Remarks of
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Good morning and thank you for your kind introduction. I would also like to thank Neil Milner, President of CSBS, for inviting me to speak today. The Federal Deposit Insurance Corporation (FDIC) enjoys a close working relationship with the Conference of State Banking Supervisors (CSBS) and it is a partnership that we value highly.

There is no shortage of important issues confronting the FDIC today – implementation of the new deposit insurance law, industrial loan companies, and the Basel II and Basel IA capital rules. But perhaps the most urgent and compelling issue confronting the FDIC and the other federal bank regulatory agencies today is the deterioration in the subprime mortgage market. It is also an issue that clearly requires close cooperation between federal and state banking regulators because although half of the outstanding subprime mortgages were made by federally insured banks and thrifts or their affiliates, the other half were made by unaffiliated lenders subject only to state regulation. As a result, CSBS will have to play a critical role, along with the federal banking agencies, in addressing the challenges currently facing the subprime mortgage market.

I would like to take a few minutes this morning to discuss the evolution of the mortgage market in the United States over the past 70 years, the development of the problems in the subprime mortgage market, and what we can do to address them.

The Evolution of the U.S. Mortgage Market

The United States (U.S.) has a long history of valuing the ability to own a home. Homeownership promotes stable communities and has been an important contributor to the accumulation of household wealth.

Not too long ago, the 30 year, fixed rate mortgage dominated the U.S. mortgage market. The Federal Housing Administration (FHA) popularized the 30 year fixed rate mortgage in the 1930s following disruption in the U.S. housing industry during the Great Depression. Relatively short term balloon mortgages were the norm prior to the Great Depression. On most such balloon mortgages, principal was at most only partially amortized at maturity, leaving the borrower with the challenge of refinancing the balance. This system of mortgage lending resulted in a lengthy period of defaults and foreclosures. It has been viewed as having contributed to and perhaps even deepened the Great Depression.

The FHA's 30 year fixed rate mortgage introduced the concept of a standardized, long-term, self-amortizing, home loan that allowed homebuyers to lock in fixed, affordable monthly payments over the entire duration of the loan. The 30 year fixed rate mortgage was extremely popular and became the standard loan product of the U.S. housing

industry. It allowed millions of Americans to build equity in their homes over their working lives and accumulate assets for retirement.

It wasn't until the 1980s that an alternative mortgage product, the adjustable rate mortgage (ARM), gained some popularity. ARMs gained traction at that time due to the extremely high interest rates that prevailed then. Lenders liked ARMs because the product allowed them to better match their cost of funds with their cost of liabilities and shift interest rate risk to the borrower. As a result, ARMs grew to account for a substantial but limited share – generally less than a quarter -- of all mortgage originations, until recently.

As I am sure you are aware, over the last several years there has been a dramatic shift in the mortgage market away from the traditional 30 year fixed rate mortgage and toward ARMs and the so-called nontraditional mortgages, principally interest only and payment option ARMs. The share of mortgage originations accounted for by fixed rate mortgages fell from 84 percent in 2001 to 55 percent last year.[1] Traditional 30 year fixed rate mortgages thus now account for less than 55 percent of mortgage originations, since nontraditional mortgages, such as interest only loans, include some fixed rate products. Last year ARMs accounted for 45 percent of originations and nontraditional mortgages, most of which are ARMs, accounted for 32 percent of originations. This is a dramatic development with significant implications for borrowers and lenders.

The Development of the Subprime Mortgage Problem

Subprime mortgage lending is another relatively recent mortgage market development. Until the mid-to-late 1990s, mortgages were generally available to homeowners with unimpaired credit histories and stable, verifiable, sources of income. Subprime mortgage lending, which began to achieve some momentum in the mid to late 1990s, expanded mortgage finance options available to borrowers with impaired credit histories. It is important to recognize that refinancings, and in particular, cash out refinancings, have historically accounted for the majority of subprime mortgage lending.

The subprime mortgage market accounted for a relatively small share of total mortgage originations until a few years ago. But at the same time that nontraditional mortgages began growing rapidly a few years ago, subprime mortgage lending also began to escalate. The subprime share of mortgage originations grew to over 20 percent by 2006 compared to 5 percent in 2001.[2] Subprime mortgages account for about 14 percent of first lien mortgages outstanding and represent about 7.5 million loans.[3]

It has now become clear that during this rapid growth in subprime lending many loans were made without regard to prudent underwriting standards. About 70 percent were the sort referred to as the 2/28 or 3/27 hybrid ARM.[4] These are mortgages with a low fixed initial interest rate for 24 or 36 months after which the payment rises significantly – as much as 6 percentage points. Borrowers face significant payment shock upon expiration of the initial fixed period if they are unable to refinance due, for example, to changes in interest rates or the value of their home.

The underwriting characteristics of recently originated subprime loans are equally troubling. Many of these subprime 2/28-type mortgages were underwritten to the introductory, teaser rate. Most do not escrow taxes and insurance, exposing credit-impaired borrowers to unexpected large bills. About 65 percent of subprime 2/28s have prepayment penalties.[5] And at least a quarter of subprime mortgages originated last year had the added layered risk of piggyback or second loans, resulting in high loan to value ratios or no equity at all.[6] Relative to prime mortgages, subprime mortgages are more likely to have a combination of risk factors and to have higher loan to value (LTV) ratios and higher debt-to-income (DTI) ratios.[7]

Another troubling aspect of the recent subprime lending boom has been the practice of making these loans on a stated income basis, in other words, requiring no verification or documentation of ability to pay the loan. Over 40 percent of subprime loans originated and securitized last year were stated income.[8] It used to be that underwriters were required to consider the borrower's ability to pay along with property value and willingness to pay when evaluating whether to grant a mortgage.[9] Underwriters spent considerable effort to verify the borrower's ability to pay by thoroughly documenting income and calculating housing to income and debt to income ratios. These prudent lending practices appear to have fallen by the wayside in the subprime mortgage market.

In 2001, the federal regulatory agencies identified the characteristics most often associated with predatory lending: making unaffordable loans based on the collateral of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time a loan is refinanced; and engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.[10] We used to think that the second and third practices of loan flipping and deception were the most common. It now appears that the most elementary notion of predatory lending – failure to underwrite based on the borrower's ability to pay – became prevalent in the subprime mortgage market.

Moreover, Home Mortgage Disclosure Data (HMDA) reveals that minorities are more likely to receive high-cost subprime mortgages than other racial or ethnic groups. For example, a 2006 Federal Reserve study relying on HMDA data from 2005 found that 55 percent of blacks and 46 percent of Hispanics received so-called higher cost mortgages, defined as mortgages with interest rates that exceeded the Treasury rate by 3 percentage points.[11] This compared to only 17 percent for non-Hispanic whites. The study indicated that borrower related factors accounted for only one-fifth of this disparity. These data suggest that racial minorities bear a disproportionate impact of recent subprime lending practices. In my view, this represents an important dimension of this issue.

Why Did it Happen

So how did this all come about? The surge in subprime and nontraditional mortgage lending reflected a confluence of developments over the last several years. First, the

winding down of the largest refinance boom ever in 2003-2004 led to vigorous competition among originators and mortgage brokers as lenders loosened underwriting standards to try to maintain lending volume.

At the same time, homeowner demand for credit was exceptionally strong due to the vigorous economy and sustained low interest rates. But in many densely populated areas of the country that were growing rapidly, borrowers faced unprecedented affordability constraints due to rapid home price acceleration. These events together led to significant demand for and growth of risky non-traditional mortgage products as well as the 2/28-type subprime mortgage.

But fueling this surge in lending also required a pipeline of liquidity which was provided by Wall Street and global investors in search of high yielding assets. Many financial institutions sought to manage the risks associated with nontraditional and subprime mortgages by securitizing their mortgage originations. In 2006, over 70 percent of the subprime mortgages originated were securitized.[12] Most of these mortgages made their way into the so-called private label mortgage backed securities (MBS) market. Subprime MBS accounted for about 40 percent of private label MBS last year.[13] The rapid growth of subprime lending and securitization helped drive the private label share of total MBS to 56 percent last year from 18 percent in 1999.[14] This development represents another significant shift in the mortgage industry.

The Dimensions of the Subprime Mortgage Problem

You are all aware that the subprime mortgage market has experienced significant dislocation in recent months reflecting the fallout from these loose lending standards. Interest rates on a significant volume of subprime mortgages have now begun to adjust upward. Rapid home price appreciation in many parts of the country came to an end last year, exposing subprime borrowers with little equity in their homes and trapping many borrowers in mortgages that they cannot afford to pay.

Delinquency, default and foreclosure rates on subprime mortgages have risen substantially in recent quarters and subprime mortgage bond downgrades have accelerated. Many subprime lenders have been hit by put-backs – forced to buy back delinquent securitized mortgages - and, as a result, many – thus far 23 - have failed and more have been sold.[15]

There are now significant concerns about the prospects of the millions of subprime borrowers who hold 2/28 type mortgages. According to recent studies, about 2 million subprime loans will reset and cause homeowners to face payment shock in 2007 and 2008.[16] This represents about a third of outstanding subprime mortgage loans valued at about $480 billion. A significant portion of these resetting subprime loans could end up in foreclosure, further depressing housing markets in areas of the country significantly affected. It is important to recognize that when foreclosures occur they affect not only the homeowners and their families, but have spillover effects on the housing values of their neighbors and the entire community. Many of these loans are expected to reset

later this year and the outlook could worsen, depending on the state of the economy and the housing market.

Regulatory Responses

We confront two critical issues in addressing the subprime mortgage problem. First, we need to restore responsible underwriting standards to the subprime mortgage market. Second, we have to address the potential foreclosure problem for the two plus million homeowners whose loans will reset over the coming year and a half.

In regard to the first issue, on March 2nd, the four federal bank agencies and the National Credit Union Administration jointly issued for comment a proposed Statement on Subprime Mortgage Lending, which specifies that borrowers should be qualified at the fully indexed rate, assuming a fully amortizing repayment schedule.[17]

The proposed guidance stresses that lenders should assess borrowers' repayment capacity based on a DTI ratio which looks at a borrower's total monthly housing related payments including taxes and insurance as a percentage of gross monthly income. It stresses that this assessment is particularly important if the mortgage has risk-layered features such as reduced documentation, stated income, or simultaneous second liens.

The guidance states that consumers should be informed about potential payment shock, prepayment penalties, balloon payments, price premiums attached to reduced documentation, and responsibility for tax and insurance payments. It reiterates that institutions marketing subprime mortgages should not engage in predatory lending practices such as collateral-based lending and encouragement of loan flipping. Finally, the guidance makes it clear that the agencies will review risk management and consumer protection compliance processes, policies, and procedures at scheduled examinations and will take action against institutions that fail to implement or adhere to safe and sound practices.

CSBS and the American Association of Residential Mortgage Regulators (AARMR) publicly endorsed the proposed subprime mortgage guidance in a joint statement released on March 2nd.[18] Both groups emphasized the need for federal and state regulatory agencies to engage in a coordinated effort to provide effective supervision of the residential mortgage industry. CSBS and AARMR also announced their intention to develop a parallel statement for state supervisors to use with state-supervised entities.

The comment period for the proposed subprime guidance closed on May 7, 2007. As of May 15th, the agencies had received a total of 205 responses from financial institutions, industry trade groups, consumer advocate groups, and others. The agencies are in the process of reviewing these comments and we expect to issue final guidance in the near future.

As I mentioned earlier, non-banks overseen by state regulators account for over 50 percent of mortgage originations. We hope that the states will adopt the subprime guidance for state regulated entities as they did the nontraditional mortgage guidance the federal agencies released last year. As of this month, according to CSBS, 34 states

have formally adopted the nontraditional mortgage guidance and the guidance is pending adoption in an additional 8 states.

Further, the Federal Reserve has authority under the Home Ownership and Equity Protection Act (HOEPA) to issue regulations addressing abusive practices for all mortgage lenders whether insured banks and thrifts or non-insured lenders. The Federal Reserve Board has scheduled a public hearing on whether to exercise this authority next month. The FDIC would strongly support the Federal Reserve should it decide to exercise this authority.

