

**Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation on Legislative Proposals
On
Reforming Mortgage Practices,
before the
Financial Services Committee,
U.S. House of Representatives
October 24, 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) regarding legislation to address recent practices in the mortgage market. In its prior hearings this year, this Committee has carefully documented developments in the mortgage market that have resulted in harm to consumers and the economy.

As I have testified previously, the events that have led up to the recent market disruptions and problems in the mortgage market demonstrate how weak credit practices in one sector can lead to a wider set of credit market uncertainties that can 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 complex mortgage lending industry has resulted in serious adverse consequences for consumers, lenders, investors, and, potentially, the U.S. economy.

For borrowers, there are 2.07 million subprime first-lien hybrid adjustable rate mortgages (ARMs) outstanding that were made in 2005 and 2006, most of which have or will reset in 2007 or 2008. While about 311,000 of these are currently seriously delinquent or in foreclosure, the size and volume of resets also suggests the potential for serious financial distress among the remaining 1.75 million households whose loans are subject to reset¹. For investors, the uncertainty that now pervades the mortgage 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.

The FDIC recognizes the importance of home ownership. We also recognize that responsibly underwritten loans to consumers with less than perfect credit profiles can be prudent and profitable assets, provided that institutions have the necessary expertise and capital support to manage them in a safe and sound manner. Moreover, the FDIC is committed to the goals of the Community Reinvestment Act of 1977, which has long encouraged extending home mortgage credit to low and moderate income communities. Clear, balanced, common sense standards regarding mortgage lending practices will

reinforce market discipline and preserve an adequate flow of capital to fund responsible lending.

Returning to Fundamentals

The financial system has changed dramatically in recent years. Changes in technology, delivery channels and funding sources have resulted in financial products that are more complex and marketed through increasingly sophisticated methods. In addition, there has been increased participation in the mortgage market by providers other than insured banks and thrift institutions. For example, approximately half of subprime mortgage originations in 2005 and 2006 were carried out by companies that were not subject to examination by a federal supervisor. The proliferation of securitization as a funding method also has changed the financial system by moving large volumes of assets off the balance sheets of federally-insured financial institutions.

Unfortunately as the industry changed, many risk management fundamentals were ignored or weakened. To be sure, fraud has played a role in some portion of troubled loans, particularly those that exhibited early payment default. However, the core of the problem lies with lax lending standards and inadequate consumer protections resulting in a widespread failure to underwrite loans to borrowers based on their ability to repay.

The impact of poor underwriting practices has spread throughout the economy in recent months, harming consumers and investors while creating volatility in the financial markets. Legislative action by this Committee and rulemaking by the Federal Reserve Board under the Home Ownership and Equity Protection Act (HOEPA) hold out promise that mortgage originations will return to the standards and fundamentals that have served us well for many years.

In my June testimony before this Committee, I listed several elements that should be included in national standards for mortgage lending. Among other things, I suggested these standards should include the following elements:

- Underwriting at the fully indexed rate, which would go a long way toward helping borrowers avoid loans they cannot repay, and would improve the quality of lender portfolios and mortgage backed securities;
- A "bright line" presumption against affordability if the loan, including taxes and insurance, exceeds a debt-to-income ratio of 50 percent;
- A prohibition on stated income loans in the absence of strong mitigating factors;
- Restrictions on prepayment penalties;
- A requirement for a system of licensing and registering mortgage originators that addresses activities by entities that operate outside the supervision of the federal banking regulators or on a multi-state or nationwide basis.

In addition, any legislation or regulation to improve mortgage standards should address misleading or confusing marketing that prevents borrowers from properly evaluating loan products. The standards should require that marketing information for adjustable

rate mortgages include a benchmark comparison of the rate and payment being offered by the same lender for a traditional 30-year fixed rate mortgage. The standards also should require that all rate and payment disclosure information include full disclosure of the borrower's monthly payment at the fully amortized, fully indexed rate, not just the introductory rate -- consistent with the approach of the guidance that the FDIC and other agencies have issued².

A statute or regulation that includes the elements described above would establish strong national lending standards that would provide significantly enhanced protections for consumers, and greater transparency of the true costs and risks of financial products backed by these types of mortgages for investors.

The Mortgage Reform and Anti-Predatory Lending Act

The Mortgage Reform and Anti-Predatory Lending Act of 2007, includes a number of provisions that would address many of the standards described above. The proposed bill provides a workable and helpful vehicle for legislative action to establish proven underwriting standards for bank and non-bank lenders. Certain provisions of the bill would help ensure that borrowers receive mortgages that they can ultimately afford to repay and that lenders understand the risks of their credit decisions.

The requirements in the proposed legislation that mortgage originators be licensed and registered will improve the professionalism of mortgage originators and ensure that bad actors cannot move from one jurisdiction to another to continue their harmful activities. Many types of brokers, such as those in the insurance and securities industries, are already subject to extensive registration regimes. It seems appropriate that brokers working with borrowers on the largest financial investment most will ever make also should be subject to appropriate licensing and registration requirements. In furtherance of this objective, the Conference of State Bank Supervisors has been working to establish a nationwide database identifying all licensed mortgage brokers. The FDIC has been supportive of this effort and agrees that improved licensing and registration will benefit the originators, as well as consumers.

The provisions of the bill establishing minimum standards for mortgages also include many criteria that have long been used by lenders to evaluate a borrower's ability to repay a loan. These include requiring verified and documented financial information, considering all applicable taxes, insurance and assessments and underwriting based on the fully indexed rate assuming a fully amortizing repayment schedule.

It is especially important that the bill also mandates consideration of a borrower's debt-to-income ratio in determining repayment capacity. The debt-to-income ratio, which compares the borrower's income to their recurring monthly debts, is one of the indicators of whether the borrower will be able to repay the loan under its stated terms. Over the last 10 years, the overall proportion of household income devoted to debt service has steadily risen.

The debt-to-income ratio is the primary metric for measuring borrowers' ability to repay their increasingly heavy debt load. Establishing a rebuttable presumption of affordability based on a debt-to-income ratio of less than 50 percent will help ensure that borrowers will be able to afford their home loan payment. In addition, by permitting additional rulemaking regarding debt-to-income standards, the proposed legislation creates a mechanism for recognizing higher percentages in cases involving valid mitigating factors.

A clear bright line standard for determining repayment capacity, such as the debt-to-income ratio, will serve an especially important role by acting as a check on the significant portion of mortgage originators that are not subject to regular supervision. For depository institutions, regulators can evaluate whether the entity is complying with both the letter and spirit of provisions designed to address a borrower's ability to repay through the examination process, which includes loan level review and analysis. In the absence of ongoing supervision, there is a greater need for a clear, bright line standard to prevent efforts to subvert the ability to repay requirement.

The debt-to-income ratio will reinforce the benefits of requiring that loans be underwritten at the fully indexed interest rate. Without a debt-to-income limitation, lenders could underwrite loans to the fully indexed interest rate but at such a high percentage of a borrower's income that the loan could not realistically be repaid. The requirement that loans be fully documented also could be circumvented without a debt-to-income standard to ensure that the borrower's fully documented income can support the loan.

Although the bill does not directly address the kind of marketing disclosures I suggest above, it does include provisions requiring mortgage originators to disclose the comparative costs and benefits of mortgage loan products, the nature of the originator's relationship to the consumer, and any conflicts of interest that the originator may have. Providing this important information to consumers will empower them to make better informed decisions about the products and services being offered by mortgage originators. In addition, consumers will benefit from the prohibitions against steering a consumer to a mortgage loan that is not in the consumer's interest and against originators' receipt of incentive compensation, including yield spread premiums, based on the terms of a mortgage loan.

Finally, it is important to address assignee liability as a meaningful check on abuse by originators. Many mortgage originators are not subject to comprehensive supervision and assignee liability can provide an extra element of protection against abusive practices. Given the difficulties inherent in enforcing standards against originators, it is appropriate that those funding their activities bear some measure of responsibility for compliance with lending requirements. To be effective, however, assignee liability must be based on bright line standards so that assignees can effectively screen for noncompliance. Uncertainty regarding assignee responsibility could inadvertently dry up credit essential for responsible subprime lending.

Conclusion

As Congress moves forward on this bill and other legislation to address problems in the mortgage market, it is important that it take a balanced approach that preserves the elements of the current system that have worked well for the economy while ensuring that proven industry standards are used by all lenders. This approach will help not only borrowers. Investors and those who provide funding to the mortgage markets will benefit as well. I support the operation of market forces; however, it is appropriate to set rules for market participation. Moreover, price competition does not work if consumers do not understand the true cost of financial products. Through appropriate rulemaking and legislation, regulators and Congress can establish consumer protections that are strong and consistent across industry and regulatory lines. The FDIC stands ready to work with Congress to ensure that credit is based on standards that achieve a fair result for both the borrower and the lender.

That concludes my testimony. I would be happy to answer any questions the Committee might have.

- 1 FDIC calculations based on the Loan Performance Securities database updated through June, 2007.
- 2 Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609 (October 4, 2006); Statement on Subprime Mortgage Lending, 72 FR 37569, July 10, 2007.

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