Testimony of

Michael Middleton

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

United States House of Representatives

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Chairman Gutierrez, Ranking Member Hensarling and members of the Subcommittee, my name is Michael Middleton, President of the Community Bank of Tri-County, located in Waldorf, Maryland, and former Chairman of the Federal Home Loan Bank Committee of the American Bankers Association (ABA). The Community Bank of Tri-County is a locally owned community bank with assets of approximately $725 million. We have served the Southern Maryland community for over 58 years. I am honored to be here today on behalf of ABA. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.9 trillion in assets and employ over 2 million men and women.

We appreciate the opportunity to testify on possible legislative initiatives to improve mortgage lending standards, particularly as they relate to subprime mortgages. I wish to make it clear from the outset that the Community Bank of Tri-County is one of many banks that never varied from traditional underwriting standards and offers both prime and affordable housing loan products. Our residential loan portfolio is strong, with very low delinquency rates especially among our affordable housing portfolio. We have a "High Satisfactory" lending rating for CRA purposes and have a zero default rate on our "affordable housing" portfolio. Like other community banks, we work closely with the Federal Home Loan Banks to secure grants and affordable housing funding.

As you will find, the vast majority of banks in this country never made a toxic, subprime loan. Rather, we have followed underwriting practices that serve both our customers and our bank.

Unlike many state licensed, unsupervised mortgage originators, most banks in this country have served our respective communities for decades. Many of those originators, the biggest abusers of the subprime market and predominantly non-bank mortgage brokers, are no longer in business. They should not be permitted to reestablish similar operations in the future.

Any regulation and/or legislation should promote a return to universal and conservative underwriting practices like those maintained at most banks. They must be codified and promote those practices ***for all lenders at the same time, not, as has been suggested in legislation, for an implementation period of two years for non-bank originators. At a minimum, legislation must*** ensure that the prudent, federally regulated survivors are not subject to greater burdens than their less regulated competitors. Additionally, the outcome of any legislation cannot restrict housing credit or we will face dire economic consequences.

In July of last year, the Federal Reserve issued amendments to Regulation Z that addressed many issues that led to the house price bubble and the ensuing overextension of credit: the use of subprime mortgages; the loosening of underwriting standards, especially among non depository financial institutions; and the increase of mortgage product complexity. The amendments to Regulation Z fundamentally change the protections offered to consumers, and the changes are forcing many banks and non-bank originators to rework their mortgage lending operations. Among other things, the amendments define a new category of loan based on its Annual Percentage Rate as a "higher-priced mortgage loan." The standards are so stringent that this category will include some loans that previously were classified as prime. That definition and pricing may force State Housing Authorities to change their pricing to avoid the "higher cost" standards which in turn could curtail their ability to serve many borrowers. Conservative banks like the Community Bank of Tri-County are reevaluating lending practices to ensure we are in compliance and to consider whether or not to exit the residential mortgage product line.

In today's testimony, I would like to address three key points:

- Traditional lending practices – especially the use of conservative, standardized underwriting – have helped banks avoid troubled loans and aided borrowers in avoiding difficult financial situations.

- Amendments to Regulation Z will continue to work change in the mortgage market; and

- Further legislation should avoid major changes that would override the effects of the new regulation.

I will discuss each of these in turn.

I. Traditional lending practices – including the use of conservative, standardized underwriting – have helped banks avoid troubled loans and have helped borrowers avoid difficult financial situations.

The vast majority of banks have long followed traditional, prudent underwriting models. By doing so, they have avoided troubled loans and prevented borrowers from getting into untenable financial situations. We agree with Congressman Barney Frank, Chairman of the House Financial Services Committee, when he said: "Reasonable regulation of mortgages by the bank and credit union regulators allowed [that] market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis."[1] It has been the actions of loosely-regulated non-bank lenders, with low market entrance hurdles and little or no stake in the subsequent performance of the loans that have caused much of the damage for consumers and for the industry. In fact, we community bankers tried to warn consumers against subprime loans and deals that were too good to be true, only to watch those consumers seek out non-regulated originators.