There is also close attention being given to this issue in the Congress, and there is some prospect of legislative action as well.

In terms of preventing foreclosure and helping subprime borrowers stay in their homes, last month the FDIC and other regulatory agencies issued guidance encouraging financial institutions to work constructively with borrowers who are financially unable to make their mortgage payments.[19] Such accommodations are frequently in the interest of both the lender and the borrower as they allow the lender to avoid costly foreclosure and the borrower to stay in their homes.

There are two dimensions to addressing the hundreds of thousands of homeowners that are at risk of losing their homes. First, it appears that a substantial number of existing subprime borrowers could qualify for prime, fixed rate mortgages and could simply be refinanced out of their subprime mortgages. That is probably the simplest, surest, and best way to address the problems facing these borrowers. This represents a challenge for the major lenders, as well as for the government sponsored enterprises – Fannie Mae and Freddie Mac – all of whom have indicated a willingness to respond to this problem.

In addition, for those borrowers who are not able to refinance out of these subprime mortgages, it will be necessary to consider loan modifications within the securitizations to make these loans affordable to the borrowers. Modifications to their loan terms might include an extension of their initial interest rate or a reduction in their interest rate or principal balance to make their mortgages affordable on a long term basis. There are, as you may know, accounting, tax, and legal issues related to modifying the terms of loans held in securitization. This has been the object of intense attention by the regulators and the industry, and we think progress is being made in working through these issues. But more work needs to be done. Successful outcomes will require a committed effort by servicers and other mortgage industry participants.

The FDIC will be actively engaged, along with the other federal regulatory agencies, in trying to address these issues, and looks forward to working in partnership with CSBS and all the state banking commissioners on this urgent national problem. There is a great deal at stake and our most vigorous and concerted efforts will be required.

Thank you very much.

[1]The 2007 Mortgage Market Statistical Annual – Volume 1, *Inside Mortgage Finance*.

[2]*Inside Mortgage Finance*, March 2, 2007, page 6.

[3]Various estimates exist of the dollar volume and number of subprime mortgages outstanding. These estimates were cited by Chairman Ben S. Bernanke of the Board of Governors of the Federal Reserve System, in a speech titled “The Subprime Mortgage Market,” delivered at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 17, 2007.

[4]Based on data from First American LoanPerformance.

[5]*Inside B&C Lending*, May 18, 2007, page 6

[6]First American LoanPerformance and UBS.

[7]Id.

[8]*Inside B&C Lending*, May 18, 2007, page 6

[9]See, for example, *Handbook of Mortgage Lending*, edited by Jess Lederman, Mortgage Bankers Association of America, 1995.

[10]*Expanded Guidance for Evaluating Subprime Lending Programs*, FIL-9-2001, January 31, 2001, http://www.fdic.gov/news/news/financial/2001/fil0109.html.

[11]Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA data," *Federal Reserve Bulletin*, September 2006.

[12]*Monthly ABS Review*, Lehman Bros., April 2007, page 2

[13]*Inside MBS & ABS*, April 13, 2007, page 3

[14]*Inside MBS & ABS*, April 13, 2007, page 3

[15]"Subprime Mortgage Market: Profitability Pressures Creating Significant Turmoil," Credit Suisse, February 22, 2007.

[16]*UBS Mortgage Strategist*, April 10, 2007, and "Mortgage Payment Reset: The Issue and the Impact," First American CoreLogic, Inc., March 19, 2007.

[17]*Proposed Statement on Subprime Mortgage Lending*, March 2, 2007; http://www.fdic.gov/regulations/laws/federal/2007/07noticeSUBPRIME.pdf - PDF (PDF Help).

[18]"CSBS and AARMR Support Interagency Statement on Mortgage Guidance," CSBS and AARMR joint Press Release, March 2, 2007.

[19] *Working with Residential Borrowers; FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments*; FIL-35-2007; http://www.fdic.gov/news/news/financial/2007/fil07035.html.

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