Embargoed until
March 27, 2007, at 10:00 am

Statement of

John M. Reich, Director
Office of Thrift Supervision

concerning

Subprime and Predatory Lending

before the

Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
United States House of Representatives

March 27, 2007

Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W.
Washington, DC 20552
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Subprime and Predatory Lending
before the
Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
United States House of Representatives

March 27, 2007

John M. Reich, Director
Office of Thrift Supervision

I. Introduction

Good morning, Madame Chair, Ranking Member Gillmor, and Members of the Subcommittee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on current issues related to subprime and predatory lending.

In your invitation letter, Madame Chair, you ask us to address the focus of the recently proposed interagency guidance on subprime hybrid adjustable rate mortgages (ARMs), including the current problems that it is intended to address, our expectations with the proposed guidance, and the need for legislation to address problems in the subprime market. In addition, you inquire about whether the proposed guidance balances efforts to correct abusive lending practices with the need to preserve safe and sound extensions of credit to subprime borrowers. Finally, you ask us to address potential safety and soundness concerns with the subprime lending activities of the institutions we regulate.

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 subprime hybrid ARMs and OTS efforts to combat predatory lending. I will first highlight the relevant data and provide for your consideration some perceptions that 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 from the comment process.

I will then highlight particular issues with subprime hybrid ARMs 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 approximately 69 percent of all U.S. households are homeowners. This is up relatively significantly the last five to six years from the historical average homeownership rate of 64 percent. 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 approximately $10 trillion of outstanding mortgage debt in the U.S. 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. Currently available data indicate that 43 percent of outstanding 2/28 hybrid ARMs were purchase money loans (with 25 percent to first time buyers); 49 percent of these ARMs were cash out refinances; and 8 percent were no-cash out refinances.

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.

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.

Clearly, these raise serious concerns and we are in the midst of a market transition in response to various of the issues that arose due to the run up in subprime lending the

last several years. In exploring these issues, care is needed to understand and focus attention on the dynamics of the marketplace both to identify the real problems and develop the proper solutions.

In particular, there are issues related to subprime versus predatory lending (explored below) and concerns with poor underwriting practices (in the prime, Alt-A and subprime markets). Some of these activities, of course, arose from predatory lending practices, but many were simply inappropriate practices in response to a hot housing market. With respect to this latter point, I note that many of the issues we are discussing today were driven by market participants either outside of or marginally involved with the insured institution sector. The ability of the FBAs to reach these market players is limited largely to influencing the behavior, activities and operations of the institutions we regulate.

III. Subprime versus Predatory Lending

At the outset, I believe it is worth noting 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.

For example, a retired homeowner with significant equity in his or her home but an income stream primarily limited to social security may have a reasonably high FICO score. If a broker lures the retired homeowner into an unacceptable mortgage under the guise that he or 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.

By contrast, someone employed who has an accident and incurs significant medical bills may have a temporary delinquency problem. He or she may become 30 – 60 days delinquent on some bills but eventually will manage to bring everything current. If the person 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. Nonetheless, he or she may be a good credit risk for proper loan underwriting. This type of subprime loan is not predatory.

Generally, a loan is predatory where a lender has information that it deceptively withholds from, or misstates to, a borrower knowing or reasonably concluding that the availability of the information to the borrower could affect its decision to obtain credit on the terms offered by the lender. By contrast, a subprime loan is one made to a borrower

who has one or more risk factors that suggest the loan has a higher risk of default than a similar loan to a borrower with a good credit and debt payment history.

One other point critical to the present discussion is the concept of the fully indexed rate. Generally, the fully indexed rate is the interest rate at which a borrower would be qualified for a fully amortizing loan that is held to maturity. The discount rate is the introductory, start or teaser rate that is charged for a loan that may or may not be fully amortizing. In the case of a prime mortgage, the rate (referred to as the "teaser" rate) may be substantially lower than the fully indexed rate for a particular borrower. By contrast, the start rate (typically referred to as the "discount" rate) on a subprime mortgage loan is generally no more than 200 to 300 basis points, and occasionally lower.

IV. The Proposed Subprime Guidance

A. Overview on Development of the Proposal

The proposed guidance on subprime hybrid ARMs highlights the federal banking agencies' (FBAs) concerns with respect to the use of these products in the recent housing market. However, 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. In fact, the FBAs issued guidance specifically addressing concerns with subprime lending programs in March 1999 and again in February 2001.

In the March 1999 guidance, the FBAs outlined the risks inherent in subprime lending, including the types of controls necessary to engage in this lending activity. The guidance notes that subprime lending is a high risk activity that can lead to higher default rates than many lenders may expect.

The May 2001 guidance amplifies this point by noting that institutions engaged in subprime lending are responsible for quantifying the additional risks in their subprime lending activities. The guidance further notes that institutions engaged in subprime lending programs are expected to determine the appropriate amount of their level of Allowance for Loan and Lease Losses (ALLL) and capital required to offset subprime lending risks.

In the current proposal, the FBAs are particularly concerned about loans marketed as "credit repair" products that often involve liberal underwriting and a loan structure that requires frequent refinancing. Product features that are of concern include:

- Loans marketed principally to subprime borrowers;
- Loans with significant prepayment penalties;
- Loans underwritten with high debt-to-income ratios;

- Loans that pose significant payment shock; and
- Loans that result in frequent refinancing in order to maintain an affordable monthly payment, but that strip equity in the process.

Aside from these general observations, our views on the proposed subprime guidance that is currently out for comment are 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, nor 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 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. Description of the Proposal 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.

Generally, there are three issues that are motivating a high degree of concern with the subprime, and Alt-A mortgage markets. Each of these issues figures prominently in the FBAs' interest in the proposed subprime guidance. These are:

- The role that "payment shock" plays in subprime defaults;
- The significant rise in "early payment defaults" among subprime borrowers in the last year; and
- The lack of adequate underwriting standards that appears to have precipitated escalating delinquency and foreclosure rates in the subprime market.

Of these issues, clearly the most pivotal is the maintenance of sound underwriting. It is particularly concerning to hear of so-called "low-doc" or "stated income" loans being extended to borrowers with marginal credit histories. As numerous observers have noted, this is also a recipe for increased mortgage fraud – another concern in the subprime market.

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. 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 29 States and the District of Columbia to adopt nontraditional mortgage guidance similar to that issued by the FBAs last fall, we believe that it is

perhaps more imperative that the States take similar action with respect to guidance or laws targeted at subprime lenders within their jurisdiction.

According to some estimates, somewhere between 70 to 80 percent of subprime loans are originated through mortgage brokers. Unfortunately, there are wide variations is estimating the number of licensed mortgage brokers in the U.S. Of the estimates that are available, the numbers do not include numerous individuals who work as loan originators for and/or under the direction of a licensed mortgage broker; nor do the numbers identify mortgage brokers operating without any type of license or registration.

In addition, while mortgage brokers are typically required to obtain a state license, in many cases 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.

It was also recently reported in the American Banker that there are eight states that have no regulation of mortgage bankers and lenders. Thus, while these states license mortgage brokers with respect to the activities involved in originating a loan, the entity that may be funding the loan, i.e., a mortgage banker or lender, is not regulated. Two of the states that do not regulate mortgage bankers 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.

V. 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. Although the interests of these two groups – lenders and borrowers – are covered by the proposed subprime guidance, in fact it is borrowers who remain most exposed to the potential fallout in the subprime market. While the banking industry may have some exposure to subprime lending, it appears to be generally insulated from any significant impact. This is due in large part to the nature of the regulatory regime under which these institutions operate. The difficulty is how to protect the consumer/borrowers, particularly where their exposure comes from activities predominantly outside the regulated banking industry.

It is irrelevant to a consumer who is the recipient of a bad subprime loan whether an insured bank, a mortgage bank or a mortgage broker made the loan to them. If the consumer cannot make the payment, the result is the same. Payment shock is no different whether the loan is held in portfolio by an insured institution or sold through a securitization process to foreign or domestic investors. The problem is how to curtail irresponsible subprime lending based on poor underwriting while not shutting down credit to the subprime market.

For the most part, these are not issues for regulated depository institutions, although some will feel the fallout from their subprime programs. Rather, the problem exists largely outside the scope of insured institutions.

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.