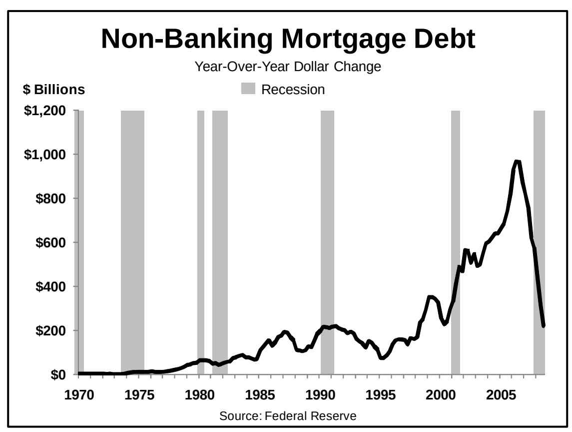
Many forces combined to create the problems we face today. The greatest was the migration of household sector financial assets from FDIC insured institutions to Wall Street. This flow of funds to the uninsured sector was driven in part by pressure to seek ever-increasing returns. The scope of the migration was impressive. Money market and mutual funds accounts grew about $16 trillion dollars from 1990 to 2008, while FDIC insured deposits grew by only about $2 trillion in the same time period. Much of that money was then directed into the housing sector, where securitized credit helped to fuel a boom in home prices. The vendors of choice for this allocation of funds were largely state licensed non-bank mortgage originators.

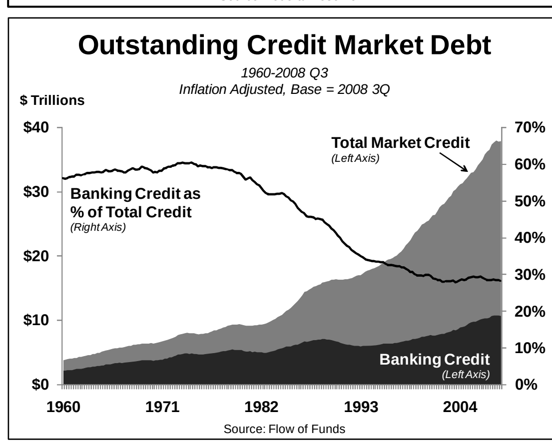
[1] *Boston Globe*, September 14, 2007.

In the frenzy that ensued, ***sound underwriting practices were sacrificed by non-bank originators because standards were lax and there was no regulator to examine them.*** The result was catastrophic. Contaminated loans populated the supply of housing assets flooding the mortgage backed securities market. Housing prices plummeted. Many homeowners found themselves upside down on their mortgages, and the housing sector collapsed.

The worsening economic situation would be difficult by itself, but banks are also struggling with mark-to-market accounting rules, which have often resulted in over-stating economic losses. For banks like mine, whose businesses are not based on buying and selling securities in the markets, current mark-to-market rules provide neither the most relevant nor the most reliable information as to our performance or financial condition. Part of the problem is improper "other than temporary impairment" (OTTI) rules. In today's illiquid market, the results of irrational OTTI rules can be severe: (1) capital is artificially eroded despite solid fundamental credit performance, (2) the lending capability of a bank is greatly reduced by the capital reduction in OTTI.

The difficult economic environment combined with irrational OTTI rules has taken its toll on lending and stock values. Even so, banks increased lending during 2008. According to the Federal Reserve, commercial bank loan balances have grown from $6.8 trillion as of December 2007 when the recession began, to $7.2 trillion by the end of 2008.





It is important to note that banks will find it impossible to make up for the gaps created in the non-bank lending market. Whereas thirty years ago, banks provided about 60 percent of all credit – today banks provide less than 30 percent. Non-bank funding, particularly over the last several years, has dominated credit markets. The financial turmoil of the last 18 months has changed this balance. Suddenly, investors have become completely risk-averse. This leaves traditional banks as not only the lenders of choice, but often as the only lender available. Given the fact that funds migration drained the system of its funding, it is challenging to fill the mortgage gap. The continued role of the Federal Home Loan Banks in providing funding to our banks is absolutely critical. Those funds that migrated to Wall Street are still there – not on Main Street – and can be accessed through the Federal Home Loan Banks.

Further complicating the current situation, bank regulators continue to caution banks about adding risk to their lending portfolios in this environment. This means that loan volume will likely decline in response to risk factors. This, I might add, is precisely why Wall Street chose unsupervised mortgage originators to funnel its money into the housing sector when investors seemed heedless of risk.

I note with concern that, despite the passage last year of the SAFE Mortgage Licensing Act, non-bank originators still have more than a year to comply with licensing requirements. A recent article in the Washington Post headlined the fact that the FHA insured 9,200 loans that defaulted after making less than one payment. Much of this lending was done ***by non-bank originators over a period of just 14 months***. This activity by non-banks is a clear obstacle to banks trying to lend in a safe manner when the competitive situation favors the non-bank originators operating under the old rules which are still acceptable to FHA.

II. Amendments to Regulation Z will continue to work change in the mortgage market.

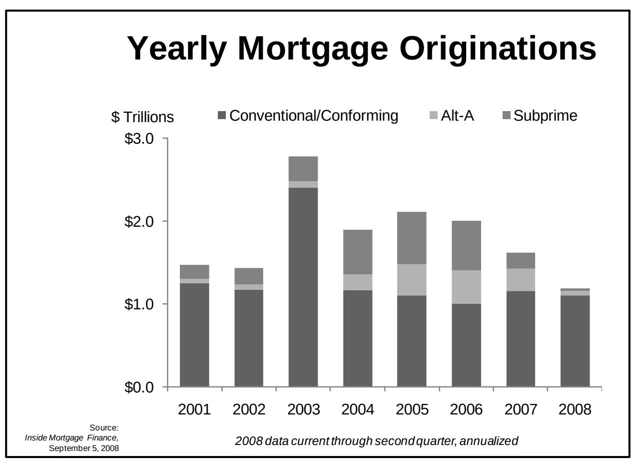
Recent changes to Regulation Z finalized by the Federal Reserve to implement the Home Owners' Equity Protection and Truth in Lending Act emphasize the need for more prudent and traditional underwriting. ABA supports many of these changes including regulations to strengthen the integrity of appraisals and prohibit deceptive advertising. ABA also supports requirements that mortgage lenders properly consider a borrower's ability to repay the mortgage, whether it is a fixed or adjustable rate loan. Some of the elements of these new rules codify the underwriting practices of many of our members. The use of these practices throughout the mortgage industry will help to ensure that future lending is done in a prudent and safe manner.

The standards set by the Federal Reserve in its amendments to Regulation Z are stringent. We believe that the subprime excesses would not have occurred had these regulations been in place and enforced earlier. We also believe that had the secondary market provided for some degree of "skin in the game" for all market participants, there would have been far less abuse and fewer bad loans made. The challenge will be to apply the rules in a targeted manner that prevents recurrence of the subprime problem without unnecessarily restricting credit. ABA has embraced the Federal Reserve's approach, and we will continue to work with the Federal Reserve and other regulators to help ensure that only the intended results are achieved. It is noted with concern that Section 209 of H.R. 3915 would double the penalties and would, unintentionally, affect parts of the prime market rather than the high-cost mortgage market.

Based on my knowledge of examination and enforcement under Regulation Z, the limited number of bank violations were discovered by federal examiners during on site exams rather than from consumer complaints. For state licensed non-bank originators there is no on-site examination. How then will violators be caught? Banks have their federal regulators on site every year; the others have nothing. Who is subjected to actual enforcement and how? Preventing bad practices is far better than catching those practices after the fact. The risk of discovery was clearly absent in the non-bank originators' business model. Further, raising the penalties will force small hometown bankers to consider exiting the market completely due to the regulatory risk of doing business.

Similarly, ABA will work with the banking agencies to help ensure that other regulatory responses to past mortgage origination and underwriting practices do not unintentionally worsen the credit crunch by impeding the offer of credit for good loans that consumers can repay and that will help communities grow and prosper. We want a return to universal underwriting practices like those maintained at most banks, and we want to codify and promote those practices ***for all lenders.*** The prudent extension of credit cannot be restricted or we will face dire economic consequences. Therefore, we stand ready to assist in restoring housing and mortgage markets in which both borrowers and lenders have confidence.

The return to traditional underwriting is already visible. This chart shows a comparison of traditional, Alt-A, and subprime loan originations. The trend away from subprime and Alt-A products is clear, and we can expect that numbers for 2009 will continue this trend.



The Federal Reserve's amendments to

Regulation Z ensure that extreme products will not come back to haunt future borrowers who are not appropriate candidates for these loans. The amendments do this, in part, by dramatically changing the threshold that defines "higher-priced mortgage loans." While the rules for higher-priced loans certainly apply to loans that have historically been categorized as subprime, the definition is based on the loan's APR instead of borrower credit or loan product characteristics. As a result, this new category is likely to include many prime loans in certain markets, depending on market conditions. The amendments come with teeth – including strict regulatory requirements, limits on terms and conditions for credit, and the possibility of expensive individual actions and penalties as well as class action litigation – all of which will have an impact on lending, reducing available credit for less creditworthy borrowers.

III. Further legislation, including a revised version of H.R. 3915 from the last Congress, should avoid major changes that would make the new regulation less clear in both intent and effect.

We understand congressional concern about the loosely regulated and largely unexamined mortgage originators operating ***outside of the regulatory structure*** within which federally insured depository institutions function. For that reason, the ABA did not oppose H.R. 3915 when it passed the House of Representatives in November of 2007. Since that time a number of important things, which we have already discussed in this testimony, have occurred: the implementation of Regulation Z changes by the Federal Reserve; the passage into law of the SAFE Act requiring the licensing of mortgage brokers and registration of bank loan originators; and the drastic changes in the marketplace. We would urge Members of Congress to take these events into consideration when crafting a new bill. We are concerned that such legislation could have a negative impact on banks that are already subject to considerable regulation and on-site examinations as well as on creditworthy customers seeking to buy homes.

As such, ABA has formulated the following principles to keep in mind when considering legislative action on subprime mortgages:

- All new standards should be national standards, preempting the myriad numbers of state laws and regulations.
- Terms should be specific and well-defined, limiting the potential for unnecessary litigation.

- Any new mortgage standards should give enough guidance to regulators to ensure that the standard is both ***meaningful*** and ***measurable***.
- ***Prime loans should be given safe harbor*** from additional requirements, recognizing that the new amendments to Regulation Z restrict the definition of "prime" to a well-defined type of loan unlikely to be problematic for qualified borrowers.
- Basic underwriting standards should be an important element of loan origination at a time in the process where a lender would reasonably expect to exercise judgment and adhere to those standards. Expecting a firm offer of credit which requires full underwriting too early in the process (such as when a consumer is merely shopping among many lenders) could expose lenders to significant liabilities.
- We remain concerned that the SAFE Act's hurdle for non-bank originators is minimal and easily met. There are no mandates for on-site examination. As noted before, consumer-initiated complaints are *de minimus* when compared to on-site examinations. Without such mandates for prevention, the state licensing requirement is of little or no value.

Conclusion

The vast majority of banks have served their communities for decades. These banks have staying power because they have maintained traditional lending practices. Even so, the most conservative banks are revising processes to ensure compliance with the new amendments to Regulation Z, which represents a dramatic change to the mortgage market. Any new legislation should recognize the strong requirements established in the amendments to Regulation Z and avoid pushing beyond those requirements, particularly in the definition of prime loans. We urge Congress to keep in mind that overly prescriptive legislation could have the unintended effect of discouraging legitimate lenders from making loans to qualifying borrowers, which would have very undesirable consequences in the current economic atmosphere.