Statement of

Scott M. Polakoff, Deputy Director
Office of Thrift Supervision

concerning

Nontraditional Mortgages and
Subprime Hybrid Adjustable Rate Mortgages

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

March 22, 2007

Office of Thrift Supervision
Department of the Treasury

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I. Introduction

Good morning, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on current issues related to nontraditional mortgages and subprime hybrid adjustable rate mortgages (ARMs). You ask us to address the impact of these products on the nationwide housing market, the insured institutions that we regulate, and their customers and other consumers of these products. And you express a particular interest in better understanding the role that these products play in recently rising foreclosure rates across the country.

You also request that we address numerous related issues and questions, including the origin and evolution of nontraditional mortgage products and subprime hybrid ARMs; issues related to the proliferation of these products; and the timing, availability and nature of the data that raised regulatory concerns and the need for guidance to address emerging problems in these product markets. In addition, you ask us to discuss the role of securitization in the development and growth of mortgage markets for subprime hybrid ARMs and nontraditional mortgage products. And you seek recommendations on preventing foreclosures, and information on our handling of consumer complaints involving potentially abusive lending practices.

In my statement, today, I will attempt to address each of these issues and discuss our overall regulatory regime with respect to the oversight of these products and OTS efforts to combat predatory lending and promote consumer education and financial literacy. I will first highlight the relevant data and provide for your consideration some initial perceptions that appear to have framed the debate on these issues. Next, I will discuss the background and development of the proposed subprime guidance and provide greater detail on the proposal, including what we hope to learn in the comment process.

I will then highlight issues with subprime hybrid ARMs, including addressing the questions and issues you raise in your invitation letter, Mr. Chairman, with respect to the impact of these products in the current housing market and recently rising foreclosure rates. Finally, I will conclude my statement with a discussion of predatory lending issues and OTS efforts to combat the problem, including various consumer awareness and financial literacy initiatives.

II. Current Industry Data

Recent data suggest that nearly 69 percent of all U.S. households are homeowners. The total U.S. home mortgage debt is $10 trillion. Of this, subprime mortgages account for a total of $1.3 trillion, or roughly 13 percent of aggregate outstanding mortgage debt. In 2005, subprime originations were approximately $600 billion, representing roughly 20 percent of the $3 trillion mortgage origination market that year.

Insured depository institutions, including banks, thrifts, and credit unions, currently hold 32 percent of the outstanding mortgage debt in the U.S. And government sponsored enterprises (GSEs) and GSE Mortgage Pools hold another 41 percent (down from 52 percent 3 years ago) of aggregate U.S. mortgage debt. Finally, more than 17 percent of mortgage debt is currently held by private asset backed security issuers, including numerous foreign investors.

With respect to the subprime market, hybrid ARMS are the predominant mortgage product. In fact, 2/28 hybrid ARMs are almost exclusively underwritten to the subprime market. With respect to the most prevalent segment of this market, 2/28 hybrid ARMs, we are able to identify the following characteristics:

- 43 percent of outstanding 2/28 hybrid ARMs were purchase money loans (25 percent were made to first time buyers);
- 49 percent of these ARMs were cash out refinances; and
- 8 percent of these ARMs were no-cash out refinances.

And we also know that subprime hybrid ARMs typically have significant prepayment speeds, as demonstrated by the following trends:

- 10.5 percent of 2003 subprime hybrid ARM originations are still active;
- 27.5 percent of 2004 originations of these products are still active; and
- 65.3 percent of 2005 originations of these products are currently active.

Finally, approximately $567 billion of subprime ARMs are scheduled for reset in 2007. While this in itself is concerning, we also know that subprime hybrid ARMs are having increased problems well before the rate reset, as demonstrated below:

- Of total 2005 originations, 8.6 percent are seriously delinquent at the 11-month mark;

- Of total 2004 originations, 6.2 percent are seriously delinquent at the 11-month mark; and
- Of total 2003 originations, 5.6 percent are seriously delinquent at the 11-month mark.

As you suggest in your letter of invitation, Mr. Chairman, these are very serious issues. I submit to you, however, that while the numbers in and of themselves may be daunting, there are also some positive dynamics in our respective industries and the overall housing market that should be considered in the context of this debate. I will attempt to highlight these for you in the course of my testimony.

III. Overview and Nature of the Current Debate

At the outset, I believe it is worth stating what may seem obvious but often gets misconstrued in the context of discussions on subprime lending and predatory lending. That is, these are not the same thing. While there is significant debate about the appropriateness of lending in the subprime market, particularly with respect to rates and terms offered to many subprime borrowers, a subprime loan is not per se predatory. For that matter, predatory lending practices may be found in the prime market as well as the subprime market. Several examples are illustrative of the distinction:

- A widowed, 75 year old grandmother who has significant equity in her home but an income stream primarily limited to social security may have a reasonably high FICO score. If a broker lures her into an unacceptable mortgage under the guise that she can get cash out of her property but without full disclosure of the terms of the loan, this predatory action does not involve a subprime borrower.
- An opposite example is a construction worker who gets into an automobile accident and incurs significant medical bills. He becomes 30 – 60 days delinquent on some bills but eventually manages to bring everything current. He is fully employed and wants to purchase a home for his family. The delinquency may have hurt his FICO score, putting him into a "subprime" category, but he may be a good credit risk for proper loan underwriting. This subprime loan is not predatory.

IV. Background on Development of the Interagency Lending Guidance

A. Overview on the Nature of "Guidance"

As noted in your invitation letter, the federal banking agencies (FBAs) issued final guidance last fall on nontraditional mortgage lending products and put out for comment several weeks ago proposed guidance on subprime hybrid ARMs. While we understand your concern with respect to the time that it took for the FBAs to issue the guidance, please bear in mind that the guidance itself is intended to address particular issues with the use of these products in the recent housing market. As described more fully later in this statement, the laws and rules that address the origination, marketing and safe and sound underwriting of these products have been in place for many years at the OTS.

With respect to the proposed subprime guidance that is currently out for comment, our observations in this statement are generally limited to a description of the proposal and the basis for its issuance. Our discussion is not intended to suggest our final views on the appropriate handling of these products, or that our position has been decided or predetermined. We encourage all interested parties to provide their views to guide us in formulating final guidance.

Finally, it is also important to bear in mind the nature of agency "guidance" and its enforceability. Guidance, particularly on an interagency basis, is typically intended to present supervisory and/or regulatory views on the implementation and applicability of existing laws and regulations to a particular issue or emerging set of circumstances that warrant heightened attention or supervisory scrutiny. Guidance provides a flexible approach to highlight issues or concerns versus a more proscriptive regulatory approach that has the potential of producing unintended consequences in an area that may be highly volatile and reactive.

One of the benefits of guidance (versus a regulation) in the current context is that it provides the FBAs the ability to address ongoing issues that may arise from future market innovations not anticipated at the time the guidance is finalized. This is particularly important in the context of the subprime market where the availability of credit can be significantly influenced by government policies affecting credit providers. While we want to intercede to weed out irresponsible and predatory lenders, we do not want to shut off the availability of credit to the subprime market. Again, subprime lending is not per se predatory lending. As you are aware, the subprime market raises numerous unique challenges, not the least of which are ensuring that subprime borrowers continue to have access to credit from regulated depository institutions and not be forced to turn to other less regulated or unregulated credit providers.

B. Differences with the Interagency Nontraditional Mortgage Guidance and the Proposed Subprime Guidance

The final guidance on nontraditional mortgage products issued last fall addressed supervisory concerns with the use and proliferation of certain nontraditional mortgage (NTM) products. That guidance, *The Interagency Guidance for Nontraditional Mortgage Product Risks* (NTM Guidance), covers mortgages with interest-only and negative amortization features. And it applies to all banks, thrifts and credit unions, their subsidiaries and affiliates. While it does not specifically cover other state-licensed lenders and brokers, the Conference of State Banking Supervisors (CSBS) and the

American Association of Residential Mortgage Regulators (AARMR), have encouraged their member States to adopt similar guidance so that it applies more broadly to non-federally regulated lenders. It is our understanding that 28 States and the District of Columbia have done so.

As finalized and implemented by the FBAs, the NTM Guidance applies to mortgages with interest-only and negative amortization features. This was the exclusive focus of the NTM Guidance, which was tailored specifically to exclude coverage of fully amortizing loans. It is important to note that in tailoring the NTM Guidance, great care was taken to avoid unintended consequences, and that was the basis for the exclusion of fully amortizing loan products.

Fundamentally, the two pieces of guidance differ in their approach – the former is product-based and the latter is principles-based.

In this regard, an examination of the NTM Guidance reveals a clear and targeted focus on particular nontraditional mortgage products, i.e., so-called "interest only" and "pay option" ARMs. The intent in the issuance of this guidance was to send a strong and unambiguous signal to the industries we regulate that we expect underwriting of these products to be at the fully indexed rate and supported with a strong analysis of the appropriate risk layering practices for these products. Significantly, the OTS signaled this same message to the thrift industry more than a year earlier in a two-part series in the agency's publication, "The Quarterly Review of Interest Rate Risk."

By contrast, the proposed interagency subprime guidance provides a more principles-based review and analysis of appropriate underwriting practices and the assumption of risks by institutions operating in the subprime market. Most importantly, the subprime guidance, as proposed, is intended to send a strong signal regarding the appropriate marketing of subprime hybrid mortgage products. As described in the proposal, it is our view that such an approach will protect the interests of both lenders and borrowers in this market.

Having noted the difference between the two sets of guidance, we fully understand and appreciate that the same concerns that exist with NTM products also exist with subprime hybrid ARMs. These issues – including loans structured with features such as significant payment shock, risk layering, or inadequate customer disclosure of nonstandard features – raise unique challenges in the subprime market. As such, we believe that separate guidance is appropriate.

Regarding the additional time required to address these concerns, it remains critical to bear in mind that the NTM Guidance addresses concerns with what are generally viewed as prime credit products. Thus, the consequences of the guidance affect the prime credit markets. While a legitimate concern was the potential constriction of credit from the issuance of the NTM Guidance, it was our view that this was a far greater danger with the application of the NTM Guidance in the subprime markets. Thus, a determination was made to develop separate guidance, i.e., the current subprime proposal, rather than extend the NTM Guidance to the subprime market with the potential of a devastating effect on credit availability.

Separate guidance addressing subprime hybrid ARMs is appropriate for a number of reasons. We have significant concerns with the proliferation and marketing practices associated with subprime lending products. These concerns include, but are not limited to, the impact on subprime borrowers of payment shock and the inability to repay a debt that was not responsibly extended to them in the first place. And when a borrower attempts to escape a bad loan, prepayment penalties are often very high. In many cases, this can limit a borrower's ability to refinance a loan with more favorable rates and terms. This can be particularly problematic with loans that have low teaser rates that adjust to higher payments. High and extended prepayments penalties also make it more expensive for a borrower in financial difficulties to refinance or sell their home. Without viable options, some borrowers may not be able to avoid foreclosure.

Customer disclosures are a particularly sensitive issue in the subprime market. In many instances, lawful disclosures can be at best confusing to even the most sophisticated borrowers. Most borrowers can generally understand fixed-rate, amortizing loans, where monthly payments, over time, will amortize a mortgage. However, the rash of new mortgage products with varying and nontraditional payment options and interest rates has left many borrowers about how exactly their mortgage works. And it does not help that many brokers sell their products by stressing the low initial interest rates and payments. As a result, many borrowers focus simply on whether they can afford the payments at inception.

Further complicating the process is that the standard truth-in-lending disclosures are not sufficient to fully inform borrowers of how their loans are structured, when payments will increase, and by what amount. In both the NTM Guidance and the proposed subprime guidance, the FBAs stress the importance of disclosures that fully inform borrowers of alternative and nontraditional mortgage products. We believe this is important both from a safety and soundness standpoint for the lenders we regulate as well as the protection of the customers and consumers they serve.

While consumer information is an important part of the loan process, it is equally important for lenders to make sure that borrowers have the ability and willingness to repay their loans. While making loans affordable is a worthy goal, it does no good to make a loan affordable for two or three years and then increase the monthly payment to the point that a borrower cannot make the payments. Foreclosures hurt lenders as well as borrowers – a point that we constantly stress with our regulated institutions. Safe and sound underwriting tailored to each individual borrower is a critical step in the loan evaluation process.

There are many factors that go into loan underwriting, including credit history, employment history, and combined loan-to-value (CLTV) and debt-to-income (DTI) ratios. Both the NTM guidance and the proposed subprime guidance state that borrowers should be qualified based on payments reflecting the fully amortizing and fully indexed interest rates, and not teaser, or low initial start rates. In this regard, while a DTI ratio is just one factor that needs to be considered in whether a borrower has the ability to repay the loan, it can be especially important. For example, we look hard at any loan where a borrower's DTI ratio exceeds 45 percent.

Closely related to DTI ratio is income and employment verification. Historically, lenders would verify an applicant's employment, income, deposits, and other financial assets to evaluate repayment capacity. Over the past few years, however, many lenders have offered loans with low documentation requirements (low-doc loans), such as simply "stated income," where the loan analyses are based on the income the borrower indicates on his loan application without any verification. For some borrowers with high down payments and high credit scores the risks for these loans may have been manageable. However, these loans are now offered beyond this class of borrowers and even include some subprime borrowers. Statistics have shown that such loans have a significantly higher risk of default than loans where income and employment are documented and verified.

Affordability is also a critical issue, and remains an important consideration in the FBAs efforts in providing responsible flexibility to lenders in structuring their loan products. It is also a reason that the FBAs have proposed the subprime guidance, rather than prohibiting or significantly limiting or curtailing subprime lending. Notwithstanding concerns with subprime credit constriction, loans to low- and moderate-income people must be structured so that the borrower can afford them both at origination and throughout the life of the loan. Loans should not be structured with the idea that a borrower will eventually be required or will elect to refinance or sell their home. This is not an affordable loan, but rather a recipe for foreclosure.

Paramount to the underwriting process is maintaining safety and soundness. Lenders that responsibly protect their own self interest also protect the interests of their borrower-customers. All loans should be underwritten in a manner that provides reasonable assurance that a borrower has both the willingness and ability to repay. Where borrowers have weak credit histories, other factors – such as private mortgage insurance, low CLTVs, current sound credit histories, proper income documentation and reasonable DTIs – can serve to mitigate higher default risks for such borrowers. However, when risk factors are layered and include high LTVs, poor recent credit, high DTIs, a lack of proper documentation, and/or loan structures that create payment shock or escrow issues, default risk for both an institution and the borrower are dangerously elevated.

With all of these factors in mind, the FBAs proposed the subprime guidance on March 2, 2007. Again, it is intended to address the particular issues and challenges presented by subprime lending, both currently and in the future.

V. Description of the Proposed Subprime Guidance and Request for Comments

As stated previously, the proposed interagency subprime guidance focuses on loans involving repayment terms that exceed a borrower's ability to service the debt without refinancing or selling the property. The proposal specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal also underscores that communications with consumers should provide clear and balanced information about the relative benefits and risks of the products.

In connection with the proposed guidance, we are particularly interested in obtaining comments on a number of issues. These include:

- Whether subprime hybrid loan products always present inappropriate risks to institutions and consumers, or the extent to which they can be appropriate under some circumstances;
- Whether the proposed guidance statement would unduly restrict existing subprime borrowers' ability to refinance their loans;
- Whether other forms of credit are available that do not present a risk of payment shock;
- Whether the principles of the proposed guidance should be applied beyond the subprime ARM market; and
- Whether limiting of prepayment penalties to the initial fixed-rate period would assist consumers by providing them time to assess and act on their mortgage needs.

Again, while we do not wish to comment beyond the issues already discussed given that the guidance is out for proposal, these are issues of great concern in the current housing market. Comments are extremely important in further guiding the FBAs in this process. We are requesting comments on the proposed subprime guidance by May 7, 2007.

At this point, it also bears noting that the proposed subprime guidance applies to insured depository institutions, including banks, thrifts and credit unions. As with the NTM Guidance, it does not apply to state-licensed mortgage brokers or other state-regulated and/or unregulated mortgage bankers and lenders. While we applaud the efforts of CSBS and AARMR to enlist the support of 28 States and the District of Columbia to adopt the NTM Guidance, we believe that it is even more imperative that the States take similar action with respect to guidance or laws targeted at subprime lenders within their jurisdiction.

Approximately 80 percent of subprime loans are originated through mortgage brokers. And there are currently roughly 44,000 licensed mortgage brokers in the U.S. Typically, mortgage brokers are required to obtain a state license, but frequently there are no testing or education requirements that are part of that process. Complicating the picture is that background checks may be run only against a State's own criminal database, but not against the FBI's national criminal database. Moreover, it was recently reported in the American Banker that there are eight states that have no regulation of mortgage bankers and lenders. Not coincidentally, two of these States also happen to have the highest delinquency rates for subprime hybrid ARMs, with delinquency figures substantially above the national average.

We understand that CSBS and AARMR are currently working on a nationwide residential mortgage licensing program to address part of the problem. We have been advised that the initiative will create uniform national mortgage broker and lender licensing applications and a centralized database to house relevant information regarding mortgage brokers and lenders. We applaud this initiative and encourage all States to participate in the CSBS/AARMR program. Of particular note, this initiative will free up scarce State resources currently used for processing licensing applications and permit the States to focus greater attention on supervision and enforcement of mortgage brokers and lenders.

Again, however, this is only part of what is required to address the existing problem with the activities of state regulated mortgage brokers and lenders. We encourage CSBS and AARMR to work with their member States to review and comment on the proposed subprime guidance, and to consider appropriate action at the state level to pursue similar standards.

VI. Subprime Hybrid ARMs and Foreclosure Rates

A growing number of mortgage industry analysts are predicting significant increases in mortgage foreclosure rates. Traditional causes of foreclosure include significant medical expenses, job loss, divorce, and other unexpected challenges. Additionally, unscrupulous or predatory lending practices can also result in mortgage foreclosures.

And while there are more dual-income families servicing today's mortgages, today's mortgages (proportionate to incomes) are growing ever larger due to the high cost of housing in many markets. The financial impact of these larger mortgages grow exponentially with any upward movement in interest rates and/or loan balances, as allowed under the terms of many of today's mortgage products.

The proposed subprime guidance was issued in response to concerns that certain subprime hybrid loan products, which increased in volume significantly the past few years, are posing greater risks to lending institutions and borrowers.

A. National and Industry Foreclosure Rates

Based on the data currently available to us regarding subprime lending activities and the exposure of institutions that we regulate to this market segment, we can make a number of observations. First, external data available to us shows that the foreclosure rate on subprime mortgages nationwide, i.e., for all lenders, as of December 2006 was 3.63 percent of outstanding subprime mortgage products. This compares to a foreclosure rate of 2.48 percent one year earlier. This represents a year-over-year increase of 46 percent. While this large percentage increase is clearly a concern, it is important to keep it in context. For example, at 3.63 percent, the current foreclosure rate is where it was in September 2003, and substantially lower than the rate of 4.73 percent in December 2001. In other words, while the recent percentage increase is significant, in aggregate, the current level is not extraordinary.