The same cannot be said, however, in the Alt-A mortgage market. While the Alt-A foreclosure rate remains lower than the subprime rate – 3.26 percent compared to 3.63 percent as of December 2006, the increase in Alt-A foreclosures is daunting. Since December 2005 the Alt-A foreclosure rate has increased 65 percent, from 1.97 percent to 3.26 percent. In comparison, as noted earlier, the subprime foreclosure rate is up 46 percent for the one-year period.

There is substantial evidence suggesting that low-doc underwriting is the significant driver of problems in the Alt-A market. According to one estimate, these low-doc or stated income loans represented 81 percent of total Alt-A originations in 2006.

Within the thrift industry, we survey our institutions semi-annually on their subprime lending activities. As of December 2006, we had 19 (out of 845) thrifts with significant subprime lending operations. These institutions reported having approximately $35.4 billion (a 25 percent decline from mid-year holdings of $47 billion) in subprime mortgage products. This amount represents about 7.5 percent of the home mortgages held by these particular lenders, and 5 percent total OTS-regulated thrift industry home mortgage holdings.

OTS-regulated thrift institutions engaged in subprime lending programs are 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 part of our normal oversight process for all institutions, the OTS maintains contact on a quarterly (or more frequent) basis with institution management. This dialogue includes a discussion of new products, including subprime lending activities. We also prepare a quarterly subprime report for institutions with significant subprime lending programs (i.e., subprime lending activities that exceed 25% of their capital), and conduct a quarterly survey of the nontraditional mortgage activities of the institutions we regulate. Finally, the OTS has a Core Specialty Program with specialized examiners

dedicated to reviewing institutions' operations in mortgage banking, credit card and auto lending, nontraditional mortgages, and securitizations.

As noted previously, 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 and consumer protection perspective, and are also scrutinized to ensure that the institution is lending responsibly and following all 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 that are developed and implemented 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 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".

In two other cases, similar results were achieved. Using a combination of formal and informal enforcement actions, the agency forced the discontinuation of lending operations by two federally chartered thrifts based on poorly supervised lending activities. In both cases, subprime lending programs that exhibited predatory features coupled with lax management oversight controls were effectively terminated. A significant concern by the OTS staff was an effort by both institutions to attempt to exploit the charter to engage in lending programs lacking adequate consumer protections and management controls.

In another case, OTS staff shut down a program by a federal thrift that utilized brokers to do out-of-state lending activities, again, that were lacking sound consumer protections and controls. The agency's directive to the institution concluded that the activity was tantamount to a charter rental strategy intended to avoid State and OTS oversight of out-of-state lending activities by the institution.

We also impose conditions requiring responsible lending policies and barring abusive practices by an institution, its holding company and affiliates at the time of an acquisition. Typically, these types of conditions are appropriate where we know or have reason to believe that an acquirer plans to start or continue an existing subprime lending program at a newly acquired or *de novo* institution. Whenever such conditions are imposed, regional staff will work closely with and monitor the institution and its holding company/affiliates to ensure that adequate controls are imposed and maintained in connection with the subprime lending program.

Finally, we 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. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

VI. 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 the Truth in Lending Act. 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.

5. The NeighborWorks Center for Foreclosure Solutions

As a member of the NeighborWorks America board of directors, I have been working with several of my colleagues on a national campaign on foreclosure prevention. The NeighborWorks Center for Foreclosure Solutions is a resource that is available to provide assistance (in both English and Spanish) to provide credit counseling, rescue funds, refinance loans and other services to homeowners facing foreclosure.

E. The OTS National Housing Forum

1. 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.

2. Housing Outlook

In addition to a mortgage fraud panel, the OTS NHF featured key industry players discussing issues on the economy and the short- and long-term prospects for housing in the U.S. The discussion included extensive data and input on various mortgage products, the impact from the use of nontraditional mortgages in the current market, and concerns regarding the impact on institutions, homeowners and the broader economy of rising delinquency and foreclosure rates. Subprime lending concern were voiced by numerous participants.

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.

Finally, we 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.

VII. Conclusion

The OTS shares the concerns of the Subcommittee with respect to current issues related to subprime hybrid ARMs. The use of 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. While we do not see a need for legislation at this time, we encourage the Members of this Subcommittee and the public to comment on the interagency proposed subprime guidance to guide the FBAs in this process. Finally, we will work with the Subcommittee 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.

*****