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Statement of

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before the

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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to appear before you today to discuss recent problems in the subprime mortgage market and possible legislative responses. The challenges facing the housing market at the moment are significant. Increasing numbers of homeowners and communities are experiencing problems. We continue to work to find and implement the best and most sustainable solutions to the current challenges.

Background

In recent years, the subprime market has grown dramatically, enabling more and more borrowers to obtain credit who traditionally would have been unable to access it. Increasing numbers of lenders entered this market, with underwriting standards, industry practices, and risk-based pricing evolving along with the subprime market.

The growth of this market is well recognized. Also well recognized are the problems that have arisen with these changes. The Board believes that responsible subprime lending has an important role to play in expanding credit to traditionally underserved borrowers. It also recognizes, however, that some of the lending undertaken in recent years was neither responsible nor prudent.

Mortgage delinquency and foreclosure rates have increased substantially over the past few months. Over 17 percent of subprime adjustable-rate mortgages were in serious delinquency at the end of September, a rate over three times higher than that in mid-2005. Serious delinquencies also increased among near-prime and prime mortgages, although these delinquencies remain much lower than among subprime mortgages. Lenders initiated foreclosure proceedings for an average of 320,000 loans per quarter in the first half of this year, up from 240,000 loans per quarter in the preceding two years.

One significant factor in the increase in delinquency rates has been the slowing of house prices. Prices decreased slightly for the nation as a whole in the third quarter of 2007, and declined more dramatically in some regions. Over a quarter of homeowners report that their houses decreased in value over the past year, just a bit above the level last seen in the early 1990s.[1] These price changes will affect homeowners' abilities to resolve financial troubles by refinancing their mortgages or pulling equity out of their homes, and may lead to increased defaults. In addition, some borrowers whose mortgage balances exceed their house values may be tempted to walk away from their loans. Borrowers who purchased properties solely for investment purposes may be more likely to default in this situation; indeed, the Mortgage Bankers' Association has found a disproportionate share of serious delinquencies are associated with non-owner-occupied properties in some of the states with the highest increases in delinquencies. A recently released study by the Federal Reserve Bank of Boston attributes most of the recent rise in foreclosures in Massachusetts to declining house prices.[2]

Borrowers who have lost their jobs, not surprisingly, may have difficulty meeting their mortgage payments. Thus, increases in unemployment in certain areas, such as states in the Midwest struggling with job cuts in the auto industry, are another major factor contributing to higher delinquency rates.

The final major factor explaining the current increase in delinquency rates is the apparent deterioration in underwriting standards beginning in late 2005. An increasing number of subprime loans were made with layers of additional risk factors, such as a lack of full

[1] Reuters/University of Michigan Survey of Consumers, November 2007.
[2] Kristopher Gerardi, Adam Hale Shapiro, and Paul Willen, "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures," Federal Reserve Bank of Boston Working Paper 07-15, 2007.

documentation or very high loan-to-value ratios. Much of this weakening in underwriting standards happened outside of institutions regulated by the federal banking agencies. For instance, in 2006, over 45 percent of high-cost first mortgages were originated by independent mortgage companies.[3] In addition, prior to late 2005, high demand for housing and rising house prices allowed borrowers to recover from these risks through profitable home sales and refinancings, hiding the weakened underwriting standards from view. The slowdown in house prices, coupled with shifts in underwriting standards, are the most likely explanation for the pronounced rise we have seen in defaults occurring within a few months of origination, before most borrowers would have experienced significant changes in their payment obligations or in their financial situations.

Looking forward, we expect the substantial payment increases often experienced at the first interest-rate reset to result in higher delinquencies. From now until the end of next year, each quarter roughly one out of ten borrowers with an adjustable-rate subprime mortgage is scheduled to experience the first rate reset.[4] In addition, tightening credit conditions as reported in the Federal Reserve's Senior Loan Officer Surveys suggest that refinancing may become more difficult. In the past, many borrowers experiencing these resets were able to avoid the payment increases by refinancing their mortgages. The recent declines in house prices and the current tighter credit conditions, however, reduced the viability of this option for significant numbers of borrowers.

The Federal Reserve's Response to Problems in the Subprime Market

As I testified before this Committee in October, the Federal Reserve is actively working to respond to these challenges. If the benefits of homeownership are to be realized, we believe

[3] 2006 Home Mortgage Disclosure Act data.
[4] Federal Reserve Board staff calculations based on data from First American LoanPerformance.

that homeownership must be sustainable and that access to responsible lending be available for consumers. To achieve this, the Board believes that there must be appropriate consumer protection and responsible lending to traditionally underserved borrowers. Accordingly, we continue to coordinate with other federal and state agencies, and consult with consumer advocates, lenders, investors, and others. We take these issues very seriously, and, along with the other federal banking regulators, began issuing guidance on subprime lending in 1999 for the institutions we regulate. We significantly expanded that guidance in 2001, issued guidance on non-traditional mortgage products (such as payment-option and interest-only loans) in 2006, and issued guidance on adjustable-rate subprime mortgages earlier this year. I would like to take this opportunity to share a brief update on some of the work that the Federal Reserve is undertaking on these issues.

Coordinated enforcement of consumer protection laws

First, the enforcement of consumer protection laws and regulations is critical and the Federal Reserve enforces these measures through oversight of the institutions it examines. As the mortgage industry has diversified, increasing coordination among regulators has been helpful. In particular, our need to cooperate with state bank regulators has increased in importance, and we have responded to that need. In that vein, we launched a cooperative pilot project with other federal and state agencies to conduct reviews of certain non-depository lenders involved in the subprime market.

The reviews will evaluate underwriting standards, risk-management strategies, and compliance with certain consumer protection laws and regulations. This initiative brings together the Federal Reserve, the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the Conference of State Banking Supervisors (CSBS) and the

American Association of Residential Mortgage Regulators (AARMR). The companies being reviewed include those that are supervised by the federal agencies, as well as independent entities that are licensed by the states.

Loss mitigation efforts

Second, the Board, along with the other federal financial agencies, has worked to guide federally supervised institutions as they deal with mortgage defaults and delinquencies. The federal financial institution agencies issued a *Statement on Working with Mortgage Borrowers* in April 2007, and, in cooperation with the CSBS, a *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* in September 2007. Together, these statements encourage institutions to work proactively with borrowers who may be facing delinquency or foreclosure, and encourage servicers of securitized residential mortgages to determine the full extent of their authority to restructure failing loans and to pursue appropriate loss mitigation strategies.

The Board continues to encourage servicers and investors to make every effort to keep troubled borrowers in their homes. I, and other members of the Board, have had numerous meetings in recent months with a wide array of market participants and consumer advocates to understand the complexity of the issues and to encourage appropriate responses. Each of the twelve Federal Reserve Banks has been working with financial institutions and community groups around the country to address challenges posed by loan performance problems. And the Federal Reserve Board's staff has been working with consumer and community affairs groups throughout the Federal Reserve System to help identify localities that are most at risk of high foreclosures, with the intent to help local groups better focus their outreach efforts to borrowers.

We have also been talking with lenders, servicers and investors, independently as well as through the Hope Now alliance, to support prudent efforts to reach out to as many borrowers as possible. Many servicers have established procedures to identify segments of borrowers who are current but could face trouble at reset, to contact these borrowers ahead of the reset, and to systematically evaluate the ability of borrowers to make higher payments. On the basis of this analysis, they can sometimes present prudent refinancing or loan modification alternatives to the borrower. Other efforