money to a person that they're never going to be able to repay on a normal marketplace, that's predatory. But they have gotten by with it in recent years because when a house increases in value 10 to 15 percent a year, when you buy a $200,000 home, 5 years later it's worth $325,000, you can sell it and still make a profit even if you can't make the payment in 5 years. But today we have a lot of people who are stuck with a loan they made—they borrowed from a lender, and now they can't remake the payment.

We spent a lot of time in this committee in recent years worrying about safety and soundness on GSEs as Freddie Mac and Fannie Mae, and it seems like in the marketplace today, they're not the ones who are having the problem. It seems to be the subprime and the jumbo marketplace. And if you look at the situation in the jumbo and subprime, only about 18.2 percent of the loans are fixed 30-year loans. In the GSEs, 82 percent of the loans are fixed 30-year loans, and that's why they're doing very, very well.

I think we can do something to help the market today, especially in high-cost areas, in raising conforming limits. You have a liquidity situation occurring out there in these high-cost areas. In my district, for example, I'll give you an example, FHA. In 5 years, from 2000 to 2005, the FHA loans dropped 99 percent. In my district in 2000, they made 7,000 loans. In 2005, they made 80 loans. If you look at FHA overall in California, it went from 109,000 to 5,137.

Now I'm not talking about going out and making risky loans. But if you use reasonable underwriting criteria and standards, you can make a high-cost loan in those areas that's very safe and very sound. That's something that I think we need to look to.

I yield back.

Mrs. MALONEY. I thank the gentleman. The Chair recognizes Congressman Baca for 3 minutes.

Mr. BACA. Thank you, Madam Chairwoman, and I want to thank Barney Frank and the minority leader for having this important hearing. As chair of the Congressional Hispanic Caucus, as a member of the Financial Services Committee, I am especially concerned about the impact the foreclosure epidemic is having on our families, and all of us are very much concerned. We've seen what has happened nationwide. We've seen what's happened in our area. The fact is, subprime lending is concentrated in minority populations and in minority neighborhoods, and that's a concern to a lot of us as we've seen what has happened.

And I'd like to relate that, especially in my district, minority homeowners were more likely to receive higher rate loans than white homeowners, even with the same income level. And when you look at the same income level, but the disparity in terms of minorities receiving the higher rates, some or most of these families could have qualified for better or more affordable loans but were instead steered into subprime loans by the lender or broker to make a profit, and this continues to go on.

And we need to have accountability. We need to make sure that this does not happen. Because when someone loses their home, this is the American Dream for someone to obtain a home, have a home, and all of a sudden, they are being steered in the wrong direction. And most of these families, you know, need to be in these homes. According to the Center for Responsible Lending, almost 20 percent out of 375 subprime loans made to Hispanics in the year 2000 are likely to foreclose. And that's a high number when you look at it, not to mention the impact it's also having on the African-American community, that more than likely will end up losing their homes.

In my district, the Inland Empire has the fourth highest foreclosure filing in the Nation among the larger metro areas, and was the hardest hit in California through the first half of 2007. In San Bernardino alone, there were 19,185 foreclosures filing in the first half, representing a staggering 345 percent increase from the previous year.

Overall, there is one foreclosure filing in every 33 households in the Inland Empire. That's a lot. One out of 33 households are filing. So if you look at your neighborhood, the market value, the closure, the impact it's having in our area, that's a direct impact. And a lot of us, when you look at the neighborhoods too, within the area, what is it doing to the rest of the market with a lot of foreclosures that it's having in our area? So one out of 33 households. I drive down, foreclosure sign.

No one gains when people are thrown out of their homes, the housing market falls, and entire neighborhoods are affected. This is having a terrible impact on our national economy, as I stated, and also within our neighborhood and the cleanups in the areas.

I look forward to hearing the witnesses' testimony today. Thank you very much, Madam Chairwoman.

Mrs. MALONEY. Thank you very much. The Chair recognizes Congressman Hensarling for 2 minutes.

Mr. HENSARLING. Thank you, Madam Chairwoman. And, I, too, want to thank our chairman for calling this hearing. As we contemplate perhaps some kind of legislative remedy, I once again want to remind our colleagues we should always be careful about our unintended consequences. And I want to associate myself with the comments of our ranking member to put the challenge in the proper context. That is, I still believe, last I looked, that subprime lending was roughly 13 to 15 percent of the entire mortgage market. And of that, 83 percent are still paying on time. So we need to make sure we put this in the proper context.

Now clearly, there may be broader threats to the economy, and that's something that deserves a serious look. We need to also take a look at why it is that borrowers default on their loans. Well, the number one reason still continues to be personal setbacks—job loss, illness, or disability. That's why we have the social safety net. Some may fail to understand the consequences of their action, and clearly there may be more opportunity for this committee in the area of financial literacy, not to mention more effective disclosure, since I do believe that on occasion less could be more.

Fraud is certainly out there. Fraud has been there since the dawn of man, and we need to examine, is there proper enforcement? But there's another reason that borrowers default, and that is, is that they do foolish things. And perhaps part of personal freedom is the freedom to do something that may be foolish.

The question is, did some borrowers in the appreciation, in the housing appreciation, use their homes as a personal ATM machine? And what does it mean for national policy for us to go and bail these people out? Will we incent even more bad behavior? So I think we have to take a very serious look at that for the greater macroeconomic implications. We do need to see that perhaps the tools that are available to the Fed and Treasury are not adequate to the task.

So I would caution us once again, Madam Chairwoman, to be very wary of unintended consequences, and I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman. I would note that the hearing has changed, and while we did discuss transgender issues at the other hearing, we're back to a more conventional format here today.

The gentleman from New Jersey is recognized for 2 minutes.

Mr. GARRETT. Thank you. As indicated, we have recently seen a steep decline in two specific sections of the market. We talked about the subprime market, and also the jumbo mortgages. However, most housing data shows that these numbers, while they are rising dramatically, are expected to peak basically in the next several months. And the problems that we see are basically due to bad prior underwriting practices. And Chairman Bernanke indicated some of the causes when he stated increased reliance on securitization has led to a greater separation between mortgages and mortgage investing.

I think you have to step back for a second and realize that the push by some in Congress and the Administration and society in general to increase homeownership rates has led to more lenders expanding into various segments of the mortgage market, especially subprime, and to be able to better serve this market, there have been large numbers of newly created and increasingly complex products. And if you add to that the lowering underwriting standards and incorrect or questionable ratings of borrowers, it increased the risk incurred to that segment of the market and homeownership.

But you have to ask yourselves something. Owning your home is an extremely noble goal, is long part of the definition of the American Dream, but not everyone in the current financial conditions is allowed to have that in their own reality. The Federal Reserve states that the United States is at full employment when the unemployment rate is between 4 and 5 percent. So we have to ask, at what point do we define the country at full homeownership? Now, while it is essential for Congress to examine what led to the situation and what steps either the Administration or Congress or both should take to ensure that these problems do not expand into the rest of the marketplace, we have to, as Mr. Hensarling just said, put this in perspective. And the perspective is this: The subprime market makes up around 13 percent of the entire housing market, and the problem in the subprime area is around 12 or 13 percent, so we are looking at dealing with something a little less than 2 percent of the overall entire market.

And finally, we must remember again what Chairman Bernanke recently said, that the failure of investors to provide adequate oversight of originators and to ensure that originators' incentives were properly aligned was the major cause of the problem that we see today in the subprime market.

But he continued, finally, and said, in recent months, we have seen a reassessment of the problems in maintaining adequate monitoring and incentives in the lending practices. In essence, the market has worked itself out to deal with those poor underwriting practices of the past.

And with that, Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from Texas is recognized for 2 minutes.

Mr. NEUGEBAUER. I thank the chairman. I want to associate myself with a lot of the remarks that have already been made, but, you know, one of the things I want to point out is that this is not an issue that we haven't seen before. Those of us who have been in the housing business for a number of years remember the 1980's, and where we saw some of the similar kind of problems with, as the gentleman said, an endangered species called savings and loans. They're not endangered anymore. They're not here anymore, and they're not here anymore because, quite honestly, they asked for some expanded responsibilities and abilities that they were not able to manage.

And so where we are faced today is with problems with an industry that got very aggressive, very "innovative," is the word that has been used, and now what we need today is to let the marketplace work this problem out. One of the things we do, though, I think is a huge mistake, we have some of the players that were a big help for us in the 1980's, and that was Fannie Mae and Ginnie Mae, their ability to come in and provide some liquidity and some mortgage abilities in the 1980's really helped keep—mitigate the 1980's from being any worse than they were, although I don't know how they could have gotten much worse than they did.

But I think what we need to look at today, and I'm going to be interested to hear from the panel, is how we give the marketplace a little flexibility and liquidity here to work through this process without, as many of our colleagues have already said, undermining the greatest housing system in the world. Countries all over the world look to America as the leader in how to develop housing and housing finance, and so I hope that we'll be able to look at that.

One of the things that I think we have today is Ginnie Mae and Fannie Mae, because of the limitations. We've been having discussions here in this committee over the last few months about putting limitations on the people who probably know more about mortgage lending than anybody in the world, when we probably should have been talking about limitations on some folks that didn't know as much about mortgage lending as Fannie Mae and Ginnie Mae do.

You know, the term "subprime"—I think even my third-grade grandson understands what "subprime" is. And he can't go home and explain to his parents that he got subprime grades because of the interpretations and criteria that the marketplace was using at that particular time. And so I think what we have to understand is that subprime is subprime, and that the marketplace looked the other way. It took a different view. I mean, those of us in the housing business have marveled at the innovation that has gone on in the last 2 years of people getting home loans how they could have never—couldn't even get car loans in many cases, and were able to get home loans. And so, hopefully over the next few hours here, we can hear from the experts and hear some ways that we—how we fix this without wrecking a very efficient system, one allowed to work in a market-based way.

The CHAIRMAN. The gentlewoman from California is recognized for 3 minutes.

Ms. WATERS. Thank you very much. I want to thank Chairman Frank and Ranking Member Bachus for holding today's hearing. I believe this hearing is timely, because of the recent turmoil in financial markets here and abroad related to subprime mortgage-backed securities.

Let me just say, Chairman Frank and members, about a year-and-a- half ago, I was in Cleveland, Ohio, in Congresswoman Stephanie Tubbs Jones' district. There was a big town hall meeting there, and at that town hall meeting, the citizens described that there were blocks and blocks of boarded-up housing and that those who remained were at great risk because the boarded-up housing was under the control, sometimes, of criminals, that the deterioration of those homes was causing the price of their homes to go down, and on and on and on.

None of us really understood what was going on, and surprisingly, none of our regulators were able to understand what was going on and to try and inform us so that we could at least try to provide some assistance to people who were getting into some of these subprime loans, who did not understand what they were getting into.

Now what is so disturbing about all of this is this: For those of us who have worked for years to try and open up opportunities for people who have been locked out of the mortgage market, folks that we really believed that, given a chance—they may not be able to have a downpayment. They may have even had some credit problems, but people who work every day, who pay their rent, and who pay their electric bills, we've always wanted them to have an opportunity, and we fought with the financial services in order to do this.

And we welcomed subprime. And we agreed that subprime did not have to be predatory, that there was a case to be made that people who presented some risk, not extraordinary risk, should be afforded a mortgage and that they should be expected to pay on time, and that the subprime market could charge them a little bit more for that loan. We all agreed to that. And we thought that the regulators not only were watching what happened with loans that were delinquent that were on the books of these financial institutions, we thought that they would know when something went wrong.

And evidently, they did not know, and we're all kind of surprised to find out that once the originators discovered that they could package anything and have it packaged and securitized and the investors would put money into it, that they could just throw anything into the package.

And so all of these exotic products, it's not simply no downpayment, but we're talking about products where you don't even verify the employment of the individual, particularly with some of these jumbos that were going out. And we still don't know today how they would get a handle on these products that came into being that have created this unsettling of the market. And so I remember when Federal Reserve Chairman Bernanke was here with testimony to the full committee in 2007 on the mid-year Monetary Policy Report, and I raised these concerns, and he did not have any answers.

So the bottom line is, it seems for those of us who fight for opportunities for people who should have loans, it's either feast or famine. So now we're going to get to a point where nobody is going to be able to get a loan. And I really want our regulators to tell us why they didn't know, and what can be done about it, and how we don't have to, you know, revert to drying up the opportunities for everybody because we've gone into this situation.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from California. We went a little long in the opening statements today, but we only have the one panel, so I think we'll be able to sustain an attention span through that. The gentleman from California, for 2 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman. I want to join the chairman in saying that I, too, thought some weeks ago that this subprime problem would be contained, and I represent the district where it was pointed out that there have been more subprime failures on Jamboree Road in Irvine, California, my district, than in any other State. So I'm pretty familiar with—and pretty close to some of what's gone on here.

And, you know, Chairman Bernanke before this committee several times had said that his greatest concern for the economy in the future would be a hardfall in the housing market. The housing market was clearly teetering before the subprime problem spread to Alt A and through to—through now into AAA housing loans and credit. And, frankly, from what I understand, it has spread through into commercial real estate loans and is impacting that, too.

So I come into this hearing and in fact back to this Congress today with no preconceived notions on what we should do or what we shouldn't do, but in fact to listen. Because I come in with great concern for this economy and for what effect a hardfall in the housing market led into by this credit problem and/or in commercial real estate could lead to as far as our national economy.

It seems to me just as an observer that there is a risk premium that is being put on by investors around the world now on loans, on packages of loans securitized by real estate in the United States, and that that risk premium is there because they no longer trust what is coming out of this market, what these loans are purported to be and what checks have been done or not done, and that perhaps one of the things—and I'll be very interested to hear from the panel—is that—is what can we do to restore some confidence or to add some confidence or some transparency so that that risk premium goes down, and so that investors around the world once again can look at a package of real estate loans from the United States as being something that is worthy of investing in without an inordinate risk premium there.

I look forward to hearing the testimony from the panel, and I thank the chairman.

The CHAIRMAN. The gentleman from Georgia, for 2 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. And I, too, am looking forward to this hearing. But I wanted to just make a few brief remarks if I could because I'm anxious to hear what you have to say. I represent the Atlanta region, Atlanta, Georgia, which right now has the second highest number of foreclosures anywhere in the United States, and this is not a new phenomenon.

I heard very clearly some of the points that were raised on the other side about laissez faire, let the market take care of itself, but this is not something new. This has been going on a long, long time, certainly in my region, and I think it's wise of us to look at some of the basic issues of why this is happening. I think we need to prepare legislation or initiatives, whatever, in a very calm and responsive way, but certainly we have to look at what's causing this. Number one, what's causing this is loans are being made to people who ought not to get these loans. Something ought to be done about that. Something ought to be done about loan originators who are sitting and they know that these people do not have the capacity to pay. They know that they have weak credit histories, but yet, they are still making the loans to these individuals.

Secondly, we have over-aggressive, eager loan originators. And then thirdly, we have consumers—and this is really the heart of the matter—we have consumers in this country, most of whom, who are just woefully lacking in financial literacy and education before they sign on the dotted line. And we have moved very slowly—as a matter of fact, we have not moved at all—in putting forward a very aggressive financial literacy program with at least a toll-free number where people who are on the margins, who are in these subprime markets, who are most at risk, can at least have a place to call before signing on the dotted line.

And so it is my hope that in the hearing today, we will be able to discuss some of these issues. But I also want to put my two cents in for taking an intelligent look to see what our institutions can do that are there. The President has already moved with the FHA and first-time home buyers and giving them some help, which I applaud. But we have Fannie Mae and Freddie Mac, whose limits should be lifted. And let me also commend our banks, that are doing an excellent job, particularly Atlanta Federal Home Loan Bank in my hometown, of getting more money into the market to help with the liquidity problem.

Thank you, Mr. Chairman.

The CHAIRMAN. Finally, I will recognize the ranking member for a unanimous consent request.

Mr. BACHUS. I thank the chairman. Mr. Chairman, the ranking member of the subcommittee, Mrs. Biggert, is presently in a conference in the Senate on the student loan bill, and she has played a significant role in addressing subprime problems, and I would like to ask unanimous consent to submit her statement into the record in Mrs. Biggert's absence.

The CHAIRMAN. Without objection, it is so ordered.

And we will now turn to our witnesses. Before we do, I want to enter into the record a press release dated yesterday: "Federal Financial Agencies and Conference of State Bank Supervisors Issue Statement on Loss Mitigation Strategies for Services of Residential Mortgages."

Catchy title, guys. But it's a very important statement. It is from the bank regulators, the Conference of State Bank Supervisors, and it's a very encouraging example of Federal-State cooperation and the National Credit Union Administration. It is really quite important; I think it builds in part on some of the work that we have done in conjunction with the SEC where mortgages are held in portfolios of institutions, and you can get workouts at least directly.

A large part of the problem has been that the mortgage is held after securitization, and it has not gotten enough attention, I think, that the SEC, to its credit, at our request, got the Financial Accounting Standards Board, to its credit, to make clear that the appropriate accounting standard allows the servicer of securities to show flexibility if the holders will be better off.

As we know, increasingly now, with increased property values, with the kind of domino effect, it is better in many cases to forego every last right of the contract which would lead to foreclosure and instead do a workout. I very much appreciate what we have here, and I thank the regulators, some of whom are represented here. They have now written to the—they've issued this statement, and they are telling the securitizers to please take advantage of the flexibility. So this is one more example.

And for those who are paying attention to this, to members, this is something—we're going to send this around to all members. If you are talking to people in your districts who have these mortgage problems, if you are talking to the advocacy groups, many of which are doing a very good job, the counseling groups, they should know both about what the Financial Accounting Standards Board just said, and the fact that all of the regulators have urged them to go forward with it.

With that—and I ask that this be put into the record. Without objection, it will be.

And with that, we will begin the testimony with Secretary Steel. Well, one last explanatory point. There is one missing face at the table today, if we look at institutions with responsibility. It's the Federal Reserve System. Originally I had invited the Federal Reserve, but there is a Federal Open Market Committee meeting on the 18th of September. The Federal Reserve System asked us if they could defer appearing, given how close it is to an FOMC meeting, because they fear that people might draw the inference that whatever they did at the September 18th meeting might have been influenced by what was said today. Though, frankly, I will ask for the indulgence, that seems to me less of a terrible thing than to others. This is an institution, the House of Representatives, that can vote on the most intimate and important questions affecting humanity; war and peace and life and death, and all manner of other things. But apparently, God forbid we should ever talk about a quarter percent on the interest rates, because that is beyond the competence of a democratic institution. I don't agree with that, but I have deferred to it in this instance. We will get back to the Fed later.

The gentleman from Alabama.

Mr. BACHUS. Mr. Chairman, you noted the absence of the Federal Reserve. I also would like to say that the director of the OTS—

The CHAIRMAN. Yes.

Mr. BACHUS. —John Reich, is not here, and of course, they regulate our thrifts, including Countrywide and—

The CHAIRMAN. Will the gentleman yield? The gentleman is right. I was hoping that this hearing would not focus so much on subprime, that we would be doing that on mortgages at the September 20th hearing, and that this would get to the broader ones. And we do have two of the bank regulators because they have regulatory authorities that go beyond that. The thrifts is—the OTS has done a good job, and I acknowledge that. They will be at the next hearing.

Mr. BACHUS. And actually, I guess my reason for pointing that out is that he has done a good job.

The CHAIRMAN. No question.

Mr. BACHUS. You and I have both discussed privately that the OTS—

The CHAIRMAN. Yes. And OTS is part of this group, and I agree with that. I would note just for the purpose of symmetry, that they used to have a practice in the House called "pairing," where a Member on one side of an issue and a Member on the other side of an issue could both be absent, and they would kind of get credit for canceling each other out.

I would note that while we don't have the Federal Reserve here today, neither do we have the gentleman from Texas, Mr. Paul. And I think from the standpoint of people who know Mr. Paul, having both the Federal Reserve and Mr. Paul not here is a reversion to the old pairing system, so we have managed to reach some parity there.

Mr. Secretary, please begin your testimony.

STATEMENT OF THE HONORABLE ROBERT K. STEEL, UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. STEEL. Chairman Frank, Ranking Member Bachus, and members of the committee, I very much appreciate the opportunity to appear before you today to present the Treasury Department's perspective on the recent events in the credit and mortgage markets and their impact upon consumers and the economy. The Treasury Department and Secretary Paulson know these events are of considerable interest to the American people, this committee, and other Members of Congress.

To give context to the current market situation, let me begin my remarks today with a brief description of both domestic and global economic conditions. In the United States, the unemployment rate is 4.6 percent, closest to its lowest reading in 6 years. Real GDP growth was 4 percent in the second quarter, supported by strong gains in business investment and in exports. Core inflation is under control. Since August of 2003, 8.3 million jobs have been created, more jobs than all of the major industrial countries combined.

The global economy continues to grow at around 5 percent annually with many emerging market economies growing even more rapidly than the global average. Over the past several years, these favorable economic conditions—low unemployment, low inflation, low interest rates—serve to fuel a demand for credit and investment, and the marketplace responded with a vast supply of both to satisfy consumers and the sophisticated market participants.

At the consumer level, this demand was very noticeable in the mortgage industry, and in recent years particularly, the subprime area. For the first time in the early 1990's, consumers with lower incomes and challenged credit histories, typical subprime borrowers, were able to access mortgage credit at interest rates a few percentage points higher than prime borrower rates. Homeownership became more widely available in the United States, growing from 64 percent in 1994 to 69 percent today.

Mortgage securitization has played a significant role in this growth. Typically, the mortgage originator distributes its loans to a securitization sponsor, who pools together the mortgages into mortgage-backed securities. Investor demand for mortgage-backed securities provided capital to mortgage originators, who were then able to use this capital to make more loans.

Throughout most of the 1990's, annual mortgage origination stood at approximately $1 trillion. With the historical low interest rate environment of 2001 to 2003, mortgage origination climbed to almost $4 trillion in 2003. Infrastructure buildup and the entry of many new participants into the mortgage industry matched this increase. As interest rates began to rise in 2004, mortgage origination fell to just under $3 trillion. With this decline, there was significant overcapacity in the mortgage industry.

To satisfy continued investor demand for mortgage-backed securities and their excess capacity, some mortgage originators relaxed their underwriting standards, lending to individuals with a lower standard of documentation, and thereby selling mortgage products which for some buyers would become unaffordable.

The combination of rising interest rates and mortgages resetting at higher rates, and a decline in house price appreciation, led to rising delinquencies and defaults among subprime borrowers, first widely evidenced in the autumn of 2006. In 2007, this trend has continued.

In turn, the mortgage-backed securities investor has felt the repercussions of the weakness in the mortgage assets underlying some of these securitized products. Over the past several months, a small number of U.S. and foreign financial institutions and hedge funds invested in mortgage-backed securities have reported large losses. Some have suspended or limited redemptions consistent with their authority, while others have liquidated or received capital infusions so as to continue.

The uncertainty regarding the future prospects of these mortgage-backed securities compelled investors to reassess the risk of these securities and subsequently reassess price. This reappraisal has spread across other parts of the credit market spectrum, first affecting residential mortgage-backed securities and then spreading to other asset classes, and in particular, securitized products.

This reappraisal of risk is normal and typically follows periods of widely available credit when markets have undervalued risk. As in other times of reappraisal, investors adverse to risk and protective of their capital, have fled to quality assets, demanding and driving up the prices, and in turn driving down the rates of securities such as Treasury bills.

In early August, this uncertainty and subsequent illiquidity began to spread to asset-backed commercial paper, typically a highly liquid market. In response, the Federal Reserve took several measures to increase liquidity and promote the orderly functioning of financial markets. The Federal Reserve provided additional reserves through open market operations in order to promote trading in Fed funds markets at rates close to the target rate. The Federal Reserve also lowered the discount rate and changed the Federal Reserve's usual practices to allow the provision of term funding at the discount window. Such actions have helped to stabilize the markets.

The ultimate impact of these different events on the economy has yet to play out. At the time of its discount rate cut, the Federal Reserve noted, "the downside risks to growth have increased appreciably."

The Treasury Department respects the independent action and leadership of the Federal Reserve. Like the Federal Reserve, the Treasury Department shares the perspective that recent market developments pose downside risks to economic growth. However, the economy was in strong condition going into the recent period of volatility, and while certain sectors like housing are undergoing a transition, overall economic fundamentals remain strong. And while recent difficulties in the subprime mortgage market are having and will continue to have a profound effect for many families, the underlying strength of the economy should allow for continued growth.

The Treasury Department closely monitors the global capital markets on a daily basis. Under Secretary Paulson's leadership, the President's Working Group on Financial Markets will examine some of the broader market issues underlying the recent market events, including the impact of securitization and the role of rating agencies in the credit and mortgage markets.

The Treasury Department will also be releasing early next year a blueprint of structural reforms to make financial services industry regulation more effective, taking into account consumer and investor protection and the need to maintain U.S. capital markets' competitiveness.

Most important, in addition to efforts to fully understand the current situation in the financial markets, last week, the President announced a series of market-based initiatives to help homeowners keep their homes. For example, the Administration, led by the Treasury Department and the Department of Housing and Urban Development, has undertaken several actions to provide assistance to homeowners, including the Administration's continued pursuit of legislation modernizing the Federal Housing Administration.

Coordinating with HUD, the Treasury Department will also reach out to a wide variety of entities, such as NeighborWorks America, mortgage originators and servicers, and government-sponsored entities like Fannie Mae and Freddie Mac, to identify struggling homeowners and expand their mortgage financing options. The Treasury Department looks forward to working with Congress in the days ahead on these important issues.

In conclusion, it is crucial that policymakers understand these issues and their underlying causes, and continue to enhance the capital markets' regulatory structure to adapt to market developments.

I appreciate having the opportunity to present the Treasury Department's perspective on these important issues and I look forward to your questions.

[The prepared statement of Under Secretary Steel can be found on page 129 of the appendix.]

The CHAIRMAN. Thank you. Next, we have the Comptroller of the Currency.

Mr. Dugan?

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate this opportunity to provide the OCC's perspective on recent events in the credit and mortgage markets.

As you know, we are the primary supervisor for the very largest commercial banks that play critical roles in virtually all aspects of today's capital markets, including the credit markets for mortgages, leveraged loans and asset-backed commercial paper that have received so much attention. The OCC maintains teams of examiners onsite at each of these institutions to monitor their activities.

More broadly, for the last 20 years, national banks across the country have become very substantial participants in residential mortgage markets where they originate, hold, sell, buy, service, and securitize most types of mortgages. These of course include subprime mortgages, but let me emphasize that national banks have proportionally been less involved in that market, originating less than 10 percent of all subprime mortgages in 2006, and have experienced default rates that are significantly lower than the national average.

Given the large aggregate credit exposure of national banks, the recent volatility in credit markets has clearly been a concern for both the OCC and the banks that we supervise. These challenging market conditions affect all market participants, including not just the largest national banks that participate actively in capital markets, but also the many mid-size and community national banks that engage in mortgage activities across the country.

Let me be very clear, however, that the worst problems that we have seen in markets—insufficient liquidity resulting in substantial declines in capital and sometimes in failure of individual firms—have occurred outside the commercial banking sector. The national banking system remains safe and sound. Unlike many non-bank lenders, national banks generally have strong levels of capital, stable sources of liquidity, and well-diversified lines of business, all of which have allowed them to weather these adverse market conditions.

As a result, national banks remain active in major markets and continue to extend credit to corporate and retail customers, including mortgage credit.

With respect to general market conditions, I am encouraged by the recent actions to restore liquidity that have been undertaken by the Federal Reserve, other central banks, and various market players, including some major national banks. Nevertheless, the situation does remain fluid and it may take some time until markets fully stabilize.

We are therefore continuing to watch conditions very closely and talking on a regular basis with other financial regulators to address issues that may arise. While recent market conditions have certainly been painful, and may continue to be painful for some time, we believe they are likely to cause some positive changes in the longer term as markets re-evaluate and reprice risk.

Part of today's problems in credit markets resulted from underwriting standards that had relaxed too much, whether in subprime loans or leverage lending, to pick two examples, which was at least partly the result of investor willingness to assume greater risk to achieve higher yields.

In both cases, market participants are now demanding changes in the form of more conservatism. While legitimate concerns remain about the pendulum swinging too far and too suddenly in the opposite direction, we remain hopeful that markets will stabilize at an equilibrium where lending standards are more rational and pricing more accurately reflects risk.

Such a positive outcome would apply in the future to loans that are yet to be made. Unfortunately, the same cannot be said for many loans that have already been made, and in particular for many homeowners holding subprime mortgages.

For those Americans who may be facing unmanageable mortgage obligations, recent events are far more serious than a simple market correct. They may instead result in foreclosure and all its potentially devastating effects on families and communities.

The OCC recognizes the need to do all we can to reduce the inevitability of that outcome. We have taken concrete steps to encourage both lenders and borrowers to respond to these situations in ways that minimize the likelihood of foreclosure while preserving safety and soundness.

Just yesterday, as the chairman stated, the banking agencies jointly released a statement encouraging lenders and servicers to work with borrowers to take appropriate steps to avoid foreclosure even where loans have been securitized. With the prospect of significantly increasing foreclosures looming on the horizon, we are fully committed to working with all interested parties to help address the many significant issues that could arise.

Thank you very much.

[The prepared statement of Comptroller Dugan can be found on page 98 of the appendix.]

The CHAIRMAN. Thank you, Mr Dugan.

Now, the chairman of the FDIC, Ms. Bair.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the credit and mortgage markets.

Events in the financial markets over the summer present all of us here today with significant challenges. My written testimony gives details about the developments that led to the current market disruptions.

I would like to focus my comments this morning on the condition of the banking industry and the role banks can play in addressing the current credit challenges. Recent events underscored my longstanding view that consumer protection and safe and sound lending are really two sides of the same coin. Failure to uphold uniform high standards across our increasingly diverse mortgage lending industry has resulted in serious adverse consequences for consumers, lenders, and potentially, the U.S. economy.

Insured financial institutions entered this period of uncertainty with strong earnings and capital, which put them in a better position both to absorb the current stresses and to provide much needed credit as other sources withdraw. Also in times of financial stress like these, the full benefit of Federal deposit insurance becomes evident.

Insured deposit accounts give consumers a safe place to put their money during times of uncertainty, and confidence in the safety of their deposits helps to preserve the liquidity and integrity of the financial system.

Last month, the FDIC released second quarter 2007 financial results for the 8,615 FDIC-insured commercial banks and savings institutions. These showed an industry with very solid performance. Second quarter earnings were the fourth highest quarterly total on record, only 3.5 percent below the all-time high, and more than 90 percent of all FDIC-insured institutions were profitable.

While the overall financial results are positive, the data also included some worrisome information. The interest rate environment continues to be difficult for financial institutions. Of most concern, credit quality is likely to get worse before it gets better.

Noncurrent one to four family residential mortgage loans represented 1.26 percent of all such loans at the end of June, the highest noncurrent rate for these loans since the first quarter of 1994.

Many credit needs of both businesses and individuals will need to be funded in the coming months. This will present both challenges and opportunities for FDIC-insured depository institutions.

Among the challenges for the industry are increased credit losses. If the housing downturn continues, some institutions that are currently in good shape could face capital challenges resulting from losses in mortgage-related assets.

At the same time, this situation may create opportunities for insured institutions to expand market share and to improve interest margins, as funding that was previously provided by the secondary market begins to shift to banks and thrifts.

Growth of portfolios, if it occurs, would pose a risk-management challenge for many institutions. Institutions that grow their loan portfolios will have to maintain sufficient capital to support that growth, however the currently strong capital base of the industry puts it in a position to be a more important source of financing for U.S. economic activity during this difficult period.

The recent events in the financial markets also remind us that strong capital requirements are essential and that models have their limitations in the assessment of risk. These are important lessons to remember as we approach implementation of Basel II.

Finally, it is crucial that we use all available tools to assist deserving borrowers who will soon be facing problems as mortgages reset in the coming months. It is also important that regulators do all they can to improve consumer protection and make certain that rules for all market participants are consistent.

I applaud the fact that Chairman Bernanke has promised to propose HOEPA rules before the end of the year to impose more uniform standards on bank and nonbank mortgage market participants.

The uncertainty that now pervades the marketplace, which in many respects is attributable to underwriting practices that were sometimes speculative, predatory, or abusive has seriously disrupted the functioning of the securitization market as well as the availability of mortgage credit for some borrowers.

The FDIC will continue to work with our colleagues and the regulatory community to address these issues. That concludes my testimony. I would be happy to respond to questions. Thank you.

[The prepared statement of Chairman Bair can be found on page 76 of the appendix.]

The CHAIRMAN. We will now hear from Mr. Sirri, with the SEC.

STATEMENT OF ERIK R. SIRRI, DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for inviting me here to testify on behalf of the Securities and Exchange Commission about recent events in the subprime mortgage and credit markets and the Commission's responses.

There is no question that over the past 2 months, the defaults by homeowners with subprime credit and mortgage obligations has had a broad and significant impact. In addition to the difficulties that this has caused borrowers and others in their communities, the sharp rise in defaults has reverberated throughout the financial markets.

As default levels on subprime mortgages exceeded expectations, market participants began to question the value of a variety of financial products. And as valuations came into doubt, liquidity in these products fell sharply, which further complicated the task of valuing particularly complex instruments.

Derivative referencing mortgages were not the only instruments that experienced an unexpected decline in liquidity. A variety of other complex financial products that involved non-mortgage assets suffered diminished liquidity as well.

As liquidity for structured products diminished, market participants needing to raise funds to meet margin calls or investor redemptions sold their less complex financial instruments such as equities and municipal securities, placing downward pressure on prices in these markets.

Overall, these dynamics have significantly impacted a wide range of market participants from individual investors to systemically important financial institutions.

In this environment, as in more benign environments, the Commission seeks to fulfill its basic mandates: to protect investors; maintain fair and orderly markets; and facilitate capital formation.

My written statement describes a full range of issues on which the Commission is engaged, but in my oral statement, I will focus on three things: our outreach to a variety of market participants to understand potential exposures to subprime mortgages and related products and to evaluate operational and liquidity issues that could require regulatory response; our implementation of the rules governing nationally recognized statistical rating organizations, NRSROs; and our oversight of consolidated supervised entities.

As a matter of course, the Commission and its staff are in regular contact with the industry to gather information and determine where regulatory action is needed. This is particularly true now, given the current state of credit markets. Similarly, we regularly confer with the President's Working Group agencies to discuss market conditions and share observations about issues facing those market participants under the PWG's members' respective jurisdictions.

All of this discussion and information sharing has ultimately led to a more consistent and coordinated response to the credit market events across markets and their participants. In June of this year, the Commission adopted rule governing NRSROs. The purpose of the rating agency act is to improve ratings quality for the protection of investors and to serve the public interest by fostering accountability, transparency, and competition in the credit rating industry.

The Commission believes that disclosures required by the credit rating agency act and its implementing rules will assist users of credit ratings in assessing the reliability of an NRSRO's ratings over time and will provide transparency with respect to the accuracy of a credit rating agency's ratings in connection with structured financial products related to subprime mortgages.

Given recent events in the subprime mortgage and credit markets, the Commission has begun a review of NRSRO policies and procedures regarding ratings of residential mortgage-backed securities and CDOs, the advisory services that may have been provided to underwriters and—provided to underwriters and mortgage originators, their conflicts of interest, disclosures of the rating processes, the agencies' rating performance after issuance, and the meanings of the assigned ratings.

Also important to systemic health of the financial services sector is the vitality of the largest financial services firms. The Commission supervises five securities firms on a groupwide basis: Bear Stearns; Goldman Sachs; Lehman Brothers; Merrill Lynch; and Morgan Stanley. For these CSE firms, the Commission provides holding company supervision in a manner that is broadly consistent with the oversight of bank holding companies by the Federal Reserve.

The program's aim is to diminish the likelihood that weakness in the holding company itself or any unregulated affiliates would place a regulated entity such as a bank or a broker dealer or the broader financial system at risk.

CSEs are subject to a number of requirements under the program, including monthly computation of capital adequacy measure consistent with the Basel II standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls that are the subject of Commission inspection.

Further, the holding company must provide the Commission, on a regular basis, with extensive information about capital and risk exposures, including market and credit exposures. Given the recent events in mortgage and credit markets and their potential impact on financial institutions, the Commission's staff is monitoring the liquidity available to the CSE parent with greater frequency than normal during these periods of unusual market stress.

In addition, the Commission staff is also monitoring contingencies that might place additional strains on the balance sheets of CSE firms. These include the potential unwinding of off balance sheet funding structures, such as conduit structures. We are also monitoring the potential funding requirements and certain leverage lending commitments that are made by the CSE firms, typically to fund corporate acquisitions or restructuring.

The Commission staff is also engaged in the ongoing oversight on valuation at the CSE firms. Current market conditions have increased the challenge of marking certain complex positions to market. We are reviewing the valuation methods that are used by each firm to ensure that they are robust and consistently applied across all of the firm's business.

I hope my remarks today have highlighted the Commission's ongoing and heightened activities. In light of the recent mortgage market events, I believe that the regulatory committee must continue to engage with the systemically important banks and securities firms, encouraging additional efforts to improve and expand risk management capabilities. We will work with our PWG colleagues and other market participants to further this agenda.

Thank you for the opportunity to testify and I would welcome any questions.

[The prepared statement of Mr. Sirri can be found on page 121 of the appendix.]

The CHAIRMAN. Thank you, Mr. Sirri, and now we will begin the questioning.

And again, I will remind members—obviously members can do what they want—but with specific reference to the current subprime crisis, the potential foreclosures, we will be having a hearing entirely on that subject on September 20th with Treasury, HUD, OTS, the bank regulators, and others to talk about the President's proposal and what we can do.

My own intention is to focus on some of the implications that we may have for the broader questions. As I said, members are free to ask what they want, but in fairness to the witnesses, they didn't come, I think, briefed to fully talk about the President's program, and that will be coming up a little after that.

I am most concerned at this point about the potential broader implications, and it does seem clear that we have a set of financial markets today that are very different than they were 10 years ago, but our regulatory structure is essentially the same as it was 10 years ago.

We are not talking about more regulation necessarily, we are talking about more appropriate regulation, regulation that responds to what we now have. And again, I was particularly pleased, Mr. Dugan, in your testimony, and I was glad to see those figures.

It is clear, with regard to subprime, that the regulated sector of the mortgage industry clearly has performed in a much more responsible fashion than the unregulated sector. There are a large number of very responsible people in the unregulated sector. The difference is that the minority that might be inclined to be irresponsible ran into fewer obstacles there than they did in the regulated sector.

And it is not my impression that the FDIC, the OTS, the OCC, and the Credit Union Administration, also not here, but part of this, it's not in my experience that they refuse loans that should have been made. In other words, people have said, "Oh, sure, they don't make bad loans, but they don't let anybody make any good loans."

The fact is that I think the balance of making the loans that should be made and not making those that shouldn't be made was approximated much better thanks to sensible regulation. And that's—I want to just talk about—we've been told earlier—Mr. Steel, maybe I'm misreading this a little bit, but I was struck by your statement, "The Treasury Department will also be releasing early next year a blueprint of structural reforms to make financial services industry regulation more effective, taking into account consumer and investor protection and the need to maintain U.S. capital markets competitiveness.''

Maybe I'm overanalyzing this. Maybe this is the old new criticism of years ago in the literary world hanging on. That was big when I was going to college; they're all dead now. But it did seem to me the emphasis on consumer and investor protection getting equal attention with competitiveness, I'm not sure I would have seen that earlier.

That is, we did hear a lot earlier this year, last year, about the need to improve the competitiveness of our financial markets, and the general argument was—the thrust of it was that we've overregulated some. People said, "Why can't you be like that nice FSA," that Financial Services Authority. "Don't be so nitpicky." "Why don't you talk principles to us?" "Why are you always making all these rules on us?" and "Why do you have so many regulators?"

I mean if this was England, this hearing would have been over because there would have been one of you, so that would have been much easier. People think that would have been a good deal. We don't know which one of you it would be, maybe one of those three. You'd still be here, Mr. Steel.

But the tone does seem to me to have shifted. The notion that the overwhelming need is for us to reduce regulation so that we can be more competitive with less regulatory regimes elsewhere, particularly England, I think there has been a shift, and I welcome that. That doesn't mean we need to be heavy handed.

And indeed, we're getting that even from England. In the New York Times last Wednesday, August 29th, there was a quote from Chris Rexworthy—easy for them to say—director of advanced regulatory services at IMS Consulting, a former regulator with the Financial Services Authority.

Mr. Rexworthy said that regulators talk about the importance of stress testing; recent development creates concerns that "institutions are either not investing enough effort in this, getting it wrong, or just producing things too complex for their risk assessment models to cope with." Continuing the quote, "greater cooperation on the international stage between regulators is undoubtedly one of the things we need to see more of." And it says U.S. regulators were.

I quoted Martin Wolfe earlier in the Financial Times saying, "the only way to insulate financial markets against the sort of panic seen in recent weeks may be to reregulate them comprehensively." He then expressed his skepticism about our ability to do that.

And I guess, again, the issue is not increasing regulation of those things that we have always regulated but addressing the question, have the markets now come up with new things for which we don't have an appropriate set of regulatory tools, the leveraging derivatives. And it is not simply that they have come up with new things but that precisely because they are leveraged, etc., that the potential negative may be even greater, that people have come up with the ability to do more, make more money but also perhaps incur more risk.

And I am particularly driven by that because it does seem clear that we did not expect the subprime issue to have the broader negative issues it has. So I just wonder if any of the members of the panel—let me ask all of you just briefly to address that.

Mr. Steel, let me begin with you.

Mr. STEEL. I would agree with your description and when Secretary Paulson focused on this issue of competitiveness, then one of the first things that he raised was the issue of the regulatory structure in our country. And it's something that he's focused on and has asked people at Treasury to work hard to deliver a blueprint: what we think it should look like if we were starting fresh.

Point two, I don't view a review of the status quo to mean necessarily less regulation. I think the issue is appropriate regulation. Business models have changed and the markets have changed. Really, that's in the wrong order. Basically, business models have changed to meet the markets, and as a result, our goal is to look at this afresh and focus on the issues. And I don't think that means less investor protection or less consumer protection, it means having the right lens on these issues. And today, the patchwork nature of what has developed over decades, since the last century, is just not as attuned as it should be.

Point two is last Friday the President specifically tasked Secretary Paulson to look at the ingredients of this latest period of turmoil, securitization, rating agencies, and to also have a fresh look on that. As I said to you in the past on other issues, there should be no acceptance of the status quo. Innovation acquires adaptation, and we have to keep moving with the innovation and to present the right regulatory focus.

The CHAIRMAN. The gentleman from Pennsylvania, the chairman of the Capital Market Subcommittee, is planning hearings on the credit rating agencies' piece of this. It's an issue that he has been working on for some time. He has been somewhat pressured to be concerned about that when some others were not, and so he will be continuing that fairly soon.

Is there any comment?

Mr. DUGAN. Yes, Mr. Chairman. I mean I think the issue you raised is the unevenness of Federal regulation and then regulation in the markets that mortgages were not being provided by federally-regulated entities. I think personally I believe there is a need for some kind of uniform standard. The question is what is the best means to get there.

I think right now the market itself has corrected and many of the most aggressive products are simply not being offered: 2/28s, for example, declined substantially in the marketplace. But I think even in terms of a standard, Federal regulators have come out with guidance, as you know. The States have embarked upon a serious effort to adopt a same kind of guidance. And if they do that on a uniform basis, that can help address that need. The Federal Reserve has also indicated its willingness to go forward with regulations under HOEPA by the end of the year.

That will be a uniform standard. The question is, do you need to go beyond that? Will that be enough? I think that's the question you're grappling with and it is a difficult and a delicate balance because of the fear of going too far, but the issues that are being put into play, you're having the hearing on on the 20th, I think, is totally appropriate.

The CHAIRMAN. Thank you. And you said the market is corrected, and I do think we would agree. Unfortunately, it is over-corrected right now. And the only thing I'm saying is there is a potential problem of over-regulation, but among the fears that do not keep me awake very long are that the Federal Reserve will overdo consumer protection. That one I'm not too worried about.

Ms. Bair?

Ms. BAIR. Well, I think the FSA model does have some advantages in that all financial services regulation is under one umbrella. We compensate for that, though, through our informal communications. The FDIC hosted a series of securitization roundtables. The servicer statement we issued yesterday was an outgrowth of that. Those were jointly hosted with the other bank regulators; they also included the SEC, OFHEO, and Treasury. Bob Steel was there.

So I think through informal mechanisms, we do a lot of communication. The President's Working Group on Financial Markets is also an umbrella group that I think helps ensure that there is appropriate coordination, even though we have these multiple, separate regulatory structures. As I've told Bob, we'd love to have a little more involvement of the FDIC in the President's Working Group.

But I think they are very competently handling a lot of the policy and market issues that are arising in this context. So I think overall it's not perfect. If you were starting from scratch, you might do something different, but overall, it works pretty well.

The CHAIRMAN. Mr. Sirri?

Mr. SIRRI. Chairman Frank, you make an important point that innovation and regulation have a tough time together, and as a regulator, we sense that, I think, on a regular basis.

We do have some tools at our disposal. So for example with systemically important, large broker-dealers, we meet that challenge with liquidity. We require tremendous amounts of liquidity at the holding company level, so when there's uncertainty, when we don't know what's going to happen, there's liquidity available to ensure the solvency of those firms and to protect against defaults.

But there are also things that have changed here. Congress, for instance, provided us new authority into the Credit Rating Agency Reform Act. This will for the first time give us the ability to register, regulate, and inspect credit rating agencies. That's new for us and I think it's an appropriate piece of legislation and we look forward to implementing it.

The CHAIRMAN. Thank you.

The gentleman from Alabama is recognized.

Mr. BACHUS. Thank you.

I'd first like to start by commending Chairwoman Bair.

Congressman Scott mentioned earlier the importance of financial literacy and Mr. Hinojosa and Ms. Biggert and Mr. Scott have talked about the importance of that. I want to commend you on your book for elementary school children where you used the two animal figures to really teach planning ahead and setting aside. It's a very good book.

One of the positive things that may come out of all this is that book, or something like it, may be offered in elementary schools. It's something I probably should have read earlier, too.

Let me also say, we talked about the credit rating agencies and I'm going to direct this to Director Sirri. The three main credit reporting agencies, Moody's, S&P, and Fetch, receive substantial revenues from their structured finance businesses. Unfortunately, it appears that in this instance, the rating agencies failed to re-evaluate the ratings given to mortgage-backed securities until their losses were already widely known in the market.

In some cases, these securities received ratings that made them appear safe as Treasury bills. As the principal regulator of the rating agencies, what is the SEC's plan to deal with the conflicts of interest inherent in a system where rating agencies are compensated by the issuers of the securities being rated? And I know the President's Working Group worked on that too, and if you have a comment, Secretary Steel?

Mr. SIRRI. Thank you.

We are charged under the statute with looking at issues relating to conflicts of interest. There are two important conflicts of interest that I think merit particular attention. The first is the one that you cite, how credit rating agencies are paid. Typically, they're paid by the underwriter or the issuer. That presents a conflict, but we believe that conflict is manageable.

Firms should have credit rating agencies policies and procedures in place and they should adhere to those policies and procedures when they evaluate deals. We are going in to look at those firms now, to look at their policies and procedures and to look at the actual ratings and their practices to understand what was actually done.

The second important conflict is one that could arise with respect to the disclosure of their methods and the meaning of ratings. Again, credit rating agencies should be clear about those and they should adhere to those practices as they rate particular securities.

If we see conflicts, if we see that they're not following their procedures with respect to information, then again we would be empowered to follow-up there.

Mr. BACHUS. Secretary Steel, Friday, when the President and the Secretary outlined their proposal on helping homeowners, one of their proposals was a plan supporting the State-based efforts to create a comprehensive mortgage broker registration system. Mr. Scott earlier said something about it twice. He mentioned mortgage originators. I will tell you that not all of these bad loans are mortgage brokers; a lot of them are mortgage bankers. They are people inside banks, so they are federally-regulated.

I've introduced, along with Mr. Gillmor, Mr. Price, Mr. Miller, and Ms. Biggert, legislation to establish a national registration system for all mortgage originators. It is very similar to what I think the President outlined last Friday, but would you comment on the need for the creation of such a system? And I think Mr. Scott in his opening statement pretty much told you about the problem we had with just a small group of mortgage originators.

Mr. STEEL. Well, sir, I think that as the President said on Friday, and I would confirm to you today, this is an issue that requires attention and people shouldn't be able to move from jurisdiction to jurisdiction. And bad actors need to be catalogued and followed. I am familiar with your legislation and others, and we at Treasury would be completely consistent with the ideas of what you're trying to accomplish. I think that what we need to work on and consult with you and other people on the table today is what is the best way to accomplish that. And the devil is in the details on this, but you should rest assured that the idea of cataloguing and being on top of this so people cannot move, bad actors cannot pack up and move to a new jurisdiction and act badly again, it is something we should track down and eliminate.

Mr. BACHUS. Well, the States already have a system that works if we required it in all States as opposed to establishing something all new. And it applies to both originators and brokers, and I know that the Federal regulators have resisted that. But let me tell you that a lot of people have suffered as a result of not having a national registration that people can go to and quickly see. I know that Chairman Frank talked about the need for this, and we've discussed it, and it's in our legislation. It was in the legislation that he and I proposed last year.

Mr. STEEL. Thank you.

Mr. BACHUS. My final question.

Comptroller Dugan, you were over in the Senate. You were a lawyer at the Senate Banking Committee during the S&L crisis. You were heavily involved in the government's response during the first Bush Administration to the savings and loan crisis in the late 1980's. Based on that experience, I know earlier you talked about unintended consequences and the government making things worse, and I think that certainly happened with savings and loans.

Would you like to share any advice for us as we attempt to address these issues on how we might avoid some mistakes of the past?

Mr. DUGAN. Certainly, and I do think this situation today is quite a bit different than the one that we had with the savings and loan crisis.

Mr. BACHUS. Oh, absolutely, and let me say, I'm not in any way equating the seriousness of that situation. The economy is very strong today. The fundamentals are very good, so I associate with Secretary Steel in his talk about how strong the fundamentals are. And I know that we've all talked about the strength of the banking system.

Mr. DUGAN. I think there were some good things that the government did when it got to the point of responding to that problem. There were some things that were issues. I think one of the lessons learned was when we waited so long to respond, and when I say we, I mean the entire Federal Government. Whether it was Congress or the regulators, it meant that the reaction in some cases wasn't overcorrection and resulted afterwards in allegations of a credit crunch and people being too conservative in the kind of credit that they were willing to provide to consumers.

And that's why I do think in the current environment, we have tried to stay on top of this at the Federal level, at the supervisory level, to impose guidance and new standards. We have to be sensitive not to pushing that too far so that people don't stop altogether providing the kind of credit to creditworthy subprime borrowers over time. We don't want that to happen.

And so I think staying on top of things in an orderly way and addressing problems as they arise instead of waiting too long to react, I think, is absolutely critical.

Mr. BACHUS. Thank you.

The CHAIRMAN. Thank you. Actually, I'd forgotten that you had been counsel to the Senate Banking Committee and any advice you can give us on how we can improve our relations with that entity would also be very good.

[Laughter]

Mr. DUGAN. Where you stand is where you sit. I'm not touching that one.

The CHAIRMAN. I'm not saying that. I'm just saying, since you sit where you sit after they voted, I don't expect you to answer the question as a confirmed appointee.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Having been in recess for the month of August, it was interesting to see the credit crisis unfold, and, with our not being in Washington, unable to get any responses or understandings, I suspect all of us have come up with different conclusions of what caused the problem, what some of the solutions may be, and what I am most interested in—the long term ramifications of what may happen if other things exacerbate the situation.

For instance, if the real estate prices were to continue to fall precipitously, if we were to move into a recession, if the resets in the mortgages will come due in 2008 and 2009, are we doing an analysis to come up with a methodology of how to handle those problems or are we just going to breathe more simply within a month? The credit crunch seems to be over and we go back to the normal state that we were in before the past 2 months?

As regulators, what are your intentions along those lines?

Mr. STEEL. Oh, I'll start sir. From the seat that I occupy, I think of this just exactly along the same lines as you do. I think there are four issues that are the gating points for us.

Number one, there are principles that should drive what we think about in the near term. And number one, the first and foremost thing to focus on, is how to have the most successful efforts to keep American homeowners in their homes. Number one.

Number two is in the process of doing that, we should be sure not to provide any rescue or bailout to investors or lenders who made these loans.

Number three, we should quickly get at the issues that seem to be party ingredients of these challenging market conditions: securitization; rating agencies; and things like that.

And the fourth thing is to take what we learn in the third bucket and apply it to the longer-term perspective of what the right, regulatory framework is for the financial system. Those would be the four ways that I would think through the issue, and that's the time sequence too. First and foremost is how can we help people who were facing the resets stay in their homes?

Mr. KANJORSKI. Okay, let me, along those lines, suggest something because we mentioned the historic nature of the S&L crisis, which I do see a parallel to, although the panel does not seem to see it. I don't see that it is nearly the nature of the same crisis, but the solutions that are being batted around, perhaps in the Administration, sound somewhat similar to the S&L crisis.

If you recall, in the late 1980's, somebody came up with the brilliant scheme of supervisory goodwill. Does anybody remember that dirty word? And we took the good S&Ls and forced them to put supervisory goodwill on their books and forced them to take bad S&Ls. And I think there has been some analysis of the S&L problem at the late period of the 1980's showing that it would have been only a $20 billion problem if we had addressed it at that time. For $20 billion from one source or another, all of the bad mortgages and bad situations in the S&Ls could have been resolved. But instead, we used the supervisory goodwill concept, and we infected good S&Ls with bad S&Ls and bad paper. And, ultimately, within 2 or 3 years, the problem became a $200 billion problem.

Now, I hear people talking about those two great institutions, or three great institutions already out there, but particularly Freddie Mac and Fannie Mae. The people are suggesting we get these folks involved and have them empowered to buy some of this bad paper or bad mortgages. I have great fear in doing that because the very same scenario, which I suggested in my earlier question, should we do that, would put them at risk and certainly strain their positions. And then we would have the real estate market really go awry and have us go into a recession. And then all hell is going to break loose and we are going to have a multi-trillion-dollar disaster or perhaps a systemic failure on our hands.

Are the regulators talking about that? Are you discouraging, in the Administration, the talk of using Fannie Mae and Freddie Mac as the lone ranger here?

Mr. STEEL. I guess it's back to me. I think that dealing with this issue in my mind is a three-part process. Number one, working with the servicers to identify those loans that are facing resets and basically getting direct line of sight early for borrowers who are facing resets. Number one.

Number two is getting those borrowers, once they've been identified, connected with qualified counselors, for example NeighborWorks, so they can get good, impartial advice on where they stand and what the best solution is to their situation. And the third part is trying to develop innovative products, both with private sector participants, public sector, like FHA, and also with the GSEs. At Treasury, we have reached out to GSEs to talk about specific products that they can offer. These are products that should be based on marketplace values, not in a subsidy form. And I'm convinced that by focusing on these three aspects: one, servicers; two, counseling; and then three, new products that actually can allow them to work, will be the right way to focus on it.

Mr. KANJORSKI. Mr. Steel, I appreciate that, and I have a great deal of respect for you, as an individual. But, one, your Administration is not going to be in office when the full impact of our financial crisis hits, probably in 2 years, 2½ years, or 3 years from now. And two, I find it very hard to believe that somebody sitting somewhere in a position of regulatory authority did not start to raise the question that liars' loans may not be the best banking practices anyone ever heard of, or that 110 percent financing of mortgages may not be the most positive thing that people ever heard of.

The excesses that were allowed to build up and occur strike me as almost panic, get on board, and get all you can while the good days last. And I do not have a great deal of confidence that you're all going to be able to predict what is going to happen over the next 2, 3, 4, or 5 years to the safety of the system if you have missed identifying that we are on our way to a very serious problem when all this occurred.

I mean, I am not at all surprised that it happened. As a matter of fact, it is probably more delayed. I thought that it was going to happen a little sooner than it has happened. I still can't conceive of people buying securities based on 110 percent financed loans of applications made by people who did not have the capacity to pay the initial loan. I have only sat on a small bank board, but I can't ever remember that type of loan getting the approval of the board of that bank. But apparently, it got the approval of some of the regulators.

Is that correct, or not?

Mr. DUGAN. Well, I would just say from the point of view of the SEC, and I think it's true of the other Federal regulators, there were concerns registered by the regulators that we advised the institutions we supervised. We did have concern with a number of the practices that you just described, and particularly the combination of those practices.

And that is the kind of advice that we begin giving our examiners that then spread to the guidance that we put into place with the non-traditional mortgage guidance which began in 2005 and then was ultimately adopted last year and then the subprime guidance. There has been a process about that. I think it goes back to something Chairman Frank said earlier. More of that was being done by the Federal banking regulators than was going on outside of the bank regulatory system.

The CHAIRMAN. Ms. Bair, do you want to respond?

Ms. BAIR. Yes. I think the bank regulators have issued very strong guidance, both with regard to non-traditional mortgages as well as subprime, requiring things like underwriting at the fully-indexed rate, and placing severe restrictions on stated income loans. The Fed now has a very unique opportunity to extend those types of rules to the non-bank sector, and that is exactly what Chairman Bernanke has proposed. They will be moving with it before the end of the year, so I think we are moving ahead with the tools that we have.

The CHAIRMAN. The gentleman from Louisiana.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. Steel, I read with great interest your narrative about the process which has led us to the current circumstance and with regard to regulated financial institutions, there appears to have been guidance issued by regulators and apparent exposure and actual losses are significantly less than other sectors of the market that were non-traditional lenders. But now we see the contagion moving over to the commercial paper side, because of much of the collateral being provided by real property. And we're not sure how far the liquidity squeeze will actually go, thereby denying people access to credit, not even mortgage borrowers, just traditional businesses.

I read with some concern that a vacuum cleaner company withdrew its intended plans for a debt issuance because of market conditions, and it's one after another that are now reigning in their expected growth plans. And that will have another layer of effect with lack of jobs that would have been created, construction opportunities, and so this will continue to have some effect, unknown to one extent.

My question is, isn't it generally true that market operatives are going to act on that information much more quickly than a regulatory regime and the regulators' role is to observe, watch, and advise. But it's to stem the contagion as best we can once it starts, because the guys who were putting their money up and writing the check, who were looking across the table at the guy who's selling them the product, are the ones to be asking the right questions before the contractual obligation is entered into.

My observation is that there is very little, I think, that the United States Congress could put into effect to keep people from making bad business judgments unless we're going to require Federal Government representatives on corporate boards. I mean, where are we going with this?

I understand that businesses make money. I also understand businesses lose money. Our job is to just watch and make sure it doesn't get into innocent third parties who had no participation, no judgment, did not condone, have knowledge of, and make sure they're not hurt. But as to gains or losses within the normal world of businesses, is there a role, in your view, for the Federal Government to step beyond where we are today?

Mr. STEEL. Well, Congressman, I think the way that I would reference back my comments earlier that I made with regard to Chairman Frank's opening observations, and that is that the regulatory structure we have to our view could use a fresh relook. That's what we at Treasury plan to do, and I can't tell you where that will go. Let's do the work before we have the conclusions.

Mr. BAKER. But in the world of lending, if you wish to come to my institution, and you have a poor credit history, and you're buying a modest home, and I choose to make you the loan, and you signed the deal, there's not a governmental role in prohibiting that activity. Certainly, we should make the borrower aware of what he's getting into. We should condone professional conduct by the lender, but we can't prohibit somebody from entering into an ill-advised deal.

Mr. STEEL. Judgment and risk taking are part of the process and people exercise good judgment and sometimes less good judgment.

Mr. BAKER. Is there anything that we could require in the way of disclosure between business participants in the mortgage world because of the significant implications to the broader economy that is now not disclosable to parties to transactions?

Mr. STEEL. Well, I think that the regulators, both Federal and State, have given several different examples since earlier this year. Whether it's the issue about the subprime standards that should be used for underwriting and just lately, yesterday, the way in which modifications and refinancings can be reviewed.

I think in the same basis, the Federal Reserve Board intends to provide comment by the end of the year on both TILA and HOEPA, and these are forward looking reviews of how we're doing currently. And I would think that those are the right places to place the bets for the best feedback on these issues.

Mr. BAKER. Well, I just hope we will use our best financial judgment in moving forward with such recommendations. I want to join with my colleague from Pennsylvania with regard to the expression of concern about the expansion of responsibility of Fannie and Freddie, and Federal Home Loan Bank for that matter.

I would add on to his observation about the S&L crisis, the next step in resolution was to create the RTC, the Resolution Trust Corporation, whose mission in life was to take a dollar's worth of assets and sell them for 13 cents. It was a heck of a job and it only ensured that we had inordinately larger taxpayer losses than we would have had, had we used I would call common sense asset disposition methodologies.

And this is bad stuff. People are losing money. Homeowners will be denied access to credit. Businesses are going to be adversely impacted and I think it is a business lesson learned that when you go too far out on the risk of chasing greater return, there are consequences. And, unfortunately, I think that's what this episode is teaching us.

One last thing: from the early identification of defaults which I think you alluded in your testimony was October or November of last year, until the time the broad market liquidity crunch occurred, how quickly did one follow the other?

Mr. STEEL. Well, I think that all of us—excuse me. Let me speak for myself. I think that the way in which the credit questions spread from subprime mortgages to other types of collateralized mortgages into other types of securitized product was faster and swifter than I would have imagined. And so that happened more quickly. But we had talked and I feel as though there was a lot of voice given to the fact that in general, the economy, people had become quite risk-comfortable in lots of ways. In almost every asset class you go through, people were demanding less and less return for accepting marginal risk.

So I think the tinder was dry for something like this to begin, and where it would begin and how it would spread is pretty unpredictable. But I think the risk premium and the way that was being priced made it apparent that we were at risk of people having taken too much risk and then retrenching from that risk-taking process, which is where we are now. But now there are signs that the risk-taking is beginning to come back into the system.

Mr. BAKER. But it wasn't an irrational jump to risk. It was more of a slide into risk over a period of time.

Mr. STEEL. Yes, and I think as I said in my written testimony, usually the ingredients to this are increasing comfort with risk and periods of economic activity, low interest rates, etc., make people comfortable. Investors, basically, are stretching for return and therefore accepting more risk, and borrowers take advantage of that situation and you have this cycle that works in that fashion.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Actually, we got exactly to the point where I wanted to pick up anyway, because Mr. Dugan has on a couple of occasions used the benchmark as the conventional institutions that the Comptroller of the Currency regulates have done much, much better in terms in this foreclosure process than others, which I think is a relevant criteria, but leaves open the question of how have those institutions done in this crisis in comparison to prior times?

Is the level of foreclosures as a result of this comfort with taking more and more risk, how has that played itself out, not in comparison to subprimes, but in comparison to historical patterns?

Mr. DUGAN. So the question is on foreclosures, generally, across the whole mortgage market. Well, I would say that clearly the trend line is up overall. It is not at the record levels that we have seen in the middle of recessions like we had in 2001, for example.

Mr. WATT. But the President told me we weren't in the middle of a recession. So in comparison to like times, did this comfort that Mr. Steel has described with taking more and more risk, did it result in the traditional mortgage market accepting more and more risk in comparison to like periods of time in history?

Mr. DUGAN. Well, I think if you look at, and I have a graph here that I actually could show you, if you look at the actual aggregate level of delinquencies and defaults, it hasn't gone up that much historically. The real spike has been more on the subprime area. But you are right that the level has gone quite a bit higher than it has been in non-recessionary times, which is an indication of the nature of these products, the lax risk underwriting that Secretary Steel was just referring to.

So, it's sort of a combination of both. We have not seen the same leakage of problems to other parts of the prime.

Mr. WATT. You made that point several times. I just wanted to make sure that in saying that we don't hide the fact that across the market the acceptance of risk has been, I guess, in the former Secretary's words, there was an irrational exuberance in the mortgage or lending market for a period of time.

Is that generally accepted now?

Mr. DUGAN. Well, I guess I would say that there were certainly parts of the market, not including the subprime that we tried to address in the non-traditional mortgage guidance where there were certain features about negative amortization and interest-only loans, and somewhat lower downpayments that we were raising concerns about that we hadn't seen previously.

So, to that extent, I would agree with you.

Mr. WATT. Okay. And one of the concerns that some of us have expressed and tried to get to the bottom of is the extent to which institutions that are regulated by the OCC at some level are owners or investors, or have subsidiaries that deal in subprime mortgages substantially.

To what extent are you all monitoring that, because one of the concerns I had with one of my own institutions—two of my own institutions—from my congressional district buying into Countrywide, for example, was that they were going into an area of the market that might not be subject to the same level of regulation.

Mr. DUGAN. Well, if it's a national bank or a subsidiary of a national bank, we regulate it the same. We regularly give it full-blown, on-site banking supervision.

If it's an affiliate of the bank through the holding company, then that's regulated by the Federal Reserve. And in the case of Countrywide, that's a thrift, and the entire organization is subject to regulation by the Office of Thrift Supervision. So I can only speak specifically to the ones that we regulate directly.

Mr. WATT. All right, my time has expired, apparently. So I'll leave that alone.

Mr. KANJORSKI. [presiding] The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. Again, I share the concern of many on this committee with the broader capital markets' reaction to what we see in the subprime mortgage market.

To ensure that we have the facts, since in some previous testimony it has been mentioned in several opening statements, but as I understand it, subprime borrowing accounts for roughly 13 percent of the outstanding mortgage debt in the United States, and the latest data that has come across my desk show that 83 percent of all subprime borrowers are paying on time, which means 17 percent were either delinquent or in foreclosure.

I think somebody, and perhaps it was Ranking Member Bachus or another member, I do not recall, did the math and said that we have roughly 2 to 3 percent of the mortgages that are in foreclosure.

I would like to ask anybody on the panel, do you have a different set of facts? I am just trying to assess the scope of the problem within the subprime mortgage market. Are those roughly accurate facts?

I see a nodding of the head in the vertical position.

Mr. DUGAN. Yes.

Mr. HENSARLING. Those are roughly the facts. I do not want to put words in anybody's mouth. I think I heard, Secretary Steel, you say something along the lines that we have seen some positive changes in that market, and something along the lines of investors are demanding changes. I think I heard the Comptroller say the market has corrected some of the worse abuses.

Is that an accurate assessment of what I heard earlier today? Can you give us a little bit of greater detail on exactly what market players are doing?

Mr. DUGAN. Yes. I guess there would be two aspects. If you look at underwriting standards in the subprime market, I think there clearly has been a move away from low documentation mortgages to demand more documentation.

There has been a move towards going away from low or virtually non-existent down payments to higher down payments.

There has been a move away from the shorter dated 2/28 and 3/27 mortgages to longer term mortgages.

Just to be clear, that was happening but in the most recent liquidity situation where so much of the subprime market depended on the securitization, there really are not many subprime loans being originated that cannot be held on the balance sheet of depository institutions at the moment.

Mr. HENSARLING. Mr. Steel?

Mr. STEEL. I think your characterization is correct and there is—let's pick one more example. It has been written about to a great degree, that there were a large amount of leverage loans that were in the process of being distributed that basically did not get distributed because of the market turmoil.

Those loans came to rest on the balance sheets of institutions and now, just as we sit here today, they are beginning to move and be distributed at prices different, lower, than they were originally bought by the financial institutions. That is happening, to use my words earlier, as credit is being re-priced and returns are being offered at a more appropriate level as opposed to the level where people might have hoped they could be distributed earlier.

That seems to be happening in that example in an orderly way and just beginning. There will be losses by the financial institutions that took them onto their books, but the distribution should happen over the weeks and months ahead and in what I would describe as an orderly way.

I defer to the regulators because they are looking at their books. That would be my description of the situation.

Mr. DUGAN. I would agree with that.

Mr. HENSARLING. I think there is general acceptance from most people on the committee that risk based pricing of credit in certain innovative products within the mortgage market have helped lead to some of the highest rates of home ownership that we have had in the history of our Nation.

I know there are some advocacy groups who have come to this committee to essentially outlaw certain mortgage transactions, like the 2/28, that they think are particularly abusive to the consumers.

Are there certain mortgage products that you see that have such a threat perhaps to our economy that this committee should just consider outlawing certain mortgage products, and if so, what standard of judgment should we use? Whomever would like to answer that one.

Comptroller Dugan?

Mr. DUGAN. I guess I will start. I, for one, would be quite reluctant to outlaw any particular product normally speaking. Having said that, I do think there are some terms which we thought were so potentially questionable and abusive, we did add it to our guidance on subprime, for example, having prepayment penalties that extend beyond reset periods to me is something that goes beyond the pale of what a normal market should operate.

Secondly, I think there is a very good case that a lot of these loans with these features were not being adequately disclosed, and I think it is absolutely critical that they be disclosed and there be a competent system for disclosing them.

In terms of actual products, I think there are many different kinds of innovations that have led to positive things and sorting out which ones are the most positive and somewhat less positive is generally not something that the Federal Government is good at doing.

Ms. BAIR. If I could, back to your earlier question, those statistics are certainly ones I would agree with and have used myself.

I do think it is important to understand the context. A lot of those current loans are current at the starter rate of these 2/28s and 3/27s. We will be having a lot of resets, which is why we got the servicer guidance out. We think there will be about 1.5 million mortgages throughout this year and next that will be resetting where borrowers cannot make the higher payment. That is one of the reasons we got the servicer guidance out.

I would agree with John. I think it is very problematic to just try to prohibit products. I do not think that is particularly helpful.

The approach we used in the subprime and the NTM guidance regarding adjustable rate or so-called teaser rate mortgages, is requiring underwriting at the fully indexed rate. So you can make the loan, but just make sure that the borrower can re-pay the loan.

I think that is a pretty basic underwriting standard. For banks, it is certainly familiar. I think it will be helpful and should be applied across the board.

Certainly, prepayment penalties have been subject to a lot of abuse and that might be one good area where you might just want to add certain categories of inappropriate practices.

Mr. HENSARLING. Thank you. I am out of time.

Mr. KANJORSKI. The gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

I am one of those who are surprised that everybody seemed surprised with what has happened in the market. While I would agree with the math that several of our colleagues have cited of the very small percentage of subprime loans that have evidently set off the chain reaction of things that have happened, one percent of one percent of a problem with a clot in your bloodstream causes the end of the total system.

Despite the fact that the math might argue that it is only a small percent, the consequences in certain systems can be absolutely dire. I think that is what we have here.

I am really surprised at the surprise. If we had allowed State motor vehicle bureaus to operate and have an independent system of basically unregulated originators of driver's licenses, and they went out and had advertising to potential drivers who wanted licenses that said, "Need a driver's license, cannot drive? No problem. No test needed. Road rage convictions? Legally blind? Do not worry."

Then we were shocked to see accidents up and down the highway, most of them involving a lot of good drivers, all caught up in a catastrophic situation.

We have all seen the ads, yet, I do not know if alarm bells went off in people's heads or they just ignored it. I do not know if anybody has taken a look at where the problem is with the small percentage as cited of subprime borrowers who cause the problem versus others and whether these so-called subprime loans were originated by bank banks or non-banks to see where we should be focusing our attention.

I guess the first question I would ask is, when these people advertise, whom are they trying to reach? I guess it is a question that is more rhetorical than anything else, when you advertise "Cannot get credit, no problem. Bankrupt? No problem. No background check. No income verification."

You see this in ad after ad after ad. Then we are wondering why these people who have been seduced by the very important lure of home ownership wind up in the tragic situation of losing everything, besides the damage that it has done to the financial markets.

My first question would be, who is supposed to do the oversight of the people who are doing this kind of advertising, the results of which should have sounded the alarm bells?

Ms. BAIR. I think the Federal Reserve Board has the authority for unfair and deceptive acts and practices which can include deceptive communications. That is shared jointly with the FTC.

I share your concern. I still see them. I have some friendly mortgage originators who spam fax me at least twice a week; I am still getting them.

Mr. ACKERMAN. Which agency has done anything about it?

Ms. BAIR. I think the Federal Reserve, under its HOEPA and TILA authority, can address unfair and deceptive communications to consumers.

Mr. ACKERMAN. They can, but have they?

Ms. BAIR. And the FTC may, as well.

Mr. ACKERMAN. "Can," but have they?

Ms. BAIR. I do not know that they have specifically addressed teaser rate advertising, but we are certainly hoping that will be one area they will be looking at as part of this package of rules they are currently working on under HOEPA.

I think advertising a teaser rate without fully disclosing the fully indexed rate compared to a 30-year benchmark comparison is something that is highly problematic. In our guidance to our own banks in terms of consumer communications, we have said that the communications need to be balanced, that you should not disclose a teaser rate without also disclosing the fully indexed rate.

Mr. ACKERMAN. It is not just disclosing. If they are advertising no background checks, if they are advertising if you do not have good credit, do not worry about it, we are going to get you a mortgage, it is obvious that they are marketing to people who are going to have problems.

They are not trying to deceive anybody necessarily. They think they are going to be able to make the mortgage payments and do not understand what is going to happen in the market when the interest rates go up.

Ms. BAIR. Those are bait-and-switch tactics, and we see these. I ask my staff sometimes to follow up, to find out what is going on. Frequently, it is a bait-and-switch, where they say you can get the credit under these circumstances, and of course, you cannot, once you call.

That type of bait-and-switch is generally regulated by the FTC. If they are not banks, we really cannot do much about it. I do not think those are banks that are doing those types of communications.

Mr. ACKERMAN. I suspect you are right on that. Just to get an idea, what do you think if your agency has some oversight responsibility in this area?

Ms. BAIR. For non-banks?

Mr. ACKERMAN. For anybody that—

The CHAIRMAN. Will the gentleman try to phrase his question in a way that the recorder can more accurately capture it? I do not think hand raising makes its way into the record.

Mr. DUGAN. I think all of us have the power to take action for unfair and deceptive practices on an enforcement basis.

Mr. ACKERMAN. Have we?

The CHAIRMAN. If the gentleman would yield, is that not only for banks? You can do it for national banks, FDIC, the State banks, but the issue is if they are not a bank.

Mr. DUGAN. That is right. If they are a bank, we can, but we cannot write rules about it. That is the other issue.

Mr. ACKERMAN. If they are not a bank, who oversees this?

Mr. DUGAN. The Federal Trade Commission.

Ms. BAIR. Right.

Mr. ACKERMAN. And they are not here?

Mr. DUGAN. Correct.

Mr. ACKERMAN. I see my time has expired.

The CHAIRMAN. I do want to make it clear that the Federal Reserve asked not to be here today. They will be here after the hearing on September 20th, 2 days after the Open Market Committee. It would be about as far away from an FOMC meeting as we could get.

The Federal Reserve is the one agency to whom we would ask those questions. Maybe it should be the FTC, too. Primary jurisdiction of the FTC is with our friends in Energy and Commerce. They agreed before that they would not object if we had them here. We should probably add the FTC for the September 20th panel.

Mr. ACKERMAN. I thank the chairman. I ask unanimous consent, I have an opening statement that I would like to place in the record.

The CHAIRMAN. Yes, so moved.

The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. I am going to focus my questions less on the damage that has been done and more on the potential damage that could be done, which would be much much greater if this whole thing leads to an economic slump.

Secretary Steel, you mentioned the same thing I mentioned in my opening statement, about this risk premium that exists out there for all kinds of loans now, commercial real estate, residential real estate, etc.

If people coming into the market cannot get new loans or the loan rate to buy that house that has been foreclosed or whatever is too high, then that is the sort of thing that will lead to a drop in housing prices which can then lead to lots of undesirable things.

Do we want to do anything to try to deal with that risk premium and is there anything we can do to try to deal with that risk premium in this committee?

Mr. STEEL. Let me comment, to try to answer the question, in a broad sense, and then I am not sure about this committee, but let me just speak—

Mr. CAMPBELL. Yes, I should have made it broader.

Mr. STEEL. My experience would suggest that this is a process that basically has to work itself through. Right now, as I tried to say earlier, when the questions about the subprime market spread to other securitized products, then at some point people just said I do not care for any risk right now, I will take a time out. The market effect was that when you saw the price of Treasury bills move up dramatically and rates go down, people chose to kind of find the safest harbor to be part of.

What we are seeing now—that went on for a short period of time. Now what we are seeing is liquidity return to the market and begin to look to take on risk, but at different prices with greater returns than they might have had 6 weeks ago.

The example I gave of the leverage loans that were issued at 100, bought at 98, and maybe now will be distributed at 95.

What happened is that asset is still a good asset but it is a more attractive asset at the clearing price as the market digests all the ingredients and goes to a new level of risk premium.

Mr. CAMPBELL. I guess my question, to delve further into it is, is there adequate transparency on the real risk? Some of what I have heard is people say we thought this was AAA paper, we thought this, we thought that, we did not know you were not using docs, we did not know this, we did not know all this other stuff.

Therefore, they are now making that risk which may or may not be appropriate into virtually everything that is out there.

Mr. STEEL. This might be unpopular but that is okay. I think there is also some attention needed on investors. Investors basically were at the scene of the situation and maybe they should have asked for more information. I think what you will see in addition to the re-pricing of risk will be a re-basing of information and diligence on behalf of investors, which will also be a good thing to have develop here.

I think it is quite logical that as the market evolves and adapts, people might decide they want better—investors might decide they want better line of sight on descriptions, on characteristics, and on understanding before they invest, and move to the strategy of maybe investigate before you invest, and do it more directly as opposed to third party verifiers.

Do not take somebody else's perspective, maybe look yourself to see what is under the portfolio as opposed to taking somebody else's word. I view that as a good and logical process, and the investors not doing their work is consistent with what I tried to describe of the syndrome that developed—

Mr. CAMPBELL. Can we help that process?

Mr. STEEL. I think the things we are trying to do in the Administration were basically to look at some of the root causes, and my third point to Mr. Kanjorski's question was what are some of the issues here where better diligence, where we can be helpful, securitization, rating agencies, and things like that, and trying to bring diligence to those audiences.

Mr. CAMPBELL. I am running out of time. If I can quickly get one more question for Mr. Dugan and Ms. Bair.

Relative to the regulated entities, my question is broadly what level of concern should we have relative to the financial health of regulated entities with questions like do any of the regulating entities, banks and so forth, have recourse on some of the loans that they packaged and sold?

Did they have resource with originators who no longer exist perhaps for things that were packaged and sold, and do you analyze or look at any regulated entities' loan portfolio, how much of it is resetting and to what degree it has a greater percentage of resets with maybe Alt-A or some other sort of credit risk that bears a risk to their portfolio?

Ms. BAIR. We have been closely monitoring this on a number of fronts. The first thing we did several months ago was to identify our institutions that had significant and direct exposure to subprime and Alt-A.

Again, as indicated earlier, a lot of this lending, especially the very weak underwriting, was done outside the banking sector. We had some banks. We identified a couple of banks. Those have undergone heightened monitoring and examination processes. There have been some put-backs of loans that had early defaults or violated covenants or whatever. We closely monitored that.

I think the good news and bad news of securitization was that the risk has been more dispersed. A lot of this lending was done outside banks, and even when the banks were doing it, it was securitized, and most of it now has been put back.

There is not a lot of concentration on the balance sheets of the banks for which we are the primary regulator.

We are closely monitoring. We are doing special exams of those that we think have particular exposures. Overall, we think the banks are in pretty good shape.

Mr. CAMPBELL. They are not holding recourse on paper that is not on their books?

Ms. BAIR. Are you referring to the ABCP market? John might want to address that. If you are talking about the commercial paper market, there are liquidity and credit supports that large banks provide. In the asset-backed commercial paper market, there has been a lot of press about some of those assets coming back on the balance sheet of the larger banks.

Mr. DUGAN. I think there are some circumstances in which there are contingent funding lines, for example, that may need to be drawn down. Banks do have to hold capital even on that contingency. They would have to hold more capital to the extent they brought it directly back on their balance sheet.

With respect to some of the subprime loans that you were asking about which were originated and sold by them, in most cases, we believe there is no legal recourse that would require them to take the mass of those assets back on their balance sheets.

It is something that we look at, and as Chairman Bair indicated, we do think it is a manageable level of credit exposure to subprime loans that the national banks now have.

The CHAIRMAN. If the gentleman would yield, does that have any relevance to the entities that you supervise under your consolidated supervision?

Mr. SIRRI. I think from our point of view, we are mostly concerned again about issues about liquidity at the holding company level. Right now, as we have gone into these firms and looked at them, we have been quite content that they have adequate risk management procedures and liquidity in place.

The CHAIRMAN. The ones you supervise are not threatened by this?

Mr. SIRRI. No.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Let's talk about these no income verification loans. There are kind of two financial worlds out there, the world of securities that you folks represent, and the world of taxation that Mr. Steel may bump into if he walks down the hall of Treasury.

The question is why have you, as regulators of the financial markets, turned a blind eye to the fact that those you are regulating were facilitating tax fraud or at least insulating those who chose to commit tax fraud from any inconvenience when they went to get a loan?

Did you take into account in deciding to allow and to continue to allow these no income verification loans the effect that has on whether paying taxes continues to be the norm in our society or more and more taxpayers just begin to think that they are suckers for filling out an honest return?

I will start with Mr. Steel. You had a chance to make it more difficult for those who chose to commit tax fraud, did you take into consideration the effect of your decision on the overall tax system?

Mr. STEEL. At Treasury, we are not making the specific rules that—

Mr. SHERMAN. Let's move on, to Mr. Dugan.

Mr. DUGAN. I just want to be clear about the question. When you say "tax fraud," I am not quite sure what you mean.

Mr. SHERMAN. When you have a no income verification loan, this is basically a loan for those who have decided to commit tax fraud, those who decided not to file, those who decided to file phony returns. People saying I have money to pay the mortgage, I just have not told the IRS about it.

Why do the folks who regulate the financial field—why did they not take into consideration the effect on our tax system of allowing the very kind of advertisements that Mr. Ackerman was talking about and the general impression that those who commit tax fraud will not be impeded in their effort to get a home with no credit?

Mr. DUGAN. I guess our view on this is a little bit different. If there is no obligation to collect income in order to make a loan ever, theoretically, if someone had $1 million and they wanted a $10,000 loan, and they had it in their bank account, you would never have to look at their income.

On the other hand, there are many in most cases where income really is quite important to—

Mr. SHERMAN. If I can interrupt. These are all stated income loans. It does not say income, we do not know. There is a standard number that is not subject. They are not asking about a no income stated loan. I am asking about no income verification loans.

The loan docs have a number and you deliberately advertise that you are not going to verify it, this is a loan packaged for those who choose not to complete an accurate tax return. Why did you allow it?

Mr. DUGAN. I think our concern is more that people would pretend or potentially invite them to pretend they made more income than they actually made in order to get a bigger loan that they could not repay, and that is something—

Mr. SHERMAN. That is what you also invite with this.

Mr. DUGAN. That is where we look at, will this loan get repaid? It is something we have very strong concerns about. I gave a speech about this about 6 months ago.

Mr. SHERMAN. Strong concerns. Did the agencies prohibit those under their umbrella from buying and holding and processing these no income verification loans?

Mr. DUGAN. I think what we would say is that this practice began to creep into the mortgage underwriting practice as a more and more standard practice, particularly in the subprime and the Alt-A area, and over time, we began issuing stronger and stronger directives against it, culminating in the most recent subprime guidance.

Mr. SHERMAN. After the hurricane hit, you decided to issue something saying they should be built to standard. You could have prohibited this practice 10 years ago. It was going on 10 years ago. Why did you not?

Mr. DUGAN. I am not sure actually that it was going on, to a great extent, 10 years ago. It has developed over a period of time where some lenders maintain that they can determine the repayment capacity solely from—

Mr. SHERMAN. Ms. Bair, are you going to tell us that we did not have no income verification loans until just the last couple of years? Have you been looking at this at all?

Ms. BAIR. In the interest of self-defense, I have only been here a little over a year in this job. John is relatively new as well. I would say John has been one of the leading critics of stated income and was very active in making sure we had very strong standards against stated income in our guidance.

Mr. SHERMAN. They were still making stated income loans 3 months ago. A strong press release is not action.

Ms. BAIR. Not in banks. Not in our banks. If we find out, we do not allow it. We have cited banks. I do not think those are banks that are doing it now.

Mr. SHERMAN. Let me go to Mr. Sirri. Why do we allow the financial markets to trade in no income verification loans and why do we allow them to be highly rated?

Mr. SIRRI. The one thing that we do not tolerate in securities markets is fraud. What we have to be clear about is what is the disclosure that surrounds these instruments.

Our authority is limited. We will not tolerate fraud and we will follow through where that appears to be the case. For there to be fraud, there has to be some type of misrepresentation or omission associated with the offering of the security.

Mr. SHERMAN. Is not misrepresenting a security—when it is backed by quite a number of loans issued by people or taken out by people who are attracted by lenders who advertise if you want to lie about your income to either the IRS or to us, please come in, you are the kind of customer we want, why would such loans be part of A rated pools?

Mr. SIRRI. It is a difficult question. The issue evolves around the facts of the particular offering. It depends upon the disclosure. For example, the underwriter may state, we do not attempt to verify any of the characteristics about the collateral. Where they state that, the case for fraud may be more difficult.

It is very, very difficult to make a general statement about this.

Mr. SHERMAN. I believe my time has expired.

The CHAIRMAN. I thank the gentleman. The gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you all for being here today.

What the chairman said in his opening remarks, the discussion on a disincentive for irresponsibility, and when we see not those that many of you regulate but some in the subprime mortgage sector going bankrupt, I think that shows the real disincentive for irresponsibility. Bad judgments. Bad business calls.

This discussion about the income and everything else, that is an area where the marketplace is regulating itself and righting itself.

The question is, what do we do as a body, as a Congress, as a government, do we overreact in this time and further clamp down credit which will, I believe, exacerbate the problem going ahead when people are going through these resets and trying to access the credit markets again.

To make sure the market can actually work and function so we can get some of these folks when the reset comes, get them into mortgages that they will not automatically default on again, or just simply default on the mortgages they currently have.

I think we actually need to make sure that when and if we do act, we have to do it in a sensible way and a measured way. We cannot overreact.

Ms. Bair, in your testimony you state that non-traditional loans "invite unscrupulous lenders to impose onerous terms on less sophisticated borrowers who might not fully understand the true costs and risks of these loans."

In June, the Federal Trade Commission released a very interesting study, and I think an important study about mortgage disclosures, including, "The current disclosures fail to convey key mortgage costs to many consumers," and "In both prime and subprime, borrowers failed to understand key loan terms."

In their study they found, as you well know, that about a third of borrowers could not identify their interest rate; half could not correctly identify the loan amount; two-thirds could not recognize that they would be charged a prepayment penalty; and nine-tenths could not identify the total amount of up-front charges.

I know there is some corrective action taken from the Fed and other Federal agencies. What is happening on that? How is that working? What can be done?

Ms. BAIR. I think, clearly, mortgage disclosure needs an overhaul. I do not think we can solve it all with disclosure. I think there are certain basic core underwriting standards that need to be affirmed across the market, not just with banks.

The disclosure clearly needs to be more understandable and more meaningful. I think this needs to be joint with the Fed and HUD because HUD has part of the jurisdiction over this.

To the question earlier as well, about misleading teaser rate advertising, we not only need to make sure we affirmatively require helpful and understandable disclosures, but also get more aggressive in terms of prohibiting marketing practices that are deceptive.

Mr. MCHENRY. I am just asking about mortgage disclosures. This is a huge component of it. When you have a stack of paper in front of you, you are signing a legal document for the largest financial transaction most Americans will ever make in their lives, and people walk away not having any inkling of what they signed.

What can be done administratively to correct this mortgage disclosure issue or what should be done constructively, legislatively, to ensure there is real disclosure?

Ms. BAIR. The Fed has jurisdiction over this under HOEPA and TILA, and HUD under RESPA, for closing documents. It is something again for insured banks. We certainly require they make balanced fair disclosures in terms of clear disclosures, understandable disclosures. A lot of this is in the non-bank sector and we do not have jurisdiction.

Mr. MCHENRY. My time is running out. Mr. Steel, the President announced his policy on Friday, that I am sure you were a major part of constructing.

What is being done within the regulatory process to actually fix that issue or should Congress act to ensure there is a key amount of disclosure so people understand the key terms of the loans they are making or they are signing and agreeing to?

Mr. STEEL. I think this idea of understanding really, the President charged the Secretary of the Treasury to focus on this and come back and report. The Federal Reserve is also working on this. This is another aspect also that has been part of the program mentioned on Friday of financial literacy.

The Secretary of the Treasury has been charged to look into this. The Federal Reserve is working, and financial literacy is part of the same issue. We look forward to collecting ideas, working with Congress, and figuring out the best way to bring light on this issue.

Mr. MCHENRY. Thank you.

The CHAIRMAN. As I recall, it was part of the President's plan to do a re-do of RESPA, so on September 20th, we will get some more answers. We will hold the parties on notice that there is interest on that piece of it, improvement to convey information. That will come before us again on September 20th and HUD will be here then.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Mr. Steel, the Fannie Mae portfolio is currently capped at $727 billion, according to the consent decree by Fannie and its regulator, OFHEO; is that correct?

Mr. STEEL. Yes, sir.

Mr. MOORE OF KANSAS. Can you explain the factors that were involved in determining this dollar level? What was the rationale or what is the significance of this $727 billion cap?

Mr. STEEL. I was not here at the time, but let me tell you what I know from having studied this. Basically, there were several factors and there were a list of seven or eight that went into the calculation. This was negotiated between the safety and soundness regulator, OFHEO, as you correctly described, and the two entities.

There were adjustments made to the capital required, a premium capital was required. There were specifics as to the business model they could pursue and limitations on growth in the portfolio until certain conditions were met. This was negotiated between the safety and soundness regulator and the entities themselves.

Mr. MOORE OF KANSAS. Do you know what kind of conditions you are talking about here?

Mr. STEEL. Specifically, I can give you an example of one. There was a premium of capital required, where the normal amount of capital would be "X," then in this case it was "1.3X" until certain conditions were met, so as to allow them to move back into a more normalized state.

Mr. MOORE OF KANSAS. As you just indicated, the consent decree says that since this portfolio cap for Fannie Mae, it lays out several scenarios that might warrant temporary flexibility. One of the scenario's is for market liquidity issues; is that correct? Do you know?

Mr. STEEL. I do not know that specific language, but that sounds correct, sir.

Mr. MOORE OF KANSAS. There appears to be a real problem of liquidity in the secondary markets right now and we are seeing many lenders change their credit criteria for the loans they will make, some to the point where it is even affecting the terms and availability of credit for customers with good credit histories.

I think it is important that we improve the regulation of the GSEs and I hope the Senate will soon vote for legislation like the House has passed that would accomplish this goal, but I also think the GSEs could play a positive role in helping alleviate some of the problems that we are experiencing in the market today.

Given the Administration's position against a temporary increase in the cap, should the committee conclude that your position is that our Nation is not facing a market liquidity issue that could be benefitted by Fannie refinancing more of these loans? Should there be more flexibility there?

Mr. STEEL. There are three or four questions. Let me try, and please help me if I do not speak to the issue on your mind.

Mr. MOORE OF KANSAS. I will.

Mr. STEEL. The issue of the size of the portfolios is an issue for the independent safety and soundness regulator. I am not privy to the request that was made or to the response provided by the independent regulator to the regulatee. I know what I have read just as you have.

There is the ability—the issue of increasing the caps on performing loans really lies with Congress. That is the issue.

There are flexibilities that Fannie and Freddie can decide relative to their business model and they have announced initiatives to try to be helpful.

The last point I would make is that at Treasury, we have had a constructive dialogue with Fannie Mae and Freddie Mac about the issues going on in the mortgage market and how they might be helpful, given the current guidelines under which they operate.

They are constructive people, and we are trying to work with them to imagine when I described earlier what I view as the three-part dance of identification, counseling, and products; hopefully, the GSEs can be part of this product solution within the current construct of how they are allowed to operate.

Mr. MOORE OF KANSAS. Can Fannie and Freddie help improve liquidity through an increased cap to refinance more mortgages? Do you believe that is a possibility?

Mr. STEEL. I think the area they are prescribed to operate in, the conforming loan market, has been one that has been working among the best of the different markets, and that one has been working well.

Mr. MOORE OF KANSAS. Thank you, sir.

The CHAIRMAN. Interesting point. You say the area where they are allowed to operate has been working well and the areas where they are not allowed to operate have not been working so well. Would not the logical thing be to suggest that maybe we should expand the area of their activity so that other places could work well, like in the jumbo area?

Mr. STEEL. I think that your question is a fair one and I thought about it a great deal. I think the issue here, sir, is a balance between—

The CHAIRMAN. I like that. That is good. I will take it. The gentleman from New Mexico.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Steel, I do not want to spend too long on this, if we are to look at risk reward and the opposite of reward is pain, if we could, and I do not think we can, but if we could categorize all the pain that has been felt from the situation, that is the opposite of reward, who has borne what percent of the pain?

In other words, loan originators have probably experienced some of the pain. Capital market investors feel some of the pain. Probably some of the large funds.

If you can kind of categorize how much pain has been felt by what sector and do not leave the consumer out either.

Mr. STEEL. I think that was going to be my starting point, sir. If you look at this issue, the people, as I said earlier when I walked through the focus of the Administration, the first issue is to focus on homeowners.

Mr. PEARCE. No, I am not asking what we are going to focus on. I am asking where the real pain has been experienced in the past in this circumstance that has already occurred. Is that even too complex to even address?

Mr. STEEL. I will do my best. I wanted to make the first point that I think the most pain is being felt by the homeowners. Now I will move onto the question in the marketplace, who has been affected.

I think we saw this first spread in mortgage backed securities where basically the market has re-valued those types of assets, and in particular, those dominated by subprime. That is where the most market value has been re-evaluated. If you looked at that, that would be second. We know the size of that relates to the different pieces of the mortgage market.

Secondly, you would have to say that the next risky category of mortgages has felt some distress also, but there have been ripple effects out into other parts of the system, as I alluded to earlier in leveraged loan areas.

Mr. PEARCE. Mr. Dugan, if I go to your report and I am looking on page two, I read a very straightforward comment that insufficient liquidity has occurred outside the commercial banking sector and the national banking system remains safe and sound.

For me as a pilot, vibrations are something that sometimes you get a little tremor and that is it, that is the last you feel of it. Your wing might be about to fall off, but it is the only indication you are going to have.

When I go to Ms. Bair's page 20, she gets to the real concern I have that this tremor indicates maybe our banking system is not quite so sound. She talks about the lower capital levels required under Basel II, and she begins to say on page 21 that the entire assumption is insufficient given poor performance, and in fact the risks and stresses are impossible to quantify.

What we have done under Basel is we have scooted the risk derivatives and all those things that none of us know exactly about except you guys at the table, we have scooted those outside the measurement criteria.

I do not think it is possible for us any longer to say that our banking system is really in good shape, because the risk criteria is not measured by you all in the banking system. It is someone else's problem just outside there.

Long term capital management brought us very close to a realization that the system is very high-strung, it is very highly-wound, and small tremors can mean large problems.

Mr. Sirri also addresses that same problem, the diminished liquidity, on page one of his testimony.

We hear your testimony saying everything is great, the banking system is really sound, but I see these warning signs from the others. Can you address that if you would, please?

Mr. DUGAN. Sure. I guess what I was trying to say in the testimony is that the liquidity issue that we have seen in the market has been far more pronounced outside the banking system than it has been inside the banking system because inside the banking system, you have insured deposits. You have a federally regulated scheme. You have the Federal Reserve's discount window standing behind certain kinds of loans. All of those things have meant that institutions that are banks have had far greater access to liquidity—

Mr. PEARCE. I am about to run out of time here.

Ms. Bair, if we are going to take that, that the liquidity is sound inside the system, is it possible for illiquidity, non-liquidity, whatever we are going to call it, to transpose itself right through those barriers, that is the banking system, is that possible or is that a fear that I have that is just not possible?

Ms. BAIR. I would not say it is impossible. I would not want to suggest it would happen either. I think all institutions are being challenged right now. There is no doubt about it.

But one advantage banks have over non-banks is the ability to access deposit funding as well as other sources of liquidity such as the Fed's discount window. I think those are tools that put banks in a better position. But everybody is being challenged right now.

Mr. PEARCE. They have access to capital based on the capital requirements and the capital requirements continue to drop and drop.

Ms. BAIR. Not yet. We are still on Basel I. Regarding Basel II implementation, we will do a parallel run next year and then start up implementation a year after that. So we are still on Basel I. The leverage ratio is over 8 percent, which is historically a very strong high level. Banks have $255 billion in excess capital. That is a level above an aggregate that they—

Mr. PEARCE. Is Europe on Basel II?

Mr. BAIR. Europe is implementing now.

Mr. PEARCE. I think it was Mr. Sirri's comments that we are in an international market. Their illiquidity is going to transpose right across the system.

Maybe this tremor was just a slight tremor and maybe the wing is not going to fall off. I hope, Mr. Dugan, you are correct. I am going to lie awake at night for a while longer.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. BACA. Thank you very much, Mr. Chairman.

The first question I would like to ask is for Sheila Bair. Please describe the law that prevents brokers from selling people loans that are mostly costly when borrowers could qualify for better loans? This also applies to Mr. Dugan. Could you also respond?

Do mortgage brokers have any duty to offer consumers the best loan available to them? Question number one. What Federal safeguard should mortgage brokers and lenders put in place to ensure that all subprime borrowers are not taken advantage of and receive substantial loans.

The next question will be to all of you. Are any of you concerned that mortgage brokers are not federally regulated?

Ms. BAIR. I think a lot of these issues can and will be addressed by the Fed. We do not, but the Fed does have rulemaking authority for all participants in the mortgage process, whether it is banks or non-banks. I think there is latitude to address practices by brokers, even though they are not lenders.

I think disclosure, if you are going to do a teaser rate loan, requiring disclosure of the fully indexed rate as well as a 30-year benchmark is absolutely essential. Safeguards against steering are absolutely essential.

The thing that frustrates me about the hybrid ARM market is if you look at the rate sheets of a lot of these subprime lenders, the 30 year fixed rate is not that much higher than the starter rate of the 2/28, and I think a lot of these folks could have qualified for a 30 year fixed without the payment shock, maybe $50 or $100 more a month, which I think would have been manageable and preferable to having these payment shock loans that were underwritten under the premise that they would just refinance in a couple of years.

I think the guidance that we put out for subprime is a starting place for standards that should apply across the board and I think that can address a lot of the abuses that we have seen going forward.

Mr. BACA. Mr. Dugan?

Mr. DUGAN. I agree with those remarks. We have tried to address what we believed were the significant abuses as it relates to the institutions that we regulate.

I think the issue that has come up in a number of contexts about the most aggressive, most egregious practices, were occurring outside of the federally regulated sphere, and I think the central question confronting the Congress and the public policymakers alike is how to get a uniform standard in place so that the regulation matches what we now have at the Federal level.

As we were talking earlier, I think the notion is the States are trying to implement something new in that area to come up to that standard. I think the question of when the Federal Reserve will act by regulation, which I am sure you will talk about, and then the further question is, is that enough, whether you will need additional legislation, and I think that is the question that will be very much on the committee's mind.

Mr. BACA. Is there an oversight that looks at when you identify a subprime or mortgage loaner that actually gives the higher loan, is there some kind of an oversight to make changes to protect that consumer as well that may have signed on, once they have signed a contract?

Ms. BAIR. I think there are some short term rescission rights, but I think longer term, again, the ones I have seen were underwritten based on the assumption of continued low interest rates and home price appreciation, so there is never an expectation that a borrower could make the payment when it reset.

I think our push has been to try to encourage responsible subprime lending. Fixed rate mortgages are more appropriate, I think. Subprimes by definition are likely to have had less experience, or trouble with their financial management. To give them a product that makes them make guess about the direction of home prices as well as the direction of interest rates, I do not even want to do that. I think that is pretty challenging.

I think the direction is we want to encourage responsible subprime lending and come up with standards that will make the market more conducive to fixed rate products that are more appropriate.

Mr. BACA. I know I asked the question of all of you but I am just about to run out of time. I want to ask the following question.

What is your response to the home mortgage disclosure data that show that over half of African Americans and nearly half of Latinos are in subprime loans compared to 17 percent of white families, and have you looked into the cases of this, and are you concerned about its implication, and what do you think the Federal banking regulators, such as yourselves, or the Federal enforcement agency, could make more of an impact in fighting discrimination against Latinos, African Americans or protected classes?

Mr. DUGAN. Congressman, there was a hearing here last month about home mortgage disclosure and this very issue was front and center. It is a concern for all of us when we see that raw data suggesting that African Americans and other minorities are receiving a disproportionate share of higher-priced loans.

I do think it is quite important and it is part of our job to get behind that initial data, to make sure you are comparing people who are similarly situated to see the same kinds of loans.

We have not found the kind of discrimination that initial data would suggest, but it is something that every time we see that data, we need to re-double our efforts to make sure we are looking at the right loan characteristics.

Mr. BACA. Thank you.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Before I get started, I know most of the people here know, but we lost a dear colleague today, a member of this committee, Congressman Gillmor. My prayers and thoughts—and those of everyone on this committee and this Congress, I am sure—go out to his family.

I want to change direction a little bit and talk a little bit about how we fix some of the current situations that are involved in the marketplace today.

One of the things I said earlier was if we provide enough liquidity and capital into the market, that will give the marketplace time to work this out.

In the 1980's, we formed the RTC and we did some things which ended up being very costly for the American taxpayers and brought quite a bit of disruption to the real estate marketplace.

What I think we want to try to do is let the marketplace clean this up with the least amount of disruption to really a very important part of our economy, and that is our real estate economy.

One of the things that I know is different between now and the 1980's is we were dealing with financial institutions, and now we are dealing with people who are holding pieces of paper, and in many cases, people holding pieces of pieces of paper.

As we have these people who would probably be in the marketplace to buy some of these individual mortgages or pieces of these tranches and so forth, because of the documents and the relationships between the master servicers and the trustees, there is probably not a lot of flexibility.

We certainly do not want to go down the road of the Federal Government un-doing agreements in the marketplace that would cause a tremendous amount of disruption.

What I am wondering is, in the banking and financial marketplace today, are there any things that would be in place or inhibitions for the banking system to be able to help facilitate and finance, breaking these pieces up, because there is tremendous opportunity up side for people that are buying some of these discounted mortgages, if you can get them back into a conforming situation, and obviously that increases the value of that underlying mortgage, and then obviously the security as a whole.

What I am told is because of the different pieces, that a lot of these master agreements do not allow a lot of flexibility for the individual mortgages in the underlying paper to be worked out or payment modifications or rate modifications.

If there was liquidity in the marketplace, say for the banking industry or something like that, to help finance some of these entities that are willing to go in and look at being able to break out portions of those mortgages, is there anything that would be prohibitive in the current structure that would cause a bank to say, I do not want to get involved in that because that is going to be a classified loan, or it is going to change my capital structure?

I throw that out as a question.

Mr. DUGAN. That was one of the reasons why the agencies put out the recent guidance. I think there has been a lot of mis-information about the flexibility that servicers have to restructure individual loans once they have been sold.

I think this committee sent letters to the SEC and the SEC and the FASB have responded to clarify there is flexibility. We as bank regulators issued a statement to servicers under our jurisdiction jointly to urge them to take advantage of that flexibility more generally.

I think once you go beyond that, it is always governed by the terms of the service agreement, that contract with investors, and sometimes they do impose limits beyond the kinds of limits I was just describing.

I think to the extent that there are not such limits, there is quite a bit of flexibility. I think in some cases loans can be restructured in ways that the lender, or in this case the investor, would end up losing less money than they would if there was a foreclosure, so there is an economic incentive to do so.

I think in other circumstances, there will be some creative thinking required about different kinds of products, and I think that is what the Administration has been talking about, something they are going to be looking at very hard.

Mr. STEEL. I would only add that I think you are on exactly the right track. We need to encourage the servicers to take full advantage of the flexibility that might be in their documents and to pursue that, and the guidance provided by the regulators has encouraged that.

Then we need to look for additional ways to try to have as many of these loans reorganized to a market-based level as we possibly can, and put a thumb on the scale on behalf of the homeowner, would be our perspective.

The CHAIRMAN. There are going to be some votes fairly soon, so we are going to hold strictly to the 5-minute rule.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

I just want to go back to the other gentleman from Texas, Mr. Hensarling, who basically laid out a scenario that suggested that this problem was somewhat contained, and that most people, 87 percent of the people are still paying their mortgages, and that this problem is contained. He did not want to put words in your mouth, as he said, but he looked for your assent and he seemed to get it.

Mr. Dugan, your testimony does not seem to say that. It says that more recent data indicate that 90 day or more delinquency rates for securitized subprime mortgages have increased to over 13 percent in June 2007, and your testimony also says that increased foreclosure activity continues to spread and intensify, and according to RealtyTrac Inc., new foreclosure filings across the Nation, including default notices, auction sale notices, and bank repo's, increased to 180,000 in July 2007; that is 93 percent higher than reported in 2006. There is a fair degree of alarm here, and it is at odds, that exchange between yourself and the gentleman from Texas.

I just want you to tell me if you think this thing is contained. You also say if problems in the general housing market continue, we expect to see a further increase in mortgage delinquencies.

Where are we?

Mr. DUGAN. I would say two things, and I am sorry if there was a misunderstanding. I think with respect to the standards for new loans to be made to new borrowers, I think there has been something of a market correction, even an overcorrection, about the kinds of standards that would be put in place.

Where I do think there is still an issue are people who have loans now, and I do think you are absolutely right that we are seeing a trend line in which more foreclosures are increasing, delinquencies are increasing.

If you think about the way we look at it, a huge part of the subprime market where the most aggressive underwriting was taking place involved these 2/28 loans, and the period in which the standards were most lax was at the end of 2005 and all through 2006.

If you fast forward 2 years from those dates, you will see that this quarter coming up, you are going to see more resets, extending all through next year. That is the period, I think, that we are all concerned about seeing an increase in foreclosures that we are trying to get our arms around.

Mr. LYNCH. Let me ask you, in comparing mortgage activity, it seemed that the riskier, the more innovative mortgage products that were out there were being written largely by private mortgage companies, and when you look at the performance of the GSEs, Fannie Mae, Freddie Mac, you saw a smaller share of those riskier mortgages being written, the subprime mortgages in general, being written by the GSEs.

With respect to their portfolio cap, would it not be helpful, and I know it has been suggested by some that there be a modest increase in what their portfolio cap is right now by about 10 percent, would that not help the liquidity problem, to have them step in, in some way, to provide some relief there?

Mr. STEEL. The area that Fannie Mae and Freddie Mac focused on, the conforming loan market, as described, has been the area that has been working the best. They had the ability to help out in the top part of the subprime loan area.

Someone has suggested here—people have suggested on a couple of occasions that a large number of subprime borrowers could have qualified for prime borrowing, and in those cases, the GSEs could help.

They are operating under negotiated limits, if safety and soundness issues would have failed—the area in which they are proscribed to operate has been the one that has been operating best.

Mr. LYNCH. The negotiated limits were not made with a recognition of the situation we have right now. That is all I am asking for, some flexibility here. We have some proven entities here that could be helpful, yet we have an arbitrary limit that has been adopted largely by the President.

I just think there is some relief here that could be had if we lifted that cap. That is all.

Mr. STEEL. Those limits were negotiated between the regulator and the regulated entities, and they also related to certain requirements have to be met and then the caps are lifted. Those characteristics are being worked through, and I think Fannie and Freddie are moving towards compliance.

The CHAIRMAN. If the Senate were to take up the bill that passed the House, we would then have all those conditions satisfied.

The gentleman from California.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

It seems like a lot of the problems that are created in the marketplace were caused by the huge amount of dollars coming out of the stock market that lenders wanted to take advantage of, and they used it for subprime.

Chairman Bair, on page five, I really enjoyed your comment. You said, "In the absence of GSE sponsorship," that means there was a lack of GSE product out in the stock market to buy. "ABS's," which are asset backed securities, "were able to enhance marketability and obligations by restructuring theirs."

You also say there are trillions of dollars from investment grade mortgage backed securities that would have been better suited for hedge funds.

Would you please explain that a little better?

Ms. BAIR. I think we were just trying to put this in historical context. I think the enhanced returns and enhanced risks of the private label securitizations, lower rated tranches—

Mr. MILLER OF CALIFORNIA. The rates they would give to normal GSE sponsorships, they were able to get to these other forms.

Ms. BAIR. These are non-conforming loans. They did not meet the criteria that Fannie and Freddie had.

Mr. MILLER OF CALIFORNIA. Absolutely. There is a huge demand in the marketplace for those types of loans.

Ms. BAIR. Certainly for the returns that were provided. Those loans now are not so popular.

Mr. MILLER OF CALIFORNIA. What normally would be sponsored by a GSE, there was a huge demand for those, and there was a huge void because they were not able to put out as many as they did so the private sector filled those with very questionable risky loans to basically get a return.

Secretary Steel, you and I, I know we had a great conversation about what we thought the market should be and who should be playing in it. What do you think about the President's current position on raising FHA limits, when we talked last time, that was not even on the table?

Do you think that is an appropriate move at this point in time?

Mr. STEEL. There are two or three parts to the proposed FHA modernization bill that the Administration has been supporting. It relates to risk based pricing and other aspects which will allow FHA to do more and to be more active. That is really the proposal that is—

Mr. MILLER OF CALIFORNIA. They have to have reasonable underwriting criteria, so these are very safe loans we are making.

The problem I have, and many in this House have today with the GSE situation is, we think that it is being absolutely unfairly applied. What I mean by that is there are some members in whose districts the median home price is $150,000 and a GSE loan in that area is $400,000. That is almost triple what it should be, yet there are areas of the country that are high cost, like my area, for example. I gave statistics that in 5 years, FHA loans dropped by 99 percent because they are high-cost areas.

I am going to ask you a fair and reasonable question, and I would like a reasonable answer based on the criteria.

Do you think GSEs' underwriting criteria is adequate and their appraisal criteria to meet safety and soundness requirements today?

Mr. STEEL. I'm sorry.

Mr. MILLER OF CALIFORNIA. Do you think the underwriting criteria that GSEs apply to their loans and appraisal criteria are adequate for safety and soundness purposes?

Mr. STEEL. The loans that they are doing today are appropriate for safety and soundness, yes.

Mr. MILLER OF CALIFORNIA. Then my question is, when you look at areas of the country that have risen in price uncharacteristic of other parts of the country, but it is just because of supply and demand and the cost of land in the regions and stuff, do you not believe that if we apply the same safety and soundness criteria currently applicable to all other GSE loans, in those high-cost areas, there might be room to move up?

The reason I am asking that is because one thing the market needs is immediate liquidity, but it needs long-term liquidity, to deal with the housing problems we are facing in this country today and the foreclosure problems, money for a year or two does not benefit anybody, the long term criteria loan is what the market needs.

When you look at the GSE criteria, what they have done, they have lent money to people on 30 year fixed rate loans. It is what we need in the marketplace instead of these exotic loans that are out there.

Do you not think there is room if we applied good underwriting standards and appraisal standards to move up in some of these areas?

Mr. STEEL. You were good enough to explain to me the last time I was here with visuals about the prices and how it affected your constituents, and even first responders in your area, and made that clear.

I accept the point. When we worked through the GSE bill that passed the House, we worked with you to try to understand these issues.

Our goal is to work with the Senate and together to have a GSE bill—

The CHAIRMAN. Let me just interrupt. In fairness, when we outlined what we were talking about, we did agree, and it was last minute, I understand, the President did make these proposals. On September 20th, we are going to go over these in detail. I would hope that by September 20th, we can get some of these answered more.

We did basically ask them to be ready to come and talk about this more on September 20th.

Mr. MILLER OF CALIFORNIA. Some of us, and I know Chairman Frank and I even believe that FHA should be higher in some of these areas. We would like to see that approach.

I am just throwing it out. The GSE comment was not a matter of trying to be argumentative. In our areas, the high-cost areas, we are looking at if a GSE loan goes up to the amount we propose, people save about $175 to $180 a month in their payment. That is huge for people who might lose their home. I just wanted to throw that out as something for you to think about.

Mr. STEEL. I do not think that question is argumentative at all. I look forward to continuing the discussion.

Mr. MILLER OF CALIFORNIA. Thank you, sir.

The CHAIRMAN. We will all stipulate this is one time the gentleman was not being argumentative.

The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

I would like to ask very quickly each of you if you could respond to this first question. Who has been hurt the most by the subprime mortgage crisis?

Mr. STEEL. I will start, sir. I think as I answered the question for Mr. Pearce, that if you applied who would be most affected, I think it is the homeowners who were in the most perilous position.

If I might add, relative to your opening statement, HUD does have a national hotline for subprime assistance, and that is available for people who want help with subprime issues.

Mr. SCOTT. What we had in mind in terms of our hotline was a human being at the other end of the line, the people who were targeted most in predatory lending are largely unsophisticated and uneducated. They are people who need to call the hotline but have somebody "hot" at the end of the hotline.

Mr. STEEL. This has been connected to counseling services at HUD to try to help these people.

Mr. SCOTT. Is that consistent with the others, the homeowners?

[Panel nods affirmatively]

Mr. SCOTT. What I cannot understand is this reluctance to provide at least in a moderate way Fannie Mae and Freddie Mac from having the flexibility in this area. It is particularly true when you look at the fact that it is a part of their charter obligation to provide liquidity and stability to the secondary mortgage market, particularly during periods of market dislocation.

They have a consent order with OFHEO that allows for adjustments to the portfolio cap to address market dislocations.

It is particularly needed, I think, and it could be temporary. It could be 10 percent. It could be 12 percent. It could be targeted. I think for the Administration to just clamp down and say no concerns me.

The CHAIRMAN. Would the gentleman yield? This may have been my fault. I want to ask if we can defer that until the 20th when we have the hearing on the President's plan in context. Maybe I am hoping I will get an answer I will like more later. In fairness, we did say we would expect answers to that on September 20th.

Mr. SCOTT. All right. With that in mind, that was basically the gist of my concern. I will wait until September 20th.

The CHAIRMAN. I thank the gentleman. That was my cause of the confusion. The gentleman from Texas. I apologize for rushing you, but I would like to get to everybody.

Mr. GREEN. Yes, Mr. Chairman. I will accelerate the pace. Let's talk quickly if we may about the risk layering that has been mentioned by you, Ms. Bair. Who is going to regulate this when you have all of these various and sundry risks being placed on top of each other?

Right now, there is nothing regulating it. Who would you propose regulating this?

Ms. BAIR. We do regulate bank lending and we have through our guidance and supervisory activities put a lot of constraints on risk layering. Again, in the non-bank market, those are state regulated entities. The Federal Reserve does have the ability to impose national standards on the non-banking—

Mr. GREEN. If I may, you mention in your paper, and it is very well done, by the way, I enjoyed reading it, are you saying there is more that you will do in the area of risk layering?

Ms. BAIR. I think the risk layering was addressed, and I believe we are hopeful that the Fed will be able to address it as well under the HOEPA rules for non-bank lenders. We can only reach risk layering lending practices in the banking sector.

Mr. GREEN. Who is going to deal with the 2/28s and 3/27s and the onerous prepayment penalties? Who will eventually step in and regulate that or deal with that?

Ms. BAIR. For the non-bank lenders, the States do have some authority. They worked with us in developing our guidance and are trying to apply it.

The Federal Reserve Board, I think, is really going to be key here. They are undertaking a rulemaking right now.

Mr. GREEN. If I may quickly, we have pension funds that are investing in hedge funds, hedge funds are investing in the subprime market fronts. Many of these pensioners do not really understand how at risk their pensions are.

Who is going to look at this and make some determinations that maybe this area needs some sort of scrutiny because of the risk that the pensioners are placed at by virtue of the way this connectivity has developed?

Mr. STEEL. I can start if you wish and maybe defer to the SEC. This is an issue of private pools of capital that has been a focus of the President's Working Group. We believe there are four different actors in this situation.

There are the regulators, the regulated entities that finance the private pools of capital, the managers themselves, and investors. All four need to be diligent and vigilant with regard to their responsibilities.

When I spoke about this issue to Chairman Frank before, I said, and I remember quite clearly, the status quo is not acceptable. We are working hard now to increase the focus on this and develop best practices for each one of these people.

Mr. GREEN. Thank you very much. I yield back, Mr. Chairman. I would like to say that I think the President has stepped up to the plate. I think the Fed Chair stepped up to the plate. People are expecting the Congress to step up to the plate as well. People understand there is a crisis notwithstanding what is being said. Thank you.

Mrs. MALONEY. [presiding] Thank you. The gentlelady from Illinois.

Ms. BEAN. Thank you, Madam Chairwoman.

Mr. Steel, during the month of August, both the President and the Treasury Secretary publicly opposed raising the portfolio level for GSEs, which seems at odds with the President's recent announcement of lacking illiquidity, but is clearly inconsistent with the overwhelming bipartisan support of GSE reform earlier this year.

Given there is general consensus about the importance of a strong independent GSE regulator and yet it was the President, not OFHEO, who publicly stated that the caps would not be lifted until Congress passed GSE reform, should we be concerned that Administration policy might be influencing or interfering with what is supposed to be an independent safety and soundness regulator's authority?

Mr. STEEL. I do not think so. I do not remember the exact timing, but if my memory is correct, OFHEO had already announced their decision and communicated it to the regulatee at the time this question was asked of the President.

Ms. BEAN. Thank you. Second question, does the Treasury have broader concerns about the impact of what started in the subprime space on the overall economy, not just for those who have subprime loans and those who are unfortunately dealing with foreclosures, but for those in our districts who historically have good credit but have in many cases taken their credit card debt and then gone and gotten a home equity loan at a better rate or they have refinanced their home by borrowing against the equity to reduce that debt and that has helped stimulate our consumer spending, given that now the value of homes has come down so there is less equity to borrow against, there is less credit available now in the new space of access to credit, and you also consider some of the recent articles about how incomes in many cases are below levels that they were in 2001.

For many again who are historically good credit consumers, what is your concern about how that may affect the overall consumer spending?

Mr. STEEL. I think the second paragraph of my statement that I provided at the beginning really focused on the fact that the overall condition of the economy is quite good. If you pick any area, growth, inflation, employment, these are constructive things.

We had a period in the marketplace that has been unsettling. There are some signs now that this unsettled feeling is beginning to improve. There will be other issues or challenges that I am sure will develop as this process continues of improving, but I would be optimistic that while there may be some penalty to growth, because of this turmoil in the markets over July and August, we are still on a projectory to have good solid growth in the second half of the year.

Ms. BEAN. No concerns that what could be a short term problem in the B to C space could roll into the B to B space long term?

Mr. STEEL. I promise you I am concerned every day, but I think the specifics of this in terms of basically trying to understand what the likely effect will be on the real economy, I would stand with the description I have provided.

Ms. BEAN. Thank you.

Mrs. MALONEY. Thank you. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place the responses into the record.

The Chair recognizes herself for 1 minute, and then the gentleman for 3 minutes. I just have to ask a question about my home State, New York. In July, Governor Spitzer announced a very aggressive program. He announced $100 million to help at-risk families keep their homes, through partnering with Fannie Mae and Freddie Mac, who will be financing this initiative, the State of New York hopes to be able to refinance literally hundreds, possibly thousands of at-risk homeowners from the 2/28s and 3/27s and the 30 and 40 year fixed rate mortgages at competitive interest rates and keep them in their homes.

I understand that several other States have entered into relationships with Fannie and Freddie to do the same thing, specifically Ohio and Massachusetts.

We are concerned that we are going to be right up against the cap, and this would hinder the ability of New York to work on a local level to help people stay in their homes.

Again, it is a question that has been asked many times, but if there was ever a time that we should have more liquidity in the market and have more flexibility for Fannie and Freddie, it seems to be now.

Secondly, I support the initiatives that have come forward from the President and the Administration, but by even your account, this will only help 80,000 borrowers stay in their homes. There are at least two to three million who face foreclosures in the next 2 years, by even the Administration's accounts.

What are we going to do about them? We are concerned that because of Hurricane Katrina, 300,000 people lost their homes, but 10 times as many people may lose their homes in the subprime crisis. And what about the new guidance that came out, and it really responds to a letter from Congress on the servicers having more flexibility.

That in no way is going to take care of all of this problem. First of all, the problem of New York and Massachusetts and Ohio, where they have this relationship that can help keep people in their homes, but they need the flexibility if Fannie and Freddie are up against the cap to be able to keep them in their homes through this refinancing program.

Mr. Steel?

Mr. STEEL. Thank you. Let me try to start at the back and go forward. I am not familiar with the specifics of the New York proposal, so I look forward to learning about that and coming back to you.

Mrs. MALONEY. Very quickly, working with Fannie and Freddie that are financing that to help people stay in their homes, but they are going up against their cap, which means they may not be able to refinance them, to help them stay in their home.

It is a big problem. We need to raise those caps even if it is temporary.

Mr. STEEL. I think we are meeting with Fannie and Freddie, too, to talk about creative solutions for how to deal with this. There are other alternatives besides just buying loans yourself, and there are other ways in which they can increase their capacity.

With the second issue, 80,000 is the number of incremental FHA by the changes we have suggested. The total number is closer to 300,000.

Also, there are two million resets we are facing over the next 18 months, roughly two million. That includes things that are speculators, and it includes numbers that are not owner-occupied. We are focused on the homeowners basically themselves, individual single family owner occupied. That number is less than two million.

The third point is there are lots of things we are working with to focus on the servicers, the counselors, and other products to attack the rest of them.

I am optimistic that we will be successful to a great degree.

Mrs. MALONEY. Thank you very much. The Chair recognizes the gentleman from the great State of New York for 3 minutes.

Mr. MEEKS. I will only take 1 minute. Mr. Steel and Mr. Sirri, a quick question. This is the general market I am trying to find out about. Has the market reaction to holders of the subprime loans affected AAA rated money market mutual funds to your knowledge?

Mr. SIRRI. Money market mutual funds by definition have to hold very liquid paper. Under rule 287, which governs those funds, at a minimum, 95 percent of assets has to be in the highest rated paper, the other 5 percent can mean one notch lower. That is only a minimum. Besides that, the advisor has to go through their own credit analysis.

I think at the moment, events have not had a substantial effect on money market funds. Were that to have an effect, we have rules in place that would allow advisors to purchase some of that paper. In addition, our staff stands ready to work with those funds in case there is any dislocation in that market.

Mr. MEEKS. So far, it seems safe. Someone told me some people are putting money in there as a safe haven, investing in these.

Mr. SIRRI. So far, we have detected no serious problems.

Mr. MEEKS. Thank you. Last question of the day.

Mr. STEEL. I agree with Mr. Sirri.

Mr. MEEKS. I have been hearing this for a long period of time now. Are we heading for a recession given what is happening? Are we headed for a recession, in your opinion?

Mr. STEEL. Our view at Treasury is that the economic growth that has been going on in the second quarter will continue at a positive projectory into the third and fourth quarters and the economy seems strong.

Mrs. MALONEY. That is a good point to end on. The meeting is adjourned. We have missed a vote. The economy is strong.

[Whereupon, at 2:07 p.m., the hearing was adjourned.]

A P P E N D I X

September 5, 2007

Statement by Congressman Gary L. Ackerman to the Financial Services Committee

"Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy"

September 5, 2007

Thank you, Mr. Chairman.

Mr. Chairman, from 1995 until not so long ago, America's subprime mortgage market seemed to be in the midst of a boom. The law of gravity didn't seem to apply. Subprime products were so lucrative that brokers approved the loans hastily and sometimes recklessly, sometimes without requiring complete and proper documentation. Additionally, subprime products were being marketed to individuals who were not credit-worthy enough for a mortgage. Who are originators looking for when they advertise mortgages with no background check and that you can't be turned down? By all accounts, this rush to pass out high-risk loans was the first mistake. Individuals who had no business being approved for car loans were moving into new houses massively leveraged on easy money.

Originators then took these loans – many of which should have been assessed as much riskier than they were – and packaged them into securities to sell to investors. If there had been full disclosure, smart and careful investors would have judged that these mortgage backed bonds carried a disproportionately high level of risk. In an effort to deliberately mislead investors, however, some originators and credit-rating agencies, so-called Nationally Recognized Statistical Rating Organizations (NRSROs), colluded. First, the credit-rating firms would consult, or maybe we should say collaborate, with the originators – receiving high fees, of course – to advise the originators how to design the packaged securities to ensure that the riskiest piece of the product was adequately masked. Then, for another fee, the credit raters would assign overly favorable ratings to these mortgage-backed bonds, giving investors the impression that a neutral, unbiased party with a proven track record of assessing risk thought highly of these volatile products.

Essentially, the originators and credit raters shoved enough pigs and laying hens in with the beef herd that investors expecting prime ribs on their silver platter and money in their pocket ended up with pork ribs on their paper plate and egg on their face. The credit-rating firms were doubledipping; profiting first from helping to put these shady securities together, and then collecting fees for deliberately rating these risky products at a higher value than they were worth. It's like hiring a judge to advise you as to how to commit an act and then paying him to decide whether you have committed a crime. My strong view is that NRSROs conspired with financial institutions to fool investors by packaging and rating securitizations in a manner that was deliberately aimed at misleading them. This is the accounting firm telling shareholder companies how to fool their investors and then getting hired as independent auditors.

That's not the free market at work. That's fraud. Fraud is a crime, not a correction.

What I find, perhaps, to be most perplexing of all is that Congress already identified problems stemming from NRSROs and passed legislation seeking to increase statutory authority to oversee the credit-rating agency industry. In the 109th Congress, the Credit Rating Agency Reform Act of 2006 was passed by the House and Senate, and was signed into law by President Bush almost exactly one year ago. This legislation granted the Securities Exchange Commission much greater authority to regulate and supervise NRSROs. To my knowledge, and as the current financial debacle makes clear, the SEC has not acted to either discipline those NRSROs that were involved in these types of practices, or to make certain that these insidious practices are thwarted in the future. The SEC simply is continuing to examine the credit-rating industry, a study that has been ongoing since before the Credit Rating Agency Reform Act became law last year.

Here's a conclusion for the SEC: you're more than a few days late and more than few billion dollars short.

The SEC has all the tools it needs to act swiftly and appropriately, but it has failed to do so. Unless the SEC demonstrates to investors, quickly and convincingly, that they intend to clean up the mess that the banks and credit-rating agencies have created, Congressional action will be necessary. This Committee and this Congress will not be passive spectators as banks and credit-rating agencies use their control of information to fool investors into believing that a pig is a cow and a rotten egg is a calf.

U.S. Congresswoman
Ginny Brown-Waite
Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Committee on Financial Services

"Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy"

September 5, 2007

Statement for the Record

Thank you Mr. Chairman for holding this hearing today.

And thank you to the witnesses for your insight on this matter.

Like many Americans, what is happening in the subprime market today is bothersome to me.

This is because foreclosures do not just bring havoc to those losing their homes – foreclosures decrease the value of surrounding homes and depress an already sluggish housing market.

They also make it more difficult for all of us to get credit or loans for the things we need.

The effects of this restricted credit on America's economy were evident two weeks ago when the Fed finally had to take steps to settle markets after the Dow plummeted a few days in a row.

Owning a home is a dream that could be attainable to everyone in America.

After all, only in America can a person borrow money for a down payment, take out a first and second mortgage, and still call himself a homeowner.

Congress must ensure that those purchasing their homes are doing so through honest brokers, and they fully understand a balloon payment, mortgage insurance, negative amortization, and condo fees.

I look forward to hearing from the witnesses on their thoughts on the steps Congress can take to ensure that.

Thank you again Mr. Chairman.

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON CURRENT CONDITIONS
IN THE CREDIT MARKETS

WEDNESDAY, SEPTEMBER 5, 2007

Mr. Chairman, I commend you for convening this timely hearing. As we begin our fall legislative session, it is very appropriate for us to examine what transpired in our capital markets during the last month or so. The apprehensions of many participants in our financial markets about their exposures to financial products backed by American subprime mortgages helped to trigger significant volatility in our credit markets at home and abroad. This instability affected not only housing markets, but it also seeped over into many other commercial sectors.

Today's hearing will help us to understand at least some of the factors that contributed to this turmoil and the response of our regulators to these problems. It will also help us to discern whether Congress needs to take further steps to restore the confidence of investors in America's dynamic capital markets. Although I have not yet arrived at any conclusions, I have already identified at least three concerns that I expect we will begin to address today.

First, I would like to learn more about the transparency of our capital markets related to subprime mortgage-backed securities, consolidated debt obligations, credit default swaps, and the parties that package and hold these increasingly sophisticated financial products. From what I have read, it appears that the participants in our capital markets, as well as their regulators, have had significant difficulties in determining exposures to subprime mortgages that have defaulted or will likely default. We know from past experience that transparency and access to information provide the lubricant for our capital markets to work well.

Second, I am like you, Mr. Chairman, very interested in exploring the role that credit rating agencies played in contributing to these events. Many have already criticized their assessments of the creditworthiness of the financial products backed by subprime loans. Some have also suggested that their actions may have contributed to the engineering of faulty financial products. While we took action last year to reform the oversight of rating agencies, we may still need to do more. The testimony provided by our witnesses today will help to shape the hearing that the Capital Markets Subcommittee will hold on this issue in the coming month.

Third, I am very interested in examining how well the regulators created in the last century are responding to the problems of the new century. Our capital markets have significantly evolved since the creation of these overseers. After all, no one had conceived of mortgage-backed securities at the time we created the Federal Reserve and the Securities and Exchange Commission. Moreover, banks traditionally engaged in the role of making mortgages based on the amount of assets they held on their books. Today, financial companies accessing our capital markets often help families to buy a home.

As a result, the traditional lines between prudential regulation, investor protection, and consumer protection have blurred. Regulators now have multiple missions, such as the Commission's safety-and-soundness oversight of investment banks. In other instances, regulators are responding to problems in our capital markets using indirect means, such as the decision last month of the Federal Reserve to lower the discount rate in response to marketplace uncertainty.

Consequently, I intend to focus increasingly on whether our present regulatory architecture can anticipate and manage the risks of the modern financial system as the Capital Markets Subcommittee proceeds with its business during the remainder of the 110th Congress. I look forward to working with everyone interested in these issues in the coming months and invite them to share their ideas on these matters.

In sum, Mr. Chairman, we live in an increasingly complex and interconnected financial marketplace. We need to move deliberately and strategically to explore whether we need to update the regulatory architecture of our financial system. If we come to the conclusion that we do need to pursue such a change, we must also move carefully to modify the system in a way that protects investors and ensures the long-term stability and viability of our financial system. These are complex problems and questions, and I look forward to exploring them.

FOR IMMEDIATE RELEASE:
September 5, 2007

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Prepared Remarks of Congresswoman Maloney for Financial Services Hearing on Credit and Mortgage Markets

WASHINGTON – Congresswoman Carolyn B. Maloney (D-NY), Chair of the Financial Institutions Subcommittee, delivered the following remarks today at a Financial Services Committee hearing, *Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy*:

"Thank you Chairman Frank for holding this hearing on one of the biggest financial stories of the year and one of the most important issues confronting this nation - the turmoil in the credit and mortgage markets and its impact on consumers.

"After Hurricane Katrina, over 300,000 people lost their homes. About 10 times as many people may lose their homes to foreclosure due to the subprime crisis. The response from the administration has been slow. Therefore, I was pleased to see the President's announcement last week. His proposed changes at FHA to provide refinancing options to more homeowners and help borrowers by refinancing them into FHA loans is an important first step.

"I also support the legislative fix to change tax law so that cancelled mortgage debt is not treated as income. Individuals facing foreclosure should not get the double whammy of paying taxes on the loss in value of their home. These are helpful actions that Congress can take immediately. But it is not enough.

"Another item that can be achieved quickly is GSE reform. Fannie Mae and Freddie Mac are providing much needed liquidity in the prime market right now. If there was ever a time when they should expand their activities it is now. We need to raise the ceiling on the amount of mortgage that can be refinanced with federal insurance. We passed a GSE reform bill in the House. It needs to pass the Senate, or the administration needs to take action to raise the limit.

"I have always said that markets depend as much on confidence as on capital. Right now, there is a loss of confidence in rating agencies, and they deserve it. Large amounts of debt that are, or have been, rated highly are headed for default. As with Enron, the rating agencies have been dead wrong. Investment guidelines and capital standards need to be more accurate. We need to review the way ratings agencies are compensated by their clients and look for ways to strengthen regulatory oversight of these agencies.

"We also need a uniform national standard to fight predatory lending. We need to set a single consumer protection standard for the mortgage market.

"We have a great deal to do and I look forward to your testimony."

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Committee on Financial Services
Full Committee Oversight Hearing: Current Conditions in the Credit Markets
September 5, 2007

Thank you Chairman Frank, and Ranking Member Bachus.

Clearly this is an important topic and it has been dominating newspaper and evening news headlines all summer. But, I'm concerned about the direction that this hearing signals. As anyone paying attention can tell you, we're seeing a dramatic increase in the actual number of foreclosures.

To put the current "crisis" in prospective, according to the Mortgage Bankers Association, in the first quarter of 2007 there are about 44 million mortgages in the U.S., and less than 14 percent of them are sub-prime. And only about 13 percent of those subprime mortgages are late on payments, with the majority of late payers working through their problems with the banks.

With approximately 561,857 mortgages in foreclosures — up from roughly 517,434 from the 4th quarter of 2006 — the sub-prime "meltdown" has given us an increase of 44,423 mortgage foreclosures. Even with a dramatic increase in foreclosures like the one we're experiencing, this still represents a small percentage of the number of home mortgages.

One of the main reasons we have seen a rise in foreclosures is that, during the housing boom of the last few years, consumers with a higher credit risk qualified for mortgages. Now that those riskier loans, taken out in 2005, are resetting to higher interest rates at larger and larger amounts – a trend that will continue until April of 2008 - a credit crunch is occurring for those home buyers. It will take time to determine which of the mortgage backed securities contain "bad" loans and which don't, partially because the entire securitization process is relatively new and hasn't faced a market challenge of this size.

A comprehensive consumer advocacy driven predatory lending bill is not the answer. It is tantamount to fighting the last war and will only make the markets more skittish as they have to react to new underwriting standards and liability issues making the situation worse, not better. This would harm all consumers!

By the time a new "anti-predatory lending" law goes into effect in the marketplace, this problem will already have changed, and we will be left with strict, national underwriting standards that will prohibit various loan products and banish a number of consumers to the rental market forever. This is not a goal that is responsible.

Also, any legislation that creates additional liability in the secondary market will harm that market. The problem we're seeing in the market now is because we don't know which loans are in which securities. If trial lawyers are allowed to sue investors who buy mortgage-backed securities, investors will simply stop buying them. This would harm more people, not fewer. We saw this happen back in Georgia in 2001. We should not repeat that mistake so that Democrats can repay their campaign benefactors.

The American economy has more then enough liquidity and is plenty strong enough to weather this bump in the road. Congress should stay out of the way while the market corrects itself or it will only make matters worse. We saw last week just how strong the market is when the Commerce Department reported that the gross domestic product, the broadest measure of economic health, expanded at an annual rate of 4 percent in the April-June quarter, significantly higher than the 3.4 percent rate the government had initially estimated a month ago.

Congress needs to be very careful with how it proceeds. Bailing out investors who made bad decisions will create a moral hazard and ensure even riskier behavior in the future. Congress would better serve the American people by not legislating solely in response to a political desire. A more responsible course of action would be to continue to monitor the developments of the market, the response of the regulators and determine precisely the cause of the current challenge.

Though it is not the role of the federal government to ensure that everyone owns a house, it is the role of the government to ensure the market is vibrant and capable of responding to fiscal challenges. In our free market economy, the greatest rewards for the greatest number of people occur when Washington sets appropriate rules, but does not choose winners and losers.

Thank you Mr. Chairman.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

RECENT EVENTS IN THE CREDIT AND MORTGAGE MARKETS AND POSSIBLE IMPLICATIONS FOR U.S. CONSUMERS AND THE GLOBAL ECONOMY

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

September 5, 2007
2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the credit and mortgage markets. Events in the financial markets over this summer present all of us here today -- regulators, policymakers, and industry -- with serious challenges. The FDIC is committed to working with Congress and others to ensure that the banking system remains sound and that the broader financial system is in position to meet the credit needs of the economy, especially those of creditworthy households currently in distress. In my testimony today, I will discuss the developments that led to the current market disruptions, report on the condition of the banking industry, and describe ways to address some of the lessons we have learned from the events of recent months.

The Roots of the Current Problem

The chronology of the events that have led up to the present situation demonstrates how weak credit practices in one sector can lead to a wider set of credit market uncertainties that could affect the broader economy. Although these events have yet to fully play out, they underscore my longstanding view that consumer protection and safe and sound lending are really two sides of the same coin. Failure to uphold uniform high standards in these areas across our increasingly diverse mortgage lending industry has resulted in serious adverse consequences for consumers, lenders, and, potentially, the U.S. economy.

At the beginning of the most recent mortgage lending growth period, in 2002 and 2003, we witnessed a record boom in the volume of mortgage originations, driven primarily by the refinancing of existing mortgages. By mid-2003, as long-term mortgage interest rates fell toward generational lows, virtually every fixed-rate mortgage in America became a candidate for refinancing. The result was a wave of refinancing activity that was dominated by prime, fixed-rate loans. During 2003, some 64 percent of all mortgage applications were for refinancing, and over 80 percent were for fixed-rate loans. By the end of 2003, more than three quarters of U.S. mortgages included in non-agency securitizations were less than three years old.

With lower interest rates came higher rates of home price appreciation. As measured by the OFHEO Home Price Index, U.S. home price appreciation measured 5 percent or less in every year during the 1990s. But starting in 2000, U.S. home price appreciation rose to annual rates of between 6 percent and 8 percent followed by double-digit increases in both 2004 and 2005. This home price boom was concentrated at first in metropolitan areas of California, the Northeast, and Florida, and it then spread by the middle of the decade to much of the Mountain West and other cities further inland. While home prices were effectively doubling in a number of boom markets, median incomes grew much more slowly, severely reducing the affordability of home ownership despite the benefit of historically low interest rates.

Changes in Mortgage Lending

Home price appreciation helped set the stage for dramatic changes in the structure and funding of U.S. mortgage loans. To the extent that prime borrowers with a preference for fixed rates had already locked in their loans by 2003, the mortgage industry began to turn its attention -- and its ample lending capacity -- toward less creditworthy borrowers and home buyers struggling to cope with the high cost of housing. One result was a shift in the overall market from refinancing toward purchase financing, which rose to more than half of originations in 2004, 2005, and 2006. Another result was a larger share of originations for subprime loans, which more than doubled in 2004 to 18 percent of originations and then peaked at just over 20 percent in 2005 and 2006. Declining affordability in high-priced housing markets also contributed to a shift toward nontraditional loans such as interest-only and payment-option mortgages. Among mortgages packaged in non-agency securitizations, nontraditional mortgages rose from just 3 percent of nonprime originations in 2002 to approximately 50 percent by early 2005.[1]

The growth in nontraditional lending was associated with a larger expansion in so-called "Alt-A" mortgages, or loans made to presumably creditworthy borrowers where the terms and/or documentation of the loan fall short of the requirements placed on "conforming" loans.[2] In addition, borrowers who lacked the requisite 20 percent down

[1] "Breaking New Ground in U.S. Mortgage Lending," *FDIC Outlook*, Summer 2006, http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html.
[2] Conforming loans are loans that meet the standards for purchase or securitization by one of the government-sponsored enterprises (GSEs).

payment required for conforming loans could, in the nonconforming market, arrange to borrow their down payment through a second mortgage, or piggyback loan, and thereby avoid the cost of mortgage insurance that has traditionally been imposed on borrowers with high loan-to-value ratios. While nontraditional mortgages, subprime mortgages, and home equity loans were not new to the marketplace in 2004, they had never been originated on such a wide scale prior to this time.

Expansion of nonconforming mortgage lending has been facilitated by an increasingly diverse set of origination and funding channels. Origination channels include both FDIC-insured institutions and their finance company affiliates, as well as mortgage brokers and stand-alone finance companies that fall outside direct federal supervision. Funding channels include banks and thrift institutions, the housing-related Government Sponsored Enterprises (GSEs), GSE-sponsored mortgage pools, and, increasingly, private issuers of asset-backed securities (ABS). But an unmistakable trend that stands out as a driver of the changes we have seen in the mortgage industry has been the rise in the share of mortgages funded by ABS issuers, which rose from 8.5 percent in 2003 to 18.7 percent by 2006.[3] The availability of funding through private ABS facilitated growth in the "originate and sell" business model, under which a broad range of brokers and correspondents participate in originating mortgage loans without the need to provide permanent financing themselves. This model was pioneered by lenders selling conforming mortgages to the GSEs, but in recent years private ABS issuance has become a primary channel for the funding of subprime and Alt-A mortgage loans. Subprime and

[3] Federal Reserve, Flow of Funds, Table L.218. As of March 2007, the share of U.S. mortgage debt held by ABS issuers was 18.8 percent.

Alt-A loans together stood behind 77 percent of all private ABS outstanding as of May of this year.[4]

In the absence of GSE sponsorship, private ABS issuers were able to enhance the marketability of their obligations by structuring them into senior and subordinate tranches. The end result of this process was the creation of trillions of dollars in investment grade mortgage-backed securities (MBS) that were purchased by a range of domestic and international investors, along with a smaller volume of higher-risk securities that were better suited to hedge funds and other investors with an appetite for yield and a greater tolerance for risk.

In hindsight, it is clear that the strong performance of these securities -- both in senior and subordinate tranches -- during the period of low interest rates and rapid home price appreciation helped to obscure their true risk. While times were good, an excess volume of credit flowed to mortgages in general and nonconforming mortgages in particular. Ready access to market-based funding, in turn, contributed to what is recognized now as a serious weakening of underwriting practices. This deterioration of underwriting practices is perhaps best described by the term "risk layering," which regulators have used to describe the practice of allowing a number of different potentially risky underwriting attributes (such as low credit score, high loan-to-value, low or no documentation of income, etc.) in the same loan. These practices tend to compound the risk of default, particularly when permitted in combination. As long as home prices were rising, even these layered risks were often overlooked by lenders, borrowers, and

[4] FDIC calculations based on the Loan Performance Securities database.

investors. Rising prices delivered capital gains to existing homeowners that could be tapped through home equity loans or "cash-out" refinancing, thereby making default a relatively rare occurrence.

Another consequence of the easy credit availability afforded by lower underwriting standards and rising home prices was an increase in both the misuse of credit by speculators and perpetrators of fraud. While housing booms inevitably attract speculative investment, the prevalence of low documentation, low down payment loans in this cycle dramatically lowered the barriers to entry in this segment of the housing market. During 2006, loans to investors or for second homes made up a reported 7 percent on non-agency subprime securitized mortgages.[5] FBI data show that the number of suspicious activity reports (SARs) indicating mortgage fraud rose from fewer than 7,000 in 2003 to more than 35,000 in 2006.[6]

Meanwhile, the increasingly diverse array of loan types available to borrowers in this cycle invited unscrupulous lenders to impose onerous terms on less sophisticated borrowers who might not fully understand the true costs and risks of these loans. The culmination of this process was the subprime hybrid "2/28" or "3/27" mortgage, which typically combines a substantial increase in the interest rate and monthly payment on the loan after the initial two to three year starter period with a substantial prepayment penalty that limits the ability of the borrower to refinance the loan until that starter period is over.

[5] "An Introduction to the Subprime Mortgage Sector," Bank of America RMBS Trading Desk Strategy, June 27, 2007.
[6] Financial Crimes Report To The Public, Fiscal Year 2006. http://www.fbi.gov/publications/financial/fcs_report2006/financial_crime_2006.htm

Third party estimates of monthly payment "resets" on subprime adjustable-rate mortgages (ARMs) through year-end 2008 suggest the potential for serious financial distress for over 1.5 million households.[7] The Mortgage Bankers Association estimates that nearly 490,000 subprime loans were already seriously delinquent or in foreclosure as of March 2007.[8]

These looming payment resets are just one of a series of ongoing developments that amply demonstrate the consequences of failing to uphold a strong, uniform set of lending and underwriting standards across the mortgage industry. The transactional nature of the "originate and sell" model has contributed to lending practices that have damaged the immediate interests of consumers, mortgage lenders and mortgage investors, and now pose a risk to the broader economy. The housing boom has given way to declining home prices in an expanding list of U.S. metropolitan areas. Mortgage delinquencies and foreclosures are on the rise not only in subprime portfolios, but also in Alt-A portfolios, where risk layering is now contributing to credit problems that are no longer being masked by home price appreciation.

The Impact of Poor Mortgage Underwriting on Other Markets

The full dimensions of the problem in mortgage markets started to become clear late last year, as analysts noted the marked deterioration in the performance of recent loan originations. However, it was not until the middle of this year that we began to see a

[7] FDIC estimates based on payment reset projections provided by Credit Suisse.
[8] Mortgage Bankers Association, *National Delinquency Survey*, First Quarter 2007.

substantial number of downgrades in the credit ratings of some types of MBS. These downgrades have contributed to generalized uncertainty about the value of MBS and have in turn triggered redemptions at hedge funds, margin calls, and episodes of illiquidity in commercial paper and other areas of global financial markets.

Since the beginning of June 2007, the securities rating agencies have downgraded more than 2,400 tranches of residential MBS. Ratings downgrades led to decreased liquidity for many financial assets, not just those known to have problems. For example, the liquidity for MBS that were downgraded declined, but so did the liquidity for many securities where the ratings remained unchanged. The uncertainty that now pervades this market -- which is directly attributable to underwriting practices that are unsafe, unsound, predatory and/or abusive -- has seriously disrupted the functioning of the securitization market and the availability of mortgage credit.

Investor concern about ratings has become particularly acute in the markets for Asset-Backed Commercial Paper (ABCP) and repurchase agreements -- investments where credit risk is expected to be low and liquidity to be high. Investors' trust in the ratings assigned to the bonds and other assets used as collateral for ABCP and repurchase agreements has been integral to the orderly and efficient working of these markets. However, when ratings came into question, investors redeemed these investments and sought safety in short-term Treasury securities. During the third week in August, the volume of commercial paper outstanding dropped $90 billion, or 4.23 percent, the largest percentage decline since 2000. Almost 80 percent of the decline was in ABCP, which accounts for about half of all commercial paper. When commercial paper investors could not be found, some ABCP issuers were forced to use liquidity backstop funding to finance assets causing the rates on commercial paper to increase. Risk aversion among commercial paper investors caused them to err on the side of caution when deciding which ABCP to renew.

Credit concerns now extend more broadly to leveraged commercial lending.[9] During August 2007, credit market conditions became more challenging as investors and lenders worked to understand where the concentrations of credit risk would be most problematic. Most vulnerable were highly leveraged, poorly diversified and illiquid entities, including some hedge funds which had been buyers of syndicated loans. Illiquidity in the non-agency MBS market caused some fund managers to meet margin calls by selling non-distressed assets, contributing to weaker asset prices beyond the mortgage markets. Uncertainty about future asset prices reduced the appetite for funding for various asset classes, including leveraged loans. In some cases, originators were unable to find buyers for these loans and had no choice but to fund loans that they had originally intended to hold temporarily. Linkages between the credit and equity markets also became more apparent as the ability to raise debt funding to take public companies private came into question, causing the equity prices of targeted companies to decline.

[9] Leveraged commercial loans are those where the obligor's post-financing leverage as measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular industries significantly exceeds industry norms for leverage.

The Current Condition of the Banking Industry

Because insured financial institutions entered this period of uncertainty with strong earnings and capital, they are in a better position both to absorb the current stresses and to provide much needed credit as other sources withdraw. It is in times of financial stress that the role of federal deposit insurance becomes evident in promoting stability. Insured deposit accounts give consumers a safe place to put their money during times of uncertainty, and confidence in the safety of their deposits helps to preserve the liquidity and integrity of the financial system.

As the current period of financial stress began, both the banking industry and the deposit insurance system were sound. Two weeks ago, the FDIC released second quarter 2007 financial results for the 8,615 FDIC-insured commercial banks and savings institutions. The results reported in the *Quarterly Banking Profile* describe an industry with very solid performance. Second-quarter earnings were the fourth highest quarterly total on record -- only 3.5 percent below the all-time high. Also, the industry's return on assets of 1.21 percent remained strong by historical standards. Although the number of unprofitable institutions increased during the quarter, more than 90 percent of all FDIC-insured institutions were profitable. Nearly all institutions could be considered "well capitalized" according to the standards for Prompt Corrective Action, and the industry's leverage ratio remained above 8 percent.

Yet, it is clear that conditions for banks and thrifts are not as favorable as in the recent past. The interest rate environment continues to be difficult for financial institutions. More than two out of three institutions reported net interest margins in the second quarter that were below levels reported at the same time last year. The industry continues to generate strong noninterest income -- in the most recent quarter, noninterest income was 9 percent higher than a year earlier. However, some components of noninterest income, such as trading revenue and investment banking fees, can be subject to downward movements in times of credit market distress.

Of most concern, credit quality is likely to get worse before it gets better. Net charge-offs totaled $9.2 billion in the second quarter -- the highest quarterly total since the fourth quarter of 2005 -- and were 51 percent higher than in the second quarter of 2006. Net charge-offs of 1-4 family residential mortgage loans increased 144 percent from the prior year period, to $715 million. Noncurrent (90 days or more past due or in nonaccrual status) 1-4 family residential mortgage loans represented 1.26 percent of all such loans at the end of June -- the highest noncurrent rate for these loans since the first quarter of 1994.

Based on the challenges facing the banking industry, it is important to consider what recent market events may mean for banks and thrifts going forward. The current situation mostly affects lenders who rely on the "originate and sell" model, and this way of doing business is under intense pressure. There is a chance that larger volumes of loans may find their way onto bank and thrift balance sheets than has been the case in recent years. In some cases, insured institutions may choose to grow their loan portfolios. In other situations, banks may find themselves holding assets on a long-term basis that they planned to fund only on a short-term basis, if at all.

Many credit needs will have to be funded in the coming months. In terms of mortgage credit, an estimated $353 billion in subprime mortgages will reset between now and the end of 2008.[10] Opportunities may exist to originate and hold a range of nonconforming mortgage loans for which secondary market liquidity has receded. The commercial loan portfolios of banks and thrifts are also likely to expand as a result of a more difficult secondary market for commercial credit. Total outstanding commitments to fund U.S. leveraged loan deals in the second half of 2007 have been estimated at approximately $200 billion.[11] Moreover, the issuers of the approximately $1 trillion in ABCP outstanding may increasingly look to depository institutions as an alternative financing source when this paper comes due. Some of the leveraged loans and ABCP may reach insured institutions' balance sheets directly, as banks fund these deals through previously established backup financing arrangements, retain credits they originally intended to sell, or purchase this paper in the open market.

The problems in the credit markets represent both a challenge and an opportunity for FDIC-insured depository institutions. Among the challenges for the industry are the increased credit losses that already exist and are likely to continue in coming quarters. If the housing downturn continues, some institutions that are currently in good shape could face capital challenges resulting from losses in mortgage related assets. In general, however, the industry is well-positioned to manage these losses. This situation may also create opportunities for insured institutions to expand market share and improve interest margins as some credit market funding shifts from the secondary market to banks and

[10] "Mortgage Liquidity du Jour: Underestimated No More," Credit Suisse, March 12, 2007. Amount represents the study's estimated subprime mortgage resets from September 2007 through December 2008.
[11] "Company Flash," Citigroup Global Markets, July 26, 2007.

thrifts. Growth of portfolios, if it occurs, would pose a risk management challenge for many institutions, and institutions that expand their loan portfolios will have to maintain sufficient capital to support that growth. However, the currently strong capital base of the industry places it in a position to be a more important source of financing for U.S. economic activity through this difficult period.

Addressing the Problems

A full evaluation of lessons learned from this episode will require more time and more study. However, there are a number of near-term priorities that should be pursued now to minimize the adverse consequences of the present turmoil and begin to lay the groundwork for a more vigilant and more uniform regulatory approach going forward. In the near term, the FDIC will continue to fulfill its roles as supervisor and deposit insurer by defining and enforcing appropriate lending standards, working to suggest options for borrowers who find themselves facing financial distress, and monitoring the condition of insured institutions.

The FDIC continues to closely monitor the situation in the markets. While others -- including several of my counterparts at the table today -- are working to address the broader market issues, the FDIC will continue to play a significant role as the primary federal regulator of 5,214 commercial banks and state savings banks and as the deposit insurer for 8,615 banks and thrifts. Most of the largest mortgage lenders either are, or are affiliated with, an insured depository institution. Federal deposit insurance will assure the continued viability of a source of funding and liquidity -- in the form of deposits -- that is a vital underpinning of our financial system.

Improving Lending Standards

The FDIC and other federal banking agencies conduct regular examinations, monitoring and reporting on the mortgage activities of insured institutions. Further, the agencies have taken a series of steps to address developments in the mortgage market from both a safety and soundness and a consumer protection perspective. For example, in September 2006, the agencies issued *Interagency Guidance on Nontraditional Mortgage Product Risks* to address concerns about offering interest-only and payment-option adjustable rate mortgages to borrowers for whom they were not originally designed. The 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 time they are choosing a loan or deciding which payment option to select.

On January 22, 2007, the FDIC issued its *Supervisory Policy on Predatory Lending* 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.

Since the subprime market raised additional concerns, the agencies issued a *Statement on Subprime Mortgage Lending* on June 29, 2007. This statement makes clear that lenders should follow two fundamental consumer protection principles when underwriting and marketing mortgages. First, a loan should be approved based on a borrower's ability to repay it according to its terms (e.g., not just at the initial rate). Second, consumers should be provided with the information necessary to help them decide if a loan is appropriate for their needs. The statement cautions that such communications should not be used to steer consumers to subprime products to the exclusion of other institution products for which consumers may qualify. Relying on these principles, lenders can offer mortgages that meet the needs of most subprime customers in a safe and sound manner.

Although the FDIC and others recognized the changing nature of the mortgage lending industry, it is fair to say that the regulatory community, ratings firms, and others in the industry failed to fully appreciate the depth of the underwriting problems and the severity of subprime payment resets until late last year. Even though it was not reasonable to expect that home prices would continue to rise at double digit rates indefinitely, many of the emerging risks were masked by home appreciation. However, it also was apparent that subprime and nontraditional mortgages were growing asset classes that could expose many borrowers to payment shock. Seeing this, consumer advocacy groups were among the first to suggest that changes in the market might lead to more delinquencies and foreclosures.

Assisting Troubled Borrowers

The federal banking agencies have been working together for many months to address issues surrounding subprime mortgages, especially the possibility of increased foreclosures, and we have sought ways to help creditworthy borrowers who are currently in mortgages that are or soon will be unaffordable. In April, the FDIC and the federal banking agencies issued a *Statement on Working with Mortgage Borrowers*, which encourages financial institutions to work constructively with residential borrowers who are financially unable to make their home loan payments. The June *Statement on Subprime Mortgage Lending* reinforces the April *Statement*, encouraging institutions to work constructively with residential borrowers with troubled loans. In addition, in July, the agencies issued proposed updates to the *Interagency Questions and Answers Regarding Community Reinvestment*, including revisions which highlight that institutions can receive CRA consideration for foreclosure prevention programs for low- and moderate-income homeowners, consistent with the April and June *Statements*.

The FDIC, along with the other banking agencies, has jointly hosted a series of forums on the issues surrounding subprime mortgage securitizations. These forums have engaged market participants at every level in identifying barriers to working with borrowers to avoid foreclosure and developing solutions to permit borrowers to retain their homes. Importantly, every forum participant agreed that foreclosure of owner-occupied homes was rarely the best option for investors or borrowers.

Building on the information learned from these meetings with participants in the securitization markets, yesterday, the FDIC, the other federal banking agencies, and CSBS issued a *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* that provides instructions to the agencies' supervised institutions servicing securitized mortgage loans. The *Statement* urges institutions to review the governing documents for the securitization trusts to determine the full extent of their authority to restructure loans at risk of default. Most securitization documents allow servicers to proactively contact borrowers at risk of default, assess whether default is reasonably foreseeable, and, if so, apply loss mitigation strategies designed to achieve sustainable mortgage obligations that keep borrowers in their homes to the extent possible. The Securities and Exchange Commission and the U.S. Department of the Treasury have indicated that such servicing activities are consistent with acceptable accounting practices and controlling tax principles. As significant numbers of hybrid adjustable rate mortgages are scheduled to reset throughout the remainder of this year and next, the FDIC is encouraging institutions servicing such loans to carefully review the authority they have under the governing agreements and pursue prudent loan restructurings with borrowers to avoid unnecessary foreclosures.

It is equally important that when working with financially stressed residential borrowers, servicers should avoid temporary measures that do not address the borrower's ongoing difficulty with unaffordable payments. Institutions are encouraged to work toward long-term sustainable and affordable payment obligations that will provide stability for servicers and investors as well as borrowers. Clearly, fixed rate obligations provide the best opportunity to long-term stability. In developing a strategy to address payment difficulties, it is essential that servicers, as well as lenders, realistically evaluate the borrower's ability to repay the modified loan. One methodology commonly used by servicers is an analysis of the borrower's resulting debt-to-income (DTI) ratio. The DTI ratio should include the customer's total monthly housing-related payments (i.e., principal, interest, taxes, and insurance) as a percentage of their gross monthly income. In issuing the interagency statement, the FDIC and CSBS noted that, absent mitigating circumstances, resulting DTI ratios exceeding 50 percent will increase the likelihood of future difficulties in repayment and delinquencies or defaults.

Another effort to help troubled homeowners involves the FDIC's Alliance for Economic Inclusion. The Alliance is the FDIC's national initiative to form a network of local coalitions around the country charged with helping underserved populations in nine particular markets across the United States. As part of this effort, the Alliance for Economic Inclusion has partnered with NeighborWorks® America's Center for Foreclosure Solutions to promote foreclosure-prevention strategies for consumers at risk of foreclosure. Within each of the nine markets, the partnership is conducting outreach to identify and help homeowners at risk of foreclosure, work to increase lenders' support for foreclosure intervention, and promote best intervention practices in mortgage servicing programs for consumers at risk of foreclosure who could qualify for alternate financing.

Working with our federal and state regulatory counterparts, insured institutions, the Congress, and other parties, we are eager to help find solutions for borrowers who have mortgages they cannot afford.

Supervising Financial Institutions

The FDIC is responsible, along with the other federal banking agencies and state regulators, for monitoring insured institutions that may have exposure to troubled mortgages or related assets. Recently, exposures have manifested in the form of liquidity and funding issues for a small group of institutions that are significantly involved in mortgage banking activities. For the largest institutions whose actions can have a significant impact on the marketplace itself, the FDIC is working with each institution's primary federal regulator to monitor their on- and off-balance sheet activities. The FDIC has stepped up its offsite monitoring of other institutions with potential mortgage pipeline exposures and in some cases have made unscheduled visits to ascertain the effect of the current market interruption on their liquidity and capital. In the longer term, a significant downturn in the housing market may lead to asset quality deterioration for a larger number of institutions with heavy exposures to single-family construction loans as well as nontraditional and subprime mortgages. The vast majority of insured institutions are well positioned by virtue of their strong capital to deal with adverse conditions. Experience suggests that credit quality problems arising from economic conditions tend to play out over time. FDIC examination processes are well-suited to deal with these types of problems should they develop. The FDIC and our fellow regulators will remain vigilant as credit conditions change.

It also is important that financial institution supervisors do all they can do to improve consumer protection and make certain that rules for all market participants are consistent. The uncertainty that now pervades the marketplace -- which is in many respects attributable to underwriting practices that were sometimes speculative, predatory, or abusive -- has seriously disrupted the functioning of the securitization market and the availability of mortgage credit. In light of the credit quality problems that have already arisen and may yet emerge from MBS, investor appetite for all but high-quality, agency-conforming mortgages has been significantly reduced. Restoring the proper functioning of essential capital market processes requires that regulators better define and enforce the principles of sound underwriting for mortgage loans for all mortgage lenders, not just FDIC-insured institutions.

The Board of Governors of the Federal Reserve System (FRB) has recently solicited public comment on how to utilize its rulemaking authority under the Home Ownership and Equity Protection Act of 1994 (HOEPA) to prevent predatory lending practices. We encourage the FRB to exercise its authority to set strong national standards for all lenders that will eliminate abusive, unfair, or deceptive lending practices and consumer information, which have contributed to deterioration and uncertainty in our financial markets. The FRB's authority to reach all mortgage loan originators through a rulemaking under HOEPA gives it an exceptional opportunity to impose uniform and fair rules that protect consumers in their transactions with all mortgage loan originators, while maintaining a level playing field for banks, non-banks, and mortgage brokers.

The shakeout in the mortgage market also holds lessons for processes that rely on modeling to determine appropriate capital levels. A purely historic look at mortgage loan data would have suggested much lower capital levels under the advanced approaches of Basel II. Capital requirements generated under these assumptions would likely have been insufficient given the poor performance experienced in many of the nontraditional mortgage products in the marketplace. More broadly, it will be no less difficult to fully understand the risks in more complex and dynamic products, such as collateralized debt obligations, credit derivatives and leveraged lending. Some products and markets could pose risks and stresses that prove impossible to quantify. Banks and supervisors can attempt to build an appropriate level of stress into the advanced capital calculations of Basel II, but the lag in identifying and understanding changes in market practices may make this very difficult. Recent events have clearly demonstrated that it is essential that institutions maintain strong capital levels during the implementation of Basel II.

Conclusion

Poor, and in some cases predatory, underwriting in recent years has led to two serious consequences. First, it has created financial distress for many households. Second, it has disrupted broader credit markets that rely on the securitization process. While the resulting loss of credit capacity is expected to be temporary, it is important that during this period the banking industry is well-positioned to supply credit, especially for home mortgages. We must take additional steps to ensure that our financial system treats borrowers fairly and allows investors to have confidence in the underwriting that supports complex financial instruments. We look forward to working with this Committee to address the many issues raised by recent market developments. This concludes my statement. I will be happy to answer any questions the Committee might have.

For Release Upon Delivery
10:30 a.m., September 5, 2007

TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 5, 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

Chairman Frank, Ranking Member Bachus, and members of the Committee, as the supervisor of national banks, I appreciate this opportunity to provide the OCC's perspective on recent events in the credit and mortgage markets. My testimony today will provide an overview of market conditions, their effects on the national banks we supervise, and actions that national banks and the OCC are taking in response. Before doing so, however, let me first describe the OCC's role with respect to these issues, followed by some general observations.

The OCC is the primary supervisor for the very largest commercial banks that play critical roles in virtually all aspects of today's capital markets, including the parts of the credit markets that have received so much attention in recent weeks, *i.e.*, the markets for mortgages, leveraged loans, and asset-backed commercial paper. The OCC maintains teams of examiners on-site at each of these institutions to monitor their activities. More broadly, over the last twenty years national banks across the country have become very substantial participants in residential mortgage markets, where they originate, hold, sell, buy, service, and securitize most types of mortgages. These include subprime mortgages, which have experienced so many problems recently, but let me emphasize that national banks have been proportionally less involved in that market, originating less than 10 percent of all subprime mortgages in 2006. In addition, the default rates on subprime mortgages originated by national banks are significantly lower than the national average. The OCC actively supervises national bank mortgage activities, and as we do with all our supervision, we work closely with our colleagues at the other federal banking agencies that have overlapping jurisdiction.

From this perspective, and given that national banks account for nearly two-thirds of the total loans and leases held in the commercial banking system, the recent volatility in the mortgage and credit markets has clearly been a concern for both the OCC and the banks we supervise.[1] The challenging market conditions affect all market participants, including not just the largest national banks that participate actively in capital markets, but also the many mid-size and community national banks that engage in mortgage activities across the country.

Let me be very clear, however, that the worst problems we have seen in the markets – insufficient liquidity resulting in substantial declines in capital and sometimes in failure of individual firms – have occurred outside the commercial banking sector. The national banking system remains safe and sound. Unlike many non-bank lenders, national banks generally have strong levels of capital, stable sources of liquidity, and well diversified lines of business, which taken together provides them with substantial resources and flexibility to weather adverse market conditions. As a result, national banks remain active in major markets and continue to extend credit to corporate and retail customers, including mortgage credit.

With respect to general market conditions, I am encouraged by the recent actions to restore liquidity that have been undertaken by the Federal Reserve, other central banks, and various market players, including some major national banks. Nevertheless, the situation remains fluid, and it may take some time until the markets fully stabilize. As a

[1] As of June 30, 2007, national banks held $3.976 trillion or 64.5% of the $6.164 trillion in total loans and leases outstanding at all commercial banks.

result, we are continuing to watch conditions very closely and will continue to work with our fellow regulatory agencies to respond to issues that may arise.

While recent market conditions have certainly been painful, and may continue to be so for some time, we believe they are likely to cause some positive changes in the longer term as markets reevaluate and re-price risk. Part of today's problems in credit markets resulted from underwriting standards that had relaxed too much – whether in subprime loans or leveraged lending, to pick two examples – which was at least partly the result of investor willingness to assume greater risk to achieve higher yields. In both cases, market participants are now demanding changes in the form of more conservatism. While legitimate concerns remain about the pendulum swinging too far and too suddenly in the opposite direction, we remain hopeful that markets will stabilize at an equilibrium where lending standards are more rational and pricing more accurately reflects risk.

Such a positive outcome would apply in the future to loans that are yet to be made. Unfortunately, the same cannot be said for many loans that have already been made, and in particular, for many homeowners holding subprime mortgages. For those Americans who may be facing unmanageable mortgage obligations now or in the future, recent events are far more serious than a simple market correction or reallocation of risk. They may instead result in foreclosure and all its potentially devastating effects on families and communities. The OCC recognizes the need to do all we can to reduce the inevitability of that outcome. As a result, and as described in more detail later in my testimony, the OCC has taken concrete steps – both on our own and in conjunction with the other federal banking agencies – to encourage both lenders and borrowers to respond to these situations in ways that minimize the likelihood of foreclosure while preserving safety and soundness. With the prospect of significantly increasing foreclosures looming on the horizon, we are fully committed to working with all interested parties to help address the many significant issues that could arise.

Market Background

Let me now highlight some of the factors that have contributed to current market conditions. In brief, and as stated above, much of today's market dislocation appears to reflect an abrupt reassessment and re-pricing of risk by investors. Until recently, many market participants had been willing to invest and lend at prices and under conditions that appeared to provide less compensation for risk, at least by historical standards – no doubt fueled by a benign economic environment characterized by low interest rates, strong economic growth, rising home values, and very low rates of default. This environment, coupled with the continued globalization of financial markets that expanded the pool of liquidity and investors, spawned an array of new financial products and specialized firms. Over time, increased competition led to a loosening of underwriting standards prompted in part by capital market investors who were willing to accept higher levels of risk when purchasing credit instruments from loan originators or securitizers.

While these changing conditions were taking place throughout the financial markets, they were especially pronounced in the U.S. mortgage markets. The abundance of liquidity provided by investors searching for high-yielding financial instruments translated into new types of mortgage products for consumers, who, under prior conditions, did not have access to mortgage financing. Annual mortgage origination volumes averaged less than $1 trillion per year in the 1990s, peaking at $1.5 trillion in 1998. Beginning in 2001, as interest rates declined and home prices appreciated, additional consumers became homeowners and many others refinanced existing loans, often lowering their interest rates and monthly payments while at the same time allowing them to extract cash from increased equity. The result was a three-year rapid expansion of the mortgage market that saw annual originations exceed $2 trillion in 2001, $3 trillion in 2002, and $4 trillion in 2003.

The rapid expansion of this market attracted new mortgage lenders and brokers, many of whom had limited business experience or financial strength and operated with little regulatory oversight. Many of these new market entrants operated outside of the commercial banking system, relying instead on private mortgage conduits and third party investors to fund and buy their mortgage production. Indeed, many of the newly developed mortgage products were sold to private mortgage investors rather than the Government-sponsored enterprises (GSEs), which had traditionally dominated the secondary mortgage markets. For example, the share of mortgage debt securitized by private conduits over this period more than doubled, increasing from 8.5 percent at the end of 2000 to 19 percent at the end of first quarter 2007, while the share securitized by GSEs and agencies fell from 47 percent to 38 percent. Commercial banks' share of overall mortgage debt holdings (loans and securities) remained relatively stable during this period at roughly 28 percent. Bank ownership of securitized home mortgages, however, while stable at about 16.5 percent of all home mortgage securitizations, was increasingly centered in agency and GSE-issued securitizations, with banks' share of privately issued securitized mortgages declining from 15 percent to 9 percent.

As interest rates began to climb and the demand for mortgage loans slowed in 2004, many mortgage originators were left with excess capacity. To maintain production levels and satisfy continued strong investor appetite, mortgage originators increasingly shifted to nontraditional products, often designed to help borrowers cope with rising home prices or tap increasing home equity. These products typically included one or more relaxed underwriting standards, such as smaller down payments, lower required credit scores, higher debt-to-income ratios, reduced documentation to verify income, and temporary reductions in monthly payments through such features as "teaser rates," interest-only payments, and negative amortization. These relaxed standards – especially when combined or "layered" – increased risk for both borrowers and lenders. But that risk was largely masked by an extended period of significantly rising house prices, which made refinancing quick and easy. When house prices stopped appreciating, and in some areas began declining, the riskier subprime loans – particularly those issued in 2006 and late 2005 – began to experience sharply elevated levels of default. That in turn precipitated broader concerns about the health of the overall mortgage markets.

During this period, the OCC took preventive steps to address potential safety and soundness and consumer protection concerns in national banks. With respect to residential mortgages, by 2005 we were instructing our examiners to address the risk of products that carry the potential for significant "payment shock" – that is, mortgages where initially low monthly payments are followed by later payments that are much higher – even though home prices were continuing to escalate. We also issued strong standards on predatory lending and, as discussed in our March 2007 testimony before a subcommittee of this Committee, worked with the other federal banking agencies to issue separate guidance on both nontraditional and subprime mortgage products.

Current Market Conditions

My testimony today focuses on three aspects of current market conditions that directly affect national banks: the mortgage markets, the asset-backed commercial paper market, and the corporate leveraged lending market.

A. Mortgage Markets

With regard to the mortgage markets, performance in the subprime mortgage sector began to deteriorate late last year, and that deterioration has since accelerated. According to the Mortgage Bankers Association, the rate of total subprime mortgage delinquencies reached 12.5 percent as of March 31, 2007, significantly higher than the 10.4 percent delinquency rate from the prior year. As of that same date, the percentage of subprime ARMs that were seriously delinquent, defined as 90 or more days delinquent or in foreclosure, increased to 10.1 percent, compared with 6.9 percent a year earlier.[2] More recent data indicate that the 90-day or more delinquency rate for securitized subprime mortgages had increased to over 13 percent in June 2007.[3] Seriously delinquent and foreclosed subprime loans remain highest in the Gulf states affected by hurricane Katrina and manufacturing-dependent states in the upper Midwest that have struggled economically since the beginning of the decade. But increased foreclosure activity continues to spread and intensify. According to RealtyTrac, Inc., new foreclosure filings across the nation, including default notices, auction sale notices, and bank repossessions, increased to 180,000 in July 2007, 93 percent higher than reported in July 2006. Areas with the highest rates of new foreclosure activity in July reflect the declining conditions in former housing boom states, including the Southwest – particularly California, Nevada

[2] Mortgage Bankers Association National Delinquency Survey
[3] "Business Briefing," Washington Post, August 25, 2007.

and Colorado; and the Southeast - including Georgia and Florida. Foreclosure rates in parts of New England are also on the rise.

Early this summer, the rapid deterioration in credit quality in subprime mortgages began translating into substantial and well publicized losses by funds heavily invested in such instruments, and by companies holding such assets on their balance sheets. In turn, the credit rating agencies began downgrading a broad range of collateralized debt obligations (CDOs) where the underlying collateral consisted of the mezzanine pieces of subprime mortgage securities. Some of the tranches of these CDOs had previously received the very highest credit ratings. The combination of these and similar events prompted a broad range of capital market investors to sharply reduce their tolerance for, and exposures to, mortgage-related credit risk – and not just from subprime mortgages, but from all mortgages not operating with credit guarantees from the GSEs or federal agencies. This widespread investor apprehension has greatly diminished available liquidity for those mortgage market participants that depend on sales of mortgages to the secondary markets.

The effect has been especially pronounced for non-bank mortgage originators that do not have the flexibility to hold mortgages on their balance sheets – through deposits or other funding sources – but instead must sell them. As a result, many such non-bank mortgage originators have been sold or forced out of business, while others remain for sale or continue to search for liquidity and capital.

The effect on subprime lending has been most dramatic. Many institutions, both banks and non-banks, have stopped making subprime mortgages altogether, or have significantly reduced the number and type of subprime products they offer. Additionally, lenders have tightened underwriting standards by requiring higher borrower credit scores, larger down payments, and more robust documentation of income. Together, these factors have resulted in a sharp reduction in the origination of subprime mortgages.[4]

But the reduction in mortgage lending has not been confined to subprime. Origination of so-called "Alt-A" mortgages, which carry less credit risk than subprime mortgages, has also declined. And the broad retreat by investors from non-guaranteed mortgage-related exposures is even affecting origination of "jumbo" loans made to prime borrowers.

While much of the secondary market for mortgage products has been constrained, GSE eligible paper is one segment of the market that continues to operate smoothly, albeit at somewhat wider spreads. Indeed, conventional conforming originations rose 13 percent during the second quarter and 12 percent in first half of 2007 on a year-over-year basis.[5]

Within the national bank population, as I previously noted, national banks have not been dominant players in the subprime mortgage market and generally have adhered to more stringent underwriting standards than many non-bank lenders. As a result, the foreclosure and past due rates for mortgages held by national banks – including but not limited to subprime mortgages – continue to be lower than those experienced by the industry as a whole. Nevertheless, like the rest of the industry, these default rates are

[4] Subprime mortgage originations have declined significantly in 2007. According to Inside Mortgage Finance, origination of new subprime mortgages totaled $56 billion in the second quarter 2007, down 41 percent from first quarter 2007 and off 66 percent from the $165 billion originated in second quarter 2006. Issuance of new subprime mortgage-backed securities was 32 percent lower in the first half of 2007 than the first half of 2006. Second quarter 2007 issuance was down 12 percent from the first quarter of 2007, and down nearly 30 percent from the fourth quarter of 2006. These declines do not take into account any further reduction that is likely to have occurred in the third quarter of 2007 in reaction to current market disruptions.

[5] Inside Mortgage Finance

increasing, and if problems in the general housing market continue, we expect to see a further increase in mortgage delinquencies.

In terms of mortgage originations, national banks that are significant residential lenders continue to operate in the mortgage markets and are providing loans to customers. To date, while many of our community and mid-size banks report reduced volumes of new originations, they continue to be able to fund their mortgage production through existing channels or have the capacity to retain the mortgages on their books. In general, the same is true at our larger, more active mortgage banking institutions. Some institutions are seeing increases in loan applications for certain mortgage products, such as jumbo prime mortgages, through their retail mortgage channels. In part, these increases may be driven by consumers submitting mortgage applications to multiple lenders due to consumers' heightened concerns about the availability of these products. We will have a better understanding of actual new loan volume in the coming weeks as these recent applications work through the origination pipelines.

Due to the lack of secondary market liquidity and the fallout of many non-bank lenders, most banks are more focused on direct originations and have scaled back or curtailed their wholesale lending operations, which often relied on loans generated by mortgage brokers. These steps to reduce wholesale production are primarily affecting non-conforming mortgage applications and origination (*e.g.*, jumbo and certain Alt-A loans). Conforming loans continue to be packaged and sold, while retail originated non-conforming production is being held in banks' portfolios until liquidity returns to the secondary market.

Consistent with prudent risk management practices, national banks continue to reevaluate loan product terms and underwriting guidelines as market and economic conditions change. For example, some national banks are making more mortgage loan products conform to GSE and FHA standards. National banks are also making changes to comply with the recent interagency statements on nontraditional and subprime mortgages, such as clearer assessments of a borrower's credit qualifications and ability to repay. Some products, such as certain stated-income or low-documentation mortgage loans, as well as certain types of subprime ARMs, are being significantly revised or curtailed. And although national banks have not dominated the subprime market, they also have not completely abandoned this market or segment of borrowers. That is, some national banks continue to originate subprime mortgages, though at a reduced level given that such loans must now be held in portfolio rather than sold, given current market conditions.

B. Asset-Backed Commercial Paper Markets

One of the markets that has been most affected by the recent financial market turmoil is the asset-backed commercial paper (ABCP) market. This market represents over half of the commercial paper issued in the United States. ABCP is a highly rated, short-term money market instrument issued by a special purpose vehicle (SPV) or bankruptcy remote conduit established for that purpose. These SPVs, which are used by financial and non-financial firms, issue commercial paper with maturities of up to 270 days and use the proceeds to fund various financial assets and securities, in some cases including mortgage assets. The acquired assets serve as collateral against the ABCP. Because the maturities of the underlying financial assets are typically longer than the maturities of the ABCP issued to fund those assets, conduits typically rely on the proceeds of newly issued commercial paper to pay down previously issued commercial paper as it matures. This process is referred to as "rolling" the commercial paper. Most ABCP programs also have a back-up liquidity facility and various forms of credit enhancement, often provided by a commercial bank. The back-up liquidity facilities provide protection to the ABCP investors in the event that a program is unable to roll maturing commercial paper.

ABCP conduits have varying degrees of asset diversification and underlying collateral quality, with higher risk assets requiring more credit enhancement. By definition, commercial paper attracts investors seeking relatively safe, liquid investments. With increasing general concerns in the financial markets regarding mortgage risk, ABCP programs backed by mortgage assets have begun to receive more scrutiny, especially those that include subprime mortgage assets. During the last month, it became more difficult for some of these programs to roll maturing commercial paper by issuing new commercial paper. In these circumstances, some of the programs' only option was to extend the maturity of the outstanding paper, which they did, hoping to be able to roll those investments at a later time after markets had stabilized. Exercising that extension option was unprecedented, however, and resulted in ABCP investors not getting repaid on the dates they had anticipated. While these were fairly isolated events, they were well publicized and have had a further negative effect on the ability of ABCP programs to issue new commercial paper in the manner they have done historically, even in circumstances in which the conduits hold no mortgage assets. As a result, ABCP liquidity remains tight, maturities have shortened, and spreads have widened as investors reassess their risk exposures in these products.

A number of large national banks are active in the ABCP markets, generally in either the largely operational role of administering various conduits, or as providers of back-up lines of liquidity, or both. To date, ABCP programs administered by national banks have not faced the magnitude of issues affecting certain non-U.S. bank sponsored ABCP programs, but conditions have been challenging nevertheless. In recent weeks, sales of commercial paper have resulted in shorter maturities and, in some cases, direct investment in the paper by conduit sponsors. Continued disruption in the ABCP markets could prompt sponsors of ABCP programs to provide temporary funding under existing liquidity facilities or take other steps that increase their on-balance sheet exposure to these conduits. In such circumstances, the sponsors, including commercial banks, could need to dedicate additional capital to support those assets, depending on the action taken.

C. Corporate Leveraged Lending Markets

Although the commercial leveraged loan market is distinct from, and generally unrelated to, the subprime mortgage market, investors' heightened concerns about overall credit quality and underwriting standards have affected this higher risk credit market as well. Large commercial and investment banks have earned significant fees from originating and distributing leveraged loans associated with corporate buyouts. Because of strong corporate profits and cash flow, as well as their own strong liquidity and aggressive return expectations, institutional investors had been willing to accept increasingly lax repayment terms, reduced financial covenants, and higher borrower leverage on these transactions. The apparent risk to commercial banks' own loan portfolios was limited, because such banks increasingly followed an "originate-to-distribute" model, syndicating most of these exposures to institutional investors rather than holding them on their balance sheets for extended periods.

In the past six weeks, however, the risk appetite of institutional investors has changed abruptly, especially with respect to the degree of borrower leverage and the strength of financial covenants. This has come at a time when, because of the extraordinary volume of leveraged buyout transactions pending in the market, commercial banks have an unusually large volume of loan commitments held for sale awaiting syndication. Given the abrupt change in risk appetite, the credit terms of these "pipeline" commitments mean that the loans that ultimately are made will be unlikely to clear the market at the prices that syndicating banks had hoped to achieve. The banks are therefore holding positions, or are committed to hold positions, in excess of what they planned to hold. In some cases, banks have gone back to the buyout sponsors to try to renegotiate existing terms to make the loans more marketable. In other cases, banks have decided to sell at least parts of the loans at lower prices.

Nevertheless, the fact remains that the largest national banks face the prospect of having to fund a substantial amount of leveraged loans, at least temporarily, until loans can be sold. Such an increase in balance sheet assets would necessarily result in an increase in required regulatory capital, though the national banks active in this market all have sufficient excess regulatory capital to support such positions. In addition, because the prices that investors are currently willing to pay for such loans have declined, banks holding these loans face the prospect of writing down their value through potential charges to earnings. And, of course, by holding the loans rather than selling them, banks remain exposed to the ongoing risk posed by the underlying obligors – but, importantly, unlike the situation with mortgage-backed securities that have lost value due to increased defaults on the underlying mortgages, there is no indication at this time of systemic credit problems with the underlying borrowers on the leveraged loans likely to be held by banks.

Our assessment of the direct effect of this situation on national banks is this: while it may take some time for them to work through these excess hold positions, the principal risk is that their earnings will be reduced, rather than that there will be more significant losses that would affect the adequacy of their capital.

In terms of indirect effects, it does not appear that the difficult conditions in the leveraged loan markets have adversely affected the broader market for commercial and industrial loans. We do not believe that creditworthy commercial borrowers are having any unusual difficulty obtaining credit under prudent credit terms. While current market conditions may cause banks to tighten their overall commercial credit underwriting standards, this is not unexpected after several years of easing. Indeed, some of the recent re-pricing we have seen by lenders and investors is likely related to their expectations that today's low level of defaults may begin to return to a level closer to historical default averages. Nevertheless, while commercial credit performance remains quite strong, we have begun to see a slight deterioration in the asset quality indicators for commercial credit portfolios. Given the cyclical nature of credit risk, we are not surprised by this trend.

OCC Actions

As I have noted throughout my testimony, the OCC has been actively monitoring and evaluating recent market developments. And in addition to our direct monitoring, we are participating in periodic conference calls with the other banking agencies and the President's Working Group, to share information, identify potential issues, and coordinate any necessary regulatory responses. Also, because the recent events are global in their scope, we are sharing information with various global supervisors, through the Basel Committee on Bank Supervision and through our London office.

During these types of market events, our major response is on the front line, through our examination force, supplemented by market intelligence obtained from various industry and market contacts and sources that our policy analysts maintain. As part of our Large Bank Supervision Program, our resident examiner teams at the largest national banks are in frequent contact with the business and risk managers of those institutions' funding, trading, and mortgage areas to enable close monitoring of market conditions, deal flow, and funding availability. Those same examiners have reviewed each bank's risk selection and management processes and taken action whenever necessary to shore up weaknesses at individual banks. Moreover, we update our supervisory guidance to banks and examiners, as necessary, to assure they are positioned to mitigate the severity of unavoidable problems and inevitable market stresses. As part of our safety and soundness supervision, we require national banks to carefully monitor their liquidity and funding levels and to have contingency liquidity and funding plans that contemplate a potential disruption to their normal funding activities and market access. Our goal in requiring these plans is to ensure that these institutions can continue to conduct their business in an orderly fashion under a variety of stressed market conditions.

Examiners at both our large and community banks also help surface and provide input on various regulatory issues that may need a broader agency or interagency response as banks make adjustments to their balance sheet strategies or operations to accommodate customers and the market. One such issue has been clarification of the ability of mortgage loan servicers' to implement steps that should improve their ability to avoid unnecessary foreclosures against borrowers that are at a heightened risk of default. I am pleased that banking agencies' efforts with the SEC and the FASB have helped to clarify that servicers can work with severely troubled borrowers without prohibitive accounting restrictions. To provide more guidance on this important topic, the banking agencies yesterday released the Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages. We will continue to encourage national banks to take the affirmative steps to work with borrowers discussed in this and other guidance, consistent with prudent lending practices.

The lack of liquidity and price transparency in various markets is also posing challenges for, and raising questions by, bankers regarding the valuation and mark-to-market accounting assessments for various trading positions and assets held for sale. Consistent with generally accepted accounting principles (GAAP), we have been advising our institutions that the marks in these portfolios should be reasonable and supported by documented rationale. Under GAAP, a market under stress is still a market. Additionally, GAAP generally requires using observable market prices, even if trade volumes are far below normal. When models are being used because observable market prices are not available, the assumptions used in the model should be consistent with those that a market participant would use.

More generally, we are reminding bankers that they should consult with their external auditors and examiners as accounting or regulatory issues arise. We will continue to work on such issues with the other banking agencies, the SEC, and the FASB, as appropriate.

Working with Customers

Although we are confident that the national banking system remains safe and sound, I share the Committee's concern about the effect that current market conditions may have on individual homeowners who face sharply escalating mortgage payments and the possibility of foreclosure. While foreclosure obviously can have devastating effects on borrowers, it is less obvious but no less true that it can also result in steep losses for lenders. As a result, it is very often a "win-win" for both borrowers and lenders to take alternative courses of action to avoid foreclosure, including through loan modifications.

As a result, the OCC has stressed the importance of national banks prudently working with residential loan borrowers facing difficulty in meeting their contractual payment obligations. The OCC is using all available tools to encourage lenders and borrowers to work together, facilitated by supportive organizations such as counseling agencies, to maintain the smooth functioning of the residential lending industry and to help keep borrowers in their homes except where foreclosure is the only prudent course of action. To this end, we are co-hosting forums in parts of the country hit hard by foreclosures to introduce banks to the range of delinquency intervention services that community-based counseling organizations can provide.

We also are disseminating guidance to encourage national banks to work with borrowers in these unfortunate circumstances and to remind them of the regulatory incentives to do so. We recognize that many national banks are working with community partners to develop and implement strategies to help identify financially stressed borrowers, pursue workouts, and avoid foreclosure, and we support and publicize these efforts so that they may be replicated and enhanced as much as possible.

In April of this year, the OCC and the other federal regulators published the interagency "Statement on Working with Mortgage Borrowers." This statement encourages institutions to consider prudent, safe, and sound workout arrangements that increase the potential for financially stressed borrowers to keep their homes. It emphasizes that existing guidance and standards do not require institutions to immediately foreclose on homes when a borrower exhibits repayment difficulties. The Statement also reminds financial institutions that the Homeownership Counseling Act requires institutions to inform certain borrowers who are delinquent on their mortgage loans of the availability of homeownership counseling. Finally, the statement informs lenders that they may receive favorable Community Reinvestment Act consideration for programs that transition low- and moderate-income borrowers from higher cost loans to lower cost loans, provided that the loans are made in a safe and sound manner.

More recently, in June 2007, the OCC published the report, "Foreclosure Prevention: Improving Contact with Borrowers," which sets forth a variety of strategies lenders can use to reach borrowers for whom loan workouts may be necessary and appropriate. A number of banks are implementing initiatives to work with borrowers to avoid foreclosure and loss of their homes, for example, by contacting borrowers at an earlier stage to inform them of reset information and potential options; offering toll free numbers for additional help; and referring them to credit counseling services or third party debt management programs if appropriate. Examples of programs that may be available to assist customers to remain in their homes include refinancing plans; repayment plans for delinquent balances; forbearance programs; and loan modification programs in which one or more of the terms are permanently changed. Examples of programs that may be available if remaining in the home is not an option include sale; short sale (a workout option where the borrower sells the secured property for an amount less than that which is owed to avoid foreclosure); auction programs with deficiency notes; or deed-in-lieu-of-foreclosure programs.

Many borrowers in default do not realize that loan workouts are an available option, in part because they avoid contact with their lenders and servicers, viewing them as adversaries once they fall behind in their payments. Yet, the record shows that a large number of delinquent borrowers can avoid foreclosure if they make that call – and the sooner the better. The OCC's June 2007 report illustrates how lenders can work together with delinquent borrowers towards their mutual objective of avoiding foreclosure, with the ideal result of a prudently underwritten, reworked loan with terms that the borrower can afford and that keeps the borrower in his or her home.

In addition to guiding national banks in these outreach efforts, we also are working with nonprofit partners to encourage borrowers to work with their lenders. One very promising partnership is the NeighborWorks Center for Foreclosure Solutions, a partnership among mortgage lenders, insurance companies, government-sponsored enterprises, and community-based nonprofits. The Center, which builds capacity among foreclosure counselors through training, researching borrower behavior, working with the industry, and conducting public outreach campaigns, is sponsored by NeighborWorks America and the Homeownership Preservation Foundation. As a board member of NeighborWorks America, I am especially hopeful that the work of the NeighborWorks Center will get critical information to borrowers having difficulty paying their mortgages in a timely and effective manner.

Once contact is established, the NeighborWorks Center and its foreclosure prevention coalitions are able to help many borrowers negotiate loan workouts with their lenders. Local nonprofit housing counseling groups then work with these borrowers to help ensure that they have the personal financial and money management tools to meet their restructured obligations under these workout plans.

Because early contact is so important, the OCC helped to launch NeighborWorks America's national ad campaign, made up of TV, radio, print, and web Public Service Announcements (PSAs), all of which were aimed at encouraging delinquent mortgage borrowers to contact their lenders or a trusted housing counselor in order to avoid foreclosure. The OCC also produced its own radio and print PSAs, which ran in both English and Spanish and reached a potential audience of 100 million people in 35 states. Both sets of PSAs encourage homeowners having difficulty paying their mortgages to call the Center's toll-free hotline – 888-995-HOPE – which is open twenty-four hours a day, seven days a week. Calls flow into a national call center staffed by HUD-approved English- and Spanish-speaking counselors for borrowers to discuss their problems. The hotline, which has been in operation since April of 2005, has received over 100,000 calls from borrowers in distress and has lately been averaging 1,000 calls each day.

Depending on the nature of the problem, counseling can be provided as part of that initial call or through a series of follow-up calls or in-person visits to a local housing counseling service. These on-the-ground referrals are fielded by community-based nonprofits, including a growing number of local NeighborWorks America® and consumer credit counseling organizations. If a workout can be arranged with the lender, then these groups' counselors can provide budgeting assistance and other financial education to help ensure that these borrowers are able to meet the terms of their workout agreements.

Conclusion

While the recent instability in the financial markets has had profoundly negative consequences for a number of specialized lenders and their customers, national banks remain strong and well capitalized. With their diversified funding and earnings streams, national banks have sufficient liquidity and are well positioned to work through these market conditions. Together with our peer regulatory agencies and the Treasury Department, the OCC will continue to closely monitor developments in the markets and to pursue any policies or actions that may be needed so that banks can continue to serve the needs of their communities and provide loans to creditworthy retail and commercial borrowers.

Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy

Erik R. Sirri
Director, Division of Market Regulation
U.S. Securities & Exchange Commission

Before the House Financial Services Committee

September 5, 2007

Chairman Frank, Ranking Member Bachus and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about recent events in the subprime mortgage and credit markets and the Commission's responses.

There is no question that, over the past two months, the default by homeowners with subprime credit on mortgage obligations has had a broad and significant impact. In addition to the difficulties that this has caused borrowers and others in their communities, the sharp rise in defaults has reverberated through the financial markets. Not surprisingly, a variety of securities that referenced pools of subprime mortgages were directly affected. But, in a demonstration of the degree to which markets are linked, the indirect effects were much more broadly visible. As default levels on subprime mortgages exceeded expectations, market participants began to question the value of a variety of financial products. And as valuations came into doubt, liquidity in these products fell sharply, which further complicated the task of valuing particularly complex instruments. Derivatives referencing mortgages were not the only investments that experienced an unexpected decline in liquidity. A variety of other complex financial products that involved non-mortgage assets suffered diminished liquidity as well. As liquidity for structured products diminished, market participants needing to raise funds to meet margin calls and investor redemptions sold less complex financial instruments such as equities and municipal securities, placing downward pressure on prices in those markets. Overall, these dynamics have significantly impacted a wide range of market participants, from individual investors to systemically important financial institutions.

In this environment, as in more benign environments, the Commission seeks to fulfill its basic mandates to protect investors, maintain fair and orderly markets, and facilitate capital formation. In my testimony, I will highlight several ways that the Commission has acted to further these mandates in the context of events in the subprime mortgage and credit markets, for example, by supervising market participants such as broker dealers, investment advisers, and mutual funds, and by facilitating the orderly functioning of the securities markets. Some recent initiatives include: our outreach to a variety of market participants to understand potential exposures to subprime mortgages and related products, and to evaluate operational and liquidity issues that may result in order to assess whether a regulatory response is needed; our regular interaction and cooperation with other regulators in the President's Working Group on Financial Markets (Treasury, Federal Reserve Board, CFTC) to analyze and discuss market conditions; our implementation of rules governing Nationally Recognized Statistical Rating Organizations (NRSROs); our oversight of Consolidated Supervised Entities (CSEs); and our continuing vigorous enforcement of the federal laws in this area.

As I mentioned earlier, the current stresses in the credit markets appear to have emanated from the subprime mortgage market. While the Commission does not directly regulate the origination and sale of mortgage loans, it does have a role when the mortgages are sold to securitization vehicles and when securities are backed by those loans. These securities are sold almost exclusively to institutional investors. In 2004, the Commission adopted for the first time extensive rules – called Regulation AB – comprehensively addressing the registration, disclosure, and reporting requirements for these and other publicly offered asset-backed securities. They require expanded disclosure to investors, including expanded data on the loans underlying the securities, such as information on borrowers' credit scores. In addition, the offering materials are required to include data on the performance of prior securitized pools. The rules also require servicers to provide a report on assessment of compliance with servicing criteria and an auditor to attest to such report. These rules became effective in 2005 and have been phased in over the past few years with full compliance required for all securities sold in 2006 and thereafter.

As a matter of course, the Commission and its staff are in regular contact with the industry to gather information and are coordinating regulatory action as needed. This is particularly true now given the current state of the credit markets. Similarly, we regularly confer with the President's Working Group agencies to discuss market conditions and share observations about issues facing those market participants under the PWG members' respective jurisdictions. All of these discussions and information sharing ultimately lead to a more consistent and coordinated response to the credit market events across markets and their participants.

The Commission also seeks to protect investors through its oversight of investment companies. Investment companies may invest in securities backed by subprime mortgages such as collateralized debt obligations (CDOs) and asset-backed commercial paper. In particular, money funds frequently invest in asset-backed commercial paper, including instruments that provide financing for portfolios of mortgages. Following the emergence in mid-July of significant turbulence in the subprime market, the staff has contacted fund representatives and pricing agents to determine the effect on funds in terms of pricing their portfolio holdings and maintaining sufficient liquidity to meet redemptions. The staff also carefully monitors redemption levels. The staff has made it known that it stands ready to provide assistance, and these contacts with fund representatives are continuing.

In June of this year, the Commission adopted rules governing Nationally Recognized Statistical Rating Organizations or NRSROs. The Commission adopted these rules within the 270 day time frame required by the Credit Rating Agency Reform Act of 2006 (Rating Agency Act), which was enacted by Congress on September 29, 2006. The purpose of the Rating Agency Act is to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. A credit rating agency seeking to be registered as an NRSRO must apply for registration with the Commission, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. Consistent with the statutory mandate, the rules require disclosure of an NRSRO's conflicts of interest, and proscribe certain conflicts of interest.

The Rating Agency Act and its implementing rules require an NRSRO to disclose a general description of its procedures and methodologies for determining credit ratings. In addition, an NRSRO must make public certain performance measurement statistics including historical downgrade and default rates within each of its credit rating categories. The Commission believes that these disclosures will assist users of credit ratings in assessing the reliability of a NRSRO's ratings over time, and will provide transparency with respect to the accuracy of a NRSRO's ratings in connection with structured finance products related to subprime mortgages.

As you know, in recent months, some have criticized rating agencies for the accuracy of their ratings of certain structured finance products, including residential mortgage-backed securities (RMBS). Critics fault the rating agencies for not taking rating actions sooner on those securities as the performance of underlying assets deteriorated, and for not maintaining appropriate independence from the issuers and underwriters of those securities. Given recent events in the subprime mortgage and credit markets, the Commission has begun a review of NRSRO policies and procedures regarding ratings of RMBS and CDOs, the advisory services they may have provided to underwriters and mortgage originators, their conflicts of interest, disclosures of their rating processes, the agencies' rating performance after issuance, and the meanings of the assigned ratings. As described in the Commission's adopting release in June regarding the NRSRO rules, the Commission is studying whether it would be appropriate to require additional types of performance statistics be disclosed as an alternative, or in addition, to historical default and downgrade rates, which are required to be disclosed under the rules adopted.

Also important to the systemic health of the financial services sector is the vitality of the largest financial services firms. At present, the Commission supervises five securities firms on a consolidated, or group-wide, basis – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley – also known informally as the CSEs. For such firms, the Commission oversees not only the U.S.-registered broker-dealer, but the consolidated entity, which may include other regulated entities such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself. The Commission's CSE program provides holding company supervision in a manner that is broadly consistent with the oversight of bank holding companies by the Federal Reserve. This program's aim is to diminish the likelihood that weakness in the holding company itself or any unregulated affiliates would place a regulated entity, such as a bank or broker-dealer, or the broader financial system, at risk.

CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls which are subject to Commission inspection. Further, the holding company must provide the Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures.

Under the CSE program, in addition to adequate capital, liquidity and liquidity risk management are a critical focus of the Commission's review of broker-dealer holding companies. As you know, liquidity is essential to the viability of all financial institutions. The ability of a firm to withstand market, credit, and other types of stress events is linked not just to the amount of capital the firm possesses, but also to the sufficiency of liquid assets to meet obligations as they arise. Due to the importance of liquidity to the CSE firms, the Commission seeks to determine whether each CSE firm has adopted and follows funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year.

Given the recent events in the mortgage and credit markets and their potential impact on financial institutions, the Commission staff is monitoring the liquidity available to the CSE parent with greater frequency than during periods of normal market stress. All the CSE firms maintain pools of liquidity at the parent level, consisting of cash and highly liquid securities. Access to high levels of liquidity is particularly important in times of abnormally high market stress; so we are monitoring CSE firms' access to their usual sources of both secured and unsecured funding. In addition, the Commission staff is also monitoring contingencies that might place additional strains on the balance sheets of the CSE firms. These include the potential unwinding of off-balance sheet funding structures, such as conduit structures. We also are monitoring the potential funding requirements for certain leveraged lending commitments made by the CSE firms, typically to fund corporate acquisitions or restructurings.

In addition to liquidity monitoring, the Commission staff is engaged in ongoing oversight of the valuation processes at CSE firms. The CSE firms mark most positions to market, which is a critical governance and risk management process. Current market conditions have increased the challenge of marking certain complex positions to market. We are reviewing the valuation methods used by each firm to ensure that they are robust and consistently applied across such firm's businesses.

Finally, critical components of the Commission's efforts to protect investors and the integrity of our trading markets are our examination program that examines registered securities firms for compliance with federal securities laws, and our enforcement program that investigates indications of violations of the federal securities laws. The Commission has been, and will continue to be, vigilant in bringing cases for fraud and other violations of the securities laws that implicate the integrity and fairness of our trading markets.

I hope my remarks today have highlighted the Commission's ongoing and heightened activities in light of the recent mortgage and credit market events. I believe the regulatory community must also continue to engage with the systemically important banks and securities firms, encouraging additional efforts to improve and expand risk management capabilities. We will work with our PWG colleagues and other market participants to further this agenda.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:30 a.m., September 5, 2007
CONTACT Jennifer Zuccarelli, (202) 622-8657

TESTIMONY OF ROBERT K. STEEL
UNDER SECRETARY FOR DOMESTIC FINANCE
U.S. DEPARTMENT OF THE TREASURY

BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

WASHINGTON- Chairman Frank, Ranking Member Bachus, Members of the Committee, good morning. I very much appreciate the opportunity to appear before you today to present the Treasury Department's perspective on the recent events in the credit and mortgage markets and their impact upon consumers and the economy. The Treasury Department and Secretary Paulson know that these events are of considerable interest to the American people, this Committee, and other Members of Congress.

To give context to the current market situation, I would like to begin my remarks today with a description of both domestic and global economic conditions. In the United States, the unemployment rate is at 4.6%, close to its lowest reading in 6 years. Real GDP growth was 4.0 percent in the second quarter, supported by strong gains in business investment and exports. Core inflation is under control. Since August 2003, 8.3 million jobs have been created, more jobs than all the major industrialized countries combined; over the past 12 months, nearly 2 million jobs have been created. Real wages have increased 1.7% over the past 12 months. In the corporate sector, earnings continue to outperform expectations and default rates on corporate credits of all kinds are at historically low levels. On the government side, the U.S. fiscal deficit is declining and well below long-term averages as a share of the economy, reflecting strong revenue growth and the continued strength of the U.S. economy.

The global economy continues to grow at around 5% annually, with many emerging market economies growing even more rapidly than the global average.[1] The advanced economies also continue to perform well, with unemployment down sharply in Europe, helping to make growth of the last several years the strongest since the early 1970s.[2]

The Treasury Department, as the steward of economic and financial systems in the United States, is committed to ensuring these strong U.S. and global economic fundamentals. At the same time, the Treasury Department's mission includes the promotion of economic stability. It is important to appreciate that the core fundamental economic environment is strong globally, and it is against this backdrop that I turn to the current credit and market challenges.

General Trends in the Mortgage Industry

[1] International Monetary Fund, *World Economic Outlook Update: An Update of the Key WEO Projections* 1 (July 2007).
[2] International Monetary Fund, *World Economic Outlook: Spillovers and Cycles in the Global Economy* xiii (April 2007).

As just discussed, over the past several years the United States has enjoyed favorable economic conditions: low unemployment, low inflation, and low interest rates. These positive conditions served to fuel a demand for credit and investment and the marketplace responded with a vast supply of both to satisfy consumers and sophisticated market participants. At the consumer level, this demand was very noticeable in the mortgage industry, and in recent years particularly, the subprime arena. For the first time, in the early 1990s, consumers with lower incomes and challenged credit history—typical subprime borrowers—were able to gain access to mortgage credit at interest rates a few percentage points higher than prime borrower rates. Homeownership became more widely available in the United States, growing from 64% in 1994 to 69% today, some of that due to subprime mortgage origination volume, which increased from less than 5%, or $35 billion, of total mortgage origination volume in 1994 to nearly 20%, or $625 billion, in 2005.[3]

Mortgage securitization has fundamentally changed the mortgage industry and has played a significant role in the growth of the mortgage market. Typically in a private label mortgage securitization, the mortgage originator transfers loans to a securitization sponsor, who pools together mortgages into mortgage-backed securities, and sells pieces, or tranches, of these securities to investors. Thus, the mortgage originator, instead of holding the mortgage loan on its balance sheet, distributes the loan and its attendant risks to a securitization sponsor in return for capital. The credit rating agencies work closely with the sponsor to rate the credit risk of each tranche.

These innovative securities offered sophisticated investors a diversification tool and the ability to better target their risk/return profile. The demand for mortgage-backed securities has been global in nature and has helped to provide mortgage originators with a steady stream of capital. Over 55% of total mortgage origination volume and over 70% of subprime mortgage origination volume were securitized in 2006.[4] Further fueling this growth has been the development of another structured product, the collateralized debt obligation, which purchases asset-backed securities, such as mortgage-backed securities. Mortgage-backed CDOs, nearly 40% of the entire $500 billion CDO market in 2006,[5] have been one of the major purchasers of mortgage-backed securities, in particular the lower rated tranches.

Recent Mortgage Market and Credit Market Events

Through most of the 1990s, annual mortgage origination stood at approximately $1 trillion.[6] With the historically low interest rate environment of 2001-2003, mortgage origination climbed to nearly $4 trillion in 2003.[7] Infrastructure build-up and the entry of many new participants into the mortgage industry matched this increase. With the rise in interest rates in 2004, mortgage origination fell to just under $3 trillion.[8] With this decline, there was significant overcapacity in the mortgage industry. Competition among mortgage originators and brokers intensified. At the same time, investor demand for securitized products remained unabated. To satisfy this demand and their excess capacity, some mortgage originators relaxed their underwriting standards, lending to individuals with a lower standard of documentation and selling mortgage products, which for some borrowers would become unaffordable.

In the past few years, some of the most popular subprime products were adjustable rate mortgages, like the 2/28: a hybrid mortgage with a fixed rate of interest, often free of amortization payments, for the first two years, resetting at an adjustable rate for the remaining 28 years. The fixed rate of interest in the first

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[3] Edward M. Gramlich, *Subprime Mortgages: America's Latest Boom and Bust* 1-2, 6 (2007).
[4] Remarks of Martin J. Gruenberg, Vice Chairman, FDIC, CSBS Annual Conference (May 31, 2007).
[5] Joseph R. Mason and Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions* (Feb. 15, 2007), at 27.
[6] Gramlich, at 6.
[7] Gramlich, at 6.
[8] Gramlich, at 6.

two-year period was typically lower than the initial adjustable rate in the reset period. In the initial period of these resets, rising housing prices enabled these borrowers to refinance their original mortgages on terms more attractive and affordable. Eventually, due to both an upwards adjustment in rates and commencement of principal amortization as these mortgages began to reset in 2005, 2006, and 2007, many borrowers were faced with payment shock. These resets, combined with a decline in housing price appreciation, led to rising delinquencies and defaults among subprime borrowers, first widely evidenced in autumn 2006. In 2007 this trend has continued and spread to other participants in the mortgage industry: several mortgage originators and brokers have exited the industry.

In turn, the mortgage-backed securities investor has felt the repercussions of the weaknesses in the mortgage assets underlying some of these securitized products: in autumn 2006 with rising defaults on the underlying assets, mortgage-backed securities spreads began to widen. Over the past several months, a small number of U.S. and foreign financial institutions and hedge funds that invested in mortgage-backed CDOs and other mortgage-backed securities have reported large losses. Some have suspended or limited redemptions, while others have closed or received capital infusions. At the same time, credit rating agencies announced their intent to downgrade some of these securitized products and revise their ratings methodologies.

The uncertainty regarding both the future prospects of these mortgage-backed securities and the methodologies the credit rating agencies used to rate these securities compelled investors to reassess the risk of these securities and subsequently reassess price. Given the uncertainty of the underlying credit and cash flows, few buyers were willing to risk their capital. Valuation became extremely difficult as a no-bid environment seized certain segments of the market. This reappraisal has spread across the credit market spectrum, first affecting residential-mortgage backed securities and then spreading to other asset classes and, particularly, securitized products. Spreads have widened and a lack of liquidity has affected these other asset classes. The financing of buy-out transactions has also been challenged as higher risk premia resurfaced after a long period of favorable conditions. Volatility has increased: from Treasury bills to the stock markets.

This reappraisal of risk is normal and typically follows periods of widely available credit when markets have undervalued risk. As in other times of reappraisal, investors, adverse to risk and protective of their capital, have fled to quality assets, demanding and driving up the prices—and in turn driving down significantly the rates—of Treasury bills. For example, during the past three weeks, the demand for Treasury securities by global investors was so enormous that rates on the safest, most liquid asset in the world dropped over 250 basis points—a decline of such magnitude not seen in the past.

In early August, this uncertainty began to spread to the asset-backed commercial paper market, typically a very liquid market. The uncertainty surrounding the health of the assets underlying commercial paper (especially asset-backed commercial paper, which represents approximately 55% of the commercial paper market) compelled investors to shorten the terms to maturity that they were willing to purchase and, in some cases, even to decline to buy such paper altogether. Subsequently, banks became increasingly concerned about their own liquidity in view of the possibility that they might have to provide backup for commercial paper and take other assets onto their balance sheets. In response to such developments, the Federal Reserve took several measures to increase liquidity and promote the orderly functioning of financial markets. The Federal Reserve provided additional reserves through open market operations in order to promote trading in the Federal Funds market at rates close to the target rate. The Federal Reserve also lowered the discount rate and changed Reserve Banks' usual practices to allow the provision of term funding at the discount window. Such actions have helped stabilize the markets.

The ultimate impact of these events on the economy has yet to play out. At the time of its discount rate cut, the Federal Reserve noted that "[f]inancial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace…the downside risks to growth have increased appreciably."[9]

The Treasury Department respects the independent actions and leadership of the Federal Reserve. Like the Federal Reserve, the Treasury Department shares the perspective that recent market developments pose downside risks to economic growth. However, the economy was in strong condition going into the recent period of volatility, and while certain sectors like housing are undergoing a transition, overall economic fundamentals remain solid. And while recent difficulties in the subprime mortgage market are having and will continue to have a profound effect for many families, the underlying strength of the economy should allow for continued growth. Just last Friday, the President announced plans to help those homeowners facing mortgage delinquencies and foreclosures and I will return to these initiatives later.

Impact of Recent Market Developments on the Mortgage and Credit Markets

The financial services industry has enjoyed a period of extraordinary growth over the last several decades. Key drivers to this growth have been successful engagement with the trends of innovation, institutionalization, and internationalization.

The complexity and innovation of financial products have brought great benefits to the mortgage and credit markets. In the mortgage industry, securitization allows mortgage originators to undertake better risk management as they do not have to hold loans on their balance sheets and instead have another source of capital funding. Investors purchasing a securitized product have reduced transaction costs and can purchase an array of products at targeted risk levels. Homebuyers have expanded product offerings and more lenders competing for their business.

The recent market events have revealed potential complexities in the securitization model. In some cases, risk evaluation of securitized products can be difficult. In mortgage-backed securities and mortgage-backed collateralized debt obligations, the performance of the underlying assets, particularly many of the innovative subprime mortgage products, may not have been properly understood, or investors may have failed to perform adequate due diligence prior to their investment decision. At the same time, mortgage originators may have possessed less incentive to perform appropriate levels of due diligence because of their distributing their loans and the attendant risks through securitization.

Over the past few decades the capital markets have experienced growing institutionalization. These institutions, such as pension funds, mutual funds, and hedge funds, have provided the markets with liquidity, pricing efficiency, and risk dispersion. These institutions have also spurred on financial product innovation and complexity and possess the incentives, resources, and information to make prudent decisions. At the same time, these institutions can be highly leveraged and employ highly correlated strategies, potentially leading to more widespread market disruptions.

Finally, the capital markets are becoming increasingly internationalized. Market participants, sources of capital, product offerings, and trading strategies ignore national borders. This has contributed to the significant global economic growth over the past decade, especially in the emerging market economies. At the same time, an event in one country's market may impact the rest of the world.

Treasury, Administration, and Federal Banking Regulator Actions

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[9] Federal Reserve Press Release (Aug. 17, 2007), at http://www.federalreserve.gov/boarddocs/press/monetary/2007/20070817/default.htm.

The Treasury Department closely monitors the global capital markets on a daily basis. This is especially true given the events unfolding in the credit and mortgage markets. Secretary Paulson has been communicating regularly with federal banking regulators and the members of the President's Working Group on Financial Markets, which includes Federal Reserve Chairman Bernanke, Securities and Exchange Commission Chairman Cox, and Commodity Futures Trading Commission Acting Chairman Lukken. This complements information gathering from market participants, finance ministers, and other participants in the global marketplace. Enhanced communication is vitally important for understanding where disruptions are occurring, and evaluating what actions can be considered.

Under Secretary Paulson's leadership, the President's Working Group on Financial Markets will examine some of the broader market issues underlying the recent market events, including the impact of securitization and the role of rating agencies in the credit and mortgage markets. The Treasury Department will also be releasing early next year a blueprint of structural reforms to make financial services industry regulation more effective, taking into account consumer and investor protection and the need to maintain U.S. capital markets competitiveness.

Most important and in addition to efforts to fully understand the current situation in the financial markets, the Treasury Department, the Department of Housing and Urban Development, and others in the Administration have carefully focused on evaluating the challenges faced by individuals in the subprime market. Last week, the President announced a series of market-based initiatives to help more homeowners keep their homes. The Administration, led by the Treasury Department and HUD, has undertaken several actions to provide assistance to homeowners, including the Administration's continued pursuit of legislation modernizing the Federal Housing Administration. Coordinating with HUD, the Treasury Department also will reach out to a wide variety of entities, such as NeighborWorks America, mortgage originators and servicers, and government-sponsored entities, like Fannie Mae and Freddie Mac, to identify struggling homeowners and expand their mortgage financing options. The President has also asked Congress to temporarily change a provision of the federal tax code that currently considers cancelled mortgage debt on a primary residence as taxable income. The Treasury Department looks forward to working with Congress in the days ahead.

In addition, the federal government has taken several actions to increase transparency and enhance lending standards in the mortgage industry. For example, in 2006, the banking regulators issued supervisory guidance addressing nontraditional mortgages and in June 2007 finalized subprime lending guidance. Separately, the Federal Reserve has undertaken a comprehensive review of the disclosure system for mortgage loans under the Truth in Lending Act and is currently addressing unfair and deceptive mortgage practices using its authority under the Home Ownership and Equity Protection Act. Later this fall, HUD will propose reforms to the Real Estate Settlement Procedures Act to promote comparative shopping for the best loan terms, provide more transparent and comprehensible disclosures, including fee disclosure, and limit settlement cost increases.

Conclusion

The recent volatility in the credit and mortgage markets reflects a reassessment of risk across a broad spectrum of securities. These events have occurred during a time of solid domestic and global growth, helping to mute some of the impact of this turbulence. I do want to caution policymakers that this process is far from over. It will take more time to play out and certain segments of the capital markets are stressed. Risk is being repriced. This repricing will lead to a reevaluation of assets. This reevaluation will inevitably impact the balance sheets of financial market participants. As investors review fundamental characteristics and confidence returns, liquidity will improve. Yet, policymakers must remain vigilant as further stress could create further challenges and continued volatility.

It is critical that policymakers understand these issues and their underlying causes and continue to enhance the capital markets regulatory structure to adapt to market developments. I appreciate having the opportunity to present the Treasury Department's perspectives on these important issues.

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Board of Governors of the Federal Reserve System

Joint Press Release

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Office of Thrift Supervision
National Credit Union Administration
Conference of State Bank Supervisors

For immediate release **September 4, 2007**

Federal Financial Regulatory Agencies and CSBS Issue Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages

The federal financial regulatory agencies and the Conference of State Bank Supervisors (CSBS) on Tuesday issued a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

Significant numbers of hybrid adjustable-rate mortgages will reset throughout the remainder of this year and next. Many subprime and other mortgage loans have been transferred into securitization trusts that are governed by pooling and servicing agreements. These agreements may allow servicers to contact borrowers at risk of default, assess whether default is reasonably foreseeable, and, if so, apply loss mitigation strategies designed to achieve sustainable mortgage obligations. Servicers may have the flexibility to contact borrowers in advance of loan resets.

Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal. In addition, institutions should consider referring appropriate borrowers to qualified homeownership counseling services that may be able to work with all parties to avoid unnecessary foreclosures.

The statement, which was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and CSBS, is attached.

Attachment (21 KB PDF)

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