Within the thrift industry, we survey our institutions semi-annually on their subprime lending activities. As of June 2006 (the latest compiled report), we had 17 (out of 854) thrifts with significant subprime lending operations. These institutions reported having approximately $47 billion in subprime mortgages, which represents about 5 percent of total mortgages held by the thrift industry. More significantly, OTS-regulated thrift industry holdings represented just 3.6 percent of the aggregate subprime market.

OTS-regulated thrift institutions engaged in subprime lending programs are generally well capitalized, and are all subject to heightened supervision and regulatory scrutiny by OTS examiners with respect to the conduct and operation of these programs. As described below, examiner oversight is tied into our agency-wide consumer complaint program. Institutions with significant consumer complaint activity regarding their mortgage lending operations are subject to heightened scrutiny. While we do not separately track the performance of subprime loan products held by thrift institutions, aggregate foreclosure rates for the industry are currently running about 0.065 percent per quarter, or about 0.26 percent on an annualized basis. While the current rate is up slightly, it is about where it was in 2004.

Comparing this data with the nationwide data available to us on subprime loan performance provides some additional analysis that is helpful to understand the portion of the subprime market currently occupied by the thrift industry. We know that subprime mortgage performance is heavily affected by local economic conditions. According to nationwide data available to us, the states with the highest foreclosure rates are Ohio, Indiana, and Iowa. California, the state where thrift industry subprime lending activity is concentrated, ranks well below the national average, with a foreclosure rate of 2.73

percent. From this, we conclude a lower aggregate industry exposure and foreclosure rate than the national averages.

With respect to thrift industry exposure to potentially increasing foreclosure rates predicted by some experts, the industry is well positioned from a capital and earnings standpoint to absorb such an increase in losses, should it occur. We encourage our regulated institutions (and, as described more fully below, particularly those with subprime lending programs) to work closely with borrowers to address potential foreclosure issues as quickly as possible in order to protect both the institution and the borrower. And we are closely monitoring those thrift institutions having significant subprime lending operations.

Another important consideration regarding thrift industry involvement in subprime lending programs going forward is the recent increase in early default put-backs among subprime securitizations. This has caused some smaller mortgage banking firms (but no thrift institutions) that specialized in subprime lending to fail. The reaction of the secondary market to this perceived increase in risk has been to lower the price on such securitizations. Lower prices, in turn, have reduced the attractiveness of engaging in such securitizations. The likely impact is to reduce the profitability of subprime lending and, thus, the attractiveness of the activity.

At this point, OTS-regulated institutions' exposure to these "early payment default" (EPD) put-backs appears to be minimal, although we expect repurchase demands to continue to rise over the course of this year. And there are several isolated instances of thrifts with heightened levels of put-backs. Of the six institutions that have reported put-backs as of December 31, 2006, the reported amount equaled approximately 2.65 percent of the respective institutions' Risk-Based Capital as of the reporting date.

We are continuing to monitor thrift institutions' exposure to this area, and are well aware of the significance of early detection of potential problems. Many of our institutions with more significant levels of exposure to the subprime market have already begun to pare down their participation in this market. In fact, initial data from a year-end survey of thrifts suggest that subprime lending by institutions involved in this market has slowed at least as much as the overall mortgage market, if not more. We expect the impact on securitizations to further reduce this activity.

B. OTS Oversight of Thrifts with Subprime Lending Programs

As noted above, thrift institutions engaged in significant subprime lending activities are subject to heightened OTS supervision and oversight with respect to the conduct and operation of these programs. During the normal course of examinations, institutions with subprime credit programs are reviewed from a safety and soundness perspective, and are also scrutinized to ensure that the institution is lending responsibly and following applicable laws and regulations.

In light of recent developments in the home mortgage market, the OTS has revised and will issue shortly its examiner guidance on home mortgage lending and servicing. The examiner guidance re-emphasizes our existing policy on foreclosures and, in doing so, explicitly recognizes that foreclosure is seldom a cost effective option, and encourages lenders to make special efforts to develop and maintain effective servicing and collection procedures for home mortgages that become delinquent. For example, the guidance suggests that lenders involved in subprime lending should have their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary.

In addition, the OTS's long-standing guidance on servicing states that a thrift's collection activities must comply with the following:

- The Fair Debt Collection Practices Act – in particular, the law defines from whom a debt collector may gather information on a consumer, the type of information that it may collect, and the acceptable forms of communication with the consumer and other parties;
- State laws that pertain to collection and foreclosure actions; and
- Bankruptcy law – an institution's collection activity is affected by any bankruptcy plan into which a debtor has entered. For instance, the filing of a bankruptcy petition acts as an automatic stay on any collection activities in process at the time. After such filings, collection efforts usually process through the bankruptcy court.

In some cases, a collection unit may enter into a short-term forbearance arrangement with a delinquent borrower before beginning a foreclosure action. For example, a servicer may permit the borrower to defer payments, follow an alternative repayment plan, or execute a deed in lieu of foreclosure (which grants the borrower full forgiveness of the debt). And the use of some loss mitigation techniques, such as waiving a due-on-sale clause to allow an assumption, may require an institution to repurchase the loan out of its mortgage-backed security pool. We expect thrift management to have information systems adequate to analyze these forbearance activities.

While we stress the need for an institution to work with its borrowers to resolve any payment delinquencies, we also stress the need for the institution to be fully aware of, report properly, and reserve adequately for its troubled loans. Transparency of operations is critical to a safe and sound banking system.

As noted elsewhere in this statement, loan forbearance and foreclosure strategies targeted as a win-win for the lender and borrower are generally significantly more cost-effective from a safety and soundness standpoint. We encourage all of our regulated institutions to consider and adopt such programs in a manner consistent with their safety and soundness and the protection of their borrower customers.

C. OTS Enforcement Activities

When an institution's lending programs are found to be potentially predatory or are lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to eliminate these risks. These include informal agreements, supervisory directives, board resolutions, and various other approaches.

For example, in one relatively recent case we addressed a series of transactions where an institution entered into an agreement with an affiliated entity to originate and fund subprime loans through the institution. The affiliate provided loan sourcing and origination services, and assisted in the disposition of the originated loans to investors.

In reviewing the parameters of the relationship between the institution and its affiliate, OTS examiners determined that the thrift was not managing the relationship appropriately, and insufficient controls were in place to fully ensure effective lending practices. And there was also an indication that some of the lending practices were abusive. In response, the agency issued supervisory directives and required board resolutions to address the problem. The thrift's relationship with the affiliated entity was terminated one month after the OTS took action to address the matter.

In another case involving an institution with a high level of customer complaints regarding potentially abusive lending practices, OTS examiners were sent to the institution to review the institution's lending practices and program. Pursuant to that review, the institution was directed to implement adequate policies to address and resolve various unacceptable lending practices. When the institution failed to address these issues in a timely manner, the OTS initiated an enforcement action against the thrift.

Pursuant to the OTS's enforcement order, the institution signed a written supervisory agreement with the OTS in which it agreed to improve its compliance with the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act and the Fair Credit Reporting Act. In addition, the institution agreed to create a "Consumer Ombudsman" responsible for "fairly and impartially reviewing and addressing [customers'] borrowing issues in a timely and effective manner." The agreement also required the development of borrower-oriented customer service plan/practices, and a consumer dispute resolution initiative plan among other things.

Approximately one year following the execution of the supervisory agreement, the OTS approved the institution's request for "voluntary dissolution".

We also recently addressed an issue with an institution engaged in what we viewed as a potentially abusive subprime credit card lending program. The nature of the program was uncovered in the normal course of an examination. In connection with the resolution of that matter, we directed the institution's board of directors to establish a systematic process to withdraw from the subprime credit card program, and immediately cease new approvals under the program.

Although this was a more informal action pursued in the course of an examination, the result was that the program's growth was immediately terminated, and the program itself was unwound within a reasonably short timeframe following the examination.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so.

VII. Predatory Lending and OTS Efforts to Combat the Problem

A. OTS Examination Efforts

The OTS regularly examines thrifts for compliance with federal compliance and consumer protection statutes including fair lending statutes such as the Equal Credit Opportunity Act, the Fair Housing Act, and section five of the FTC Act which prohibits Unfair Acts and Practices. In addition, the OTS examines for compliance with our regulations that prohibit discrimination and misrepresentations in advertising. We also examine to ensure compliance with interagency guidance on subprime lending, such as the 1999 Interagency Guidance on Subprime Lending and the 2001 Expanded Guidance for Subprime Lending Programs.

Finally, we are currently developing enhanced examination procedures that specifically address responsible lending practices for our regulated lenders that have a subprime lending program. These procedures direct examiners to focus on various issues and institution program areas, including:

- Whether institution marketing materials are well designed to present the typical consumer with adequate information to help them make informed product choices;
- Whether institution sales practices – either through loan officers or third parties – may tend to mislead a consumer about the nature and scope of a credit transaction or may impose pressure on consumers to accept terms and conditions based on incomplete or unbalanced information;
- Whether institution employee training programs, including training provided to third party vendors that interact with institution customers, foster best practices; and
- Whether existing institution practices may have the effect of steering particular groups of consumers to less favorable credit products or higher cost credit products than their credit risk profile warrants.

We are in the process of field testing these examination procedures with formal adoption expected as soon as practicable after making any necessary adjustments upon conclusion of the field testing exercise.

B. Utilization of Consumer Complaint Data

The OTS continually tracks individual institution consumer complaints relating to various potential regulatory violations, such as the Equal Credit Opportunity Act, and with respect to product offerings, such as ARM products. Consumer complaint staff and managers prepare summaries of consumer complaints for OTS examiners to utilize in their review during on-site examinations.

Institution consumer complaint records are an integral part of an the OTS's individualized Pre-Examination Response Packages (PERK) for each institution, and play a significant role in identifying areas for examiners to focus on during their on-site examination. These records also play a critical role in assessing the adequacy of an institution's overall compliance management program and in pursuing corrective action that may be appropriate to address programmatic weaknesses or deficiencies.

C. OTS Examiner Consumer Compliance Test

OTS recently developed an examination that is used to test and train OTS examiners regarding their level of proficiency across a broad range of consumer compliance laws and regulations. We developed this in-house examination in order to continue to ensure that OTS examiners have significant knowledge regarding consumer compliance requirements and agency expectations of the institutions that we regulate. The new test will assist us in working with our examiners to develop professionally in order to effectively examine thrift institutions, many of which have complex, retail-focused business models.

D. Consumer Education and Responsibility

The OTS has worked on its own and cooperatively with various other agencies and organizations to promote consumer education and responsibility. We also have various initiatives to improve financial literacy and we work closely with our institutions to encourage them to do the same.

1. The CHARM Booklet

One interagency initiative involved working closely with the Federal Reserve Board to assist consumers in navigating their choices among mortgage products. The product of that effort, a consumer disclosure brochure entitled the Consumer Handbook on Adjustable Rate Mortgages – or CHARM booklet, was revised and re-released on December 26, 2006. The CHARM booklet provides information to consumers about the features and risks of ARM loans, including the potential for payment shock and negative amortization. It is tailored to help consumers better understand some of the issues and potential pitfalls with newer loan products

In particular, the CHARM booklet was substantially revised to address the growing use of NTM and newer types of ARM products that allow borrowers to defer payment of principal and sometimes interest. For example, it includes information for consumers on both "interest-only" and "payment option" ARMs. The revised booklet describes how these loans typically work, demonstrates how much (and how often) monthly payments could increase, and describes how a loan balance can increase if only minimum monthly payments are made. The booklet, which is a required consumer disclosure for ARM loans, also includes a mortgage shopping worksheet to help consumers compare the features of different mortgage products.

2. The Interest Only-Pay Option Mortgage (IO-POM) Brochure

The OTS also contributed to the development of an interagency consumer informational brochure addressing interest-only and payment option mortgages. This brochure describes payment shock and negative amortization. This work is ongoing, with illustrations of these types of mortgages being developed to educate consumers on the points discussed in the brochure.

3. The OTS Consumer Complaint Brochure

In connection with our agency-wide program for National Consumer Protection Week in February, the OTS issued a consumer information brochure on how consumers can resolve complaints with financial institutions. That brochure highlights various steps that consumers can take in order to attempt to resolve a complaint. First, consumers are encouraged to try to resolve a problem directly with an institution by contacting senior management or the institution's consumer affairs department. If this is unsuccessful, consumers are advised to contact the appropriate OTS regional office for institutions regulated by the OTS or, if the entity is not OTS-regulated, the guidance provides information for identifying the appropriate federal and/or state regulator for various types of financial institutions. Finally, the brochure reminds consumers that the best way to pursue a complaint or concern is to make sure that it is well documented.

4. OTS's National Consumer Protection Week Program

The OTS Consumer Complaint brochure was part of a 5-day series of consumer protection and awareness initiatives during National Consumer Protection Week. During the week, the OTS also highlighted various issues for thrift institutions and resources available to consumers on financial literacy and education via press releases. We also noted that the agency's five day National Consumer Protection Week program was part of a wider agency initiative intended to bolster OTS efforts to assist institutions in working with their customers to improve financial literacy and education. And it is part of an ongoing effort to upgrade substantially the agency's own compliance, consumer protection and consumer awareness programs.

An important aspect of the OTS's efforts to upgrade our own consumer awareness and protection programs is monitoring emerging trends and evolving financial products in order to develop appropriate guidance for institutions and resources that assist consumers in making informed financial decisions. As we stressed before the Financial Literacy and Education Commission (FLEC) earlier this year, financial literacy and education is equally important to institutions and the customers they serve.

During National Consumer Protection Week, we also issued a press release reminding consumers about the risks presented by identity theft and steps to guard against it. The release highlighted for consumers their right to take advantage of a free credit report from the major credit reporting agencies pursuant to the Fair Credit Reporting Act.

We noted that careful credit report monitoring not only helps consumers obtain credit at rates commensurate with their credit history, it also helps to guard against identity theft. We also encouraged all of the institutions we regulate to work with their customers to increase awareness of the importance of periodically monitoring their credit report. We reminded consumers that credit scores largely determine the cost they pay to receive loans and that over time, a consumer's ability to pay lower interest rates to a lender because of a positive credit score can save them lots of money. We also noted that insurance companies and employers also utilize information from credit reports, stressing how important it is for all of us to know what's in our credit reports.

E. The Impact of Mortgage Fraud

At the National Housing Forum (NHF) sponsored by the OTS in December 2006, another issue affecting the subprime mortgage market was highlighted. The NHF included a panel on mortgage fraud that featured an important discussion on the impact of mortgage fraud on financial institutions and borrowers. The panel discussion highlighted the fact that regulated institutions reported over a $1 billion in losses from mortgage fraud in 2005. And reports of suspected mortgage fraud doubled in just three years from 2003 to 2006.

The panel discussion noted that mortgage fraud can be divided into two broad categories – fraud for property and fraud for profit. Fraud for property generally involves misrepresentations or omissions designed to deceive the lender into extending a mortgage. Fraud for profit, frequently committed with the complicity of industry insiders, involves fraudulent appraisals, property flipping, straw borrowers, and identity theft. Fraud for profit frequently involves large schemes, concocted by sophisticated criminals. This is an important point in the context of the current discussion and, unfortunately, one that is not easily quantifiable with respect to the impact on subprime borrowers.

While lenders and consumers have benefited significantly from lower interest rates and a mortgage boom the past several years, higher loan volumes have encouraged lenders to develop ways to cut costs and create efficiencies in the mortgage underwriting process. And the recent moderation in housing has added pressure to exploit these efficiencies in order to capture demand while retaining profits. It is certainly true that mortgage lending innovations have produced efficiencies that are good for lenders and borrowers. Yet, while such innovations have made borrowing easier and more user-friendly, they have also provided opportunities for fraud to proliferate. This is an ongoing issue of concern to the OTS and all participants in the mortgage markets.

F. OTS Community Outreach Activities/Partnership Building

Another important aspect of OTS efforts to combat predatory lending is a community outreach program that includes designated community affairs liaisons – known as CALs – in each of our regional offices. OTS CALs conduct various regional outreach efforts to help identify community credit and banking needs, and match those needs and opportunities with our regulated thrifts. Over 30 new community contacts were established in 2006 to complement our many existing community-based partners. Such partners include financial institutions, government agencies, community based organizations, non-profit groups, and social service agencies. Our CALs address and work on affordable housing and economic development needs, best practices for serving emerging markets, elder financial abuse issues, financial literacy programs, and other initiatives targeted at low- to moderate-income individuals and communities.

Regional programs, organizations and forums in which OTS CALs and other OTS employees are involved include a Boston New Alliance Task Force in October 2006 addressing the unbanked and underbanked; two events in 2006 involving the New York New Alliance Task Force that involved outreach to community-based entities that cater to the needs of the unbanked and underbanked; a joint summit on financial fraud prevention in December 2006 sponsored by our Northeast Regional Office and the New England Consumer Advisory Council.

Other organizations that we worked with during 2006 include the Housing Leadership Council of San Mateo County, California; Lenders for Community Development, in San Jose, California; Coachella Valley Housing Coalition, Indio, California; the Fair Housing Councils of Riverside County, and Palm Springs, California; the San Francisco Housing Development Corporation; the San Francisco Planning and Urban Research (SPUR) Association; Los Angeles Neighborhood Housing Services; and the Clearinghouse for Affordable Housing CDFI.

We also worked closely to develop further relationships with nationally recognized community organizations such as the Greenlining Institute, the California Reinvestment Committee, and Operation HOPE. And we collaborated with our sister FBAs to co-sponsor three community development training events during 2006 – a National Community Reinvestment Conference, in Henderson, Nevada; the Greater Sacramento CRA Roundtable, in Sacramento, California; and "Exploring the Valley's Unbanked Opportunity," in Fresno, California.

We also assist in providing basic financial education training, such as to a class of graduating high school seniors in San Francisco, and providing financial education training at a low- to moderate-income community center in Palm Springs, California. And we plan various other financial education and literacy outreach events for 2007.

VIII. Conclusion

The OTS shares the concerns of the Committee with respect to current issues related to subprime hybrid ARMs. Clearly, nontraditional mortgage products, subprime hybrid ARMs, and predatory lending practices in both the prime and subprime markets have impacted the nationwide housing market. However, at this stage of the cycle the aggregate impact of subprime lending and predatory lending remain unclear. While some suggest that there is much more to come, others note that banks and thrifts are well-positioned from both a capital and earnings standpoint to weather even a sustained market downturn. For now, the data currently available to us indicate that regulated institutions have been migrating out of the subprime market sector. While we expect some institutions to continue to operate in this market, it appears that most insured depository institutions are fully cognizant of the risks posed with subprime hybrid ARMs and are underwriting these loans accordingly.

For our part, we will continue to work with our institutions to ensure safe and sound underwriting standards that benefit both the institutions that we regulate and their customers. In addition, we will encourage institutions to work with borrowers that are experiencing problems due to personal circumstances outside of their control. We also encourage the Members of this Committee and the public to comment on the interagency proposed subprime guidance. Finally, we will work with the Committee to address issues with subprime lending, as well as to combat predatory lending.

Thank you for the opportunity to present our views on these issues.

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