Remarks of
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Thank you for inviting me to speak this afternoon about the recent developments in the subprime mortgage market in the United States. If I may, in order to put this issue in context, I would like to step back for a moment and trace the evolution of the U.S. mortgage market and see how we got into the current difficulties, and then discuss where we may be heading.

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, 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] They account for about $1.4 trillion of the approximately ten trillion dollars in outstanding one to four family mortgage debt.

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 loans 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.

Why Did it Happen

So how did this problem in the subprime mortgage market 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.[11] 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.[12] 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.[13] 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 have failed or been sold.

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.[14] 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.

Furthermore, racial minorities stand to lose the most because they are more likely to hold subprime mortgages than others. This fact is repeatedly borne out by research. Just a few weeks ago, the Federal Reserve released another study based on Home Mortgage Disclosure Data (HMDA). It reported that blacks are three times more likely to have subprime loans than whites. The report said that 54 percent of blacks and 47 percent of Hispanics received so-called high cost mortgages, defined as mortgages with interest rates that exceeded the Treasury rate by 3 percentage points.[15] This compared to only 18 percent for non-Hispanic whites. The study indicated that borrower-related factors accounted for only one-sixth of this disparity.

We talk about the so-called homeownership gap. Only about half of minority families own homes compared to three quarters of white families.[16] The minority homeownership gap has narrowed a bit since 2000. It was 24.5 points in 2006 compared to 25.7 points in 2000. But during this period the black homeownership gap has widened from 26.2 to 27.4 points. Studies indicate the subprime fallout may further widen the homeownership gap.[17]

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 June 29 the agencies issued a final Statement on Subprime Mortgage Lending. The statement describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to pay.[18] These standards include qualifying borrowers on a fully indexed, fully amortizing repayment basis.

The guidance states that risk-layering features should be avoided and stated income and reduced documentation accepted only if there are documented mitigating factors. Consumers should receive clear and balanced product disclosures and prepayment penalties should allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial interest rate period without penalty.

In addition, the state regulators have a critical role in addressing this issue. Although federally insured banks and thrifts and their affiliated lenders account for approximately half of outstanding subprime mortgages originated, non-bank affiliated lenders regulated only by the states account for the other half. 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.

On March 2nd the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) publicly endorsed the proposed subprime mortgage guidance in a joint statement and announced their intention to develop a parallel statement for state supervisors to use with state-supervised entities.[19] In their statement, 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.

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 FDIC would strongly support the Federal Reserve should it decide to exercise this authority.

There is also serious attention being given to this issue in the Congress. The House of Representatives has passed a bill establishing a national standard for subprime mortgages, and a bill is expected to be introduced in the Senate soon.

In terms of preventing foreclosure and helping subprime borrowers stay in their homes, in September 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.[20] 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 fixed rate mortgages and could simply be refinanced out of their subprime mortgages.

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. 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. The regulators issued a statement in September on loss mitigation strategies which urges servicers to proactively reach out to borrowers whose mortgages will reset, and work on modifications that result in mortgage obligations that the borrower can meet in a sustained manner over the long term.

Although some servicers have responded, overall it appears there have been few mortgage modifications thus far. They key is to develop a more standardized approach to loan modifications that can quickly be implemented on a larger scale. The Chairman of the FDIC, Sheila Bair, has put forward a proposal that for subprime borrowers who live in their homes and have remained current on their mortgage payments at the starter rate, the mortgage terms be modified simply to fix the mortgage payment at the starter rate for the term of the loan. This proposal is now getting serious attention and may be the basis for an approach that could be adopted by most mortgage servicers. We are hopeful progress can be made in addressing this urgent national issue.

Thank you very much.

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

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

[3] Based on data reported by the Mortgage Bankers Association and FDIC estimates.

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

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

[13] *Inside MBS & ABS*, April 6, 2007, page 3.

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

[15] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA data," *Federal Reserve Bulletin*, September 2006, and Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin,* September 2007.

[16] "The State of the Nation's Housing," Joint Center for Housing Studies of Harvard University, 2007.

[17] "Subprime Lending: A Net Drain on Homeownership," Center for Responsible Lending Issue Paper No. 14, March 27, 2007.

[18] *Statement on Subprime Mortgage Lending*, June 29, 2007; http://www.fdic.gov/news/news/press/2007/pr07055a.html.

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

[20] *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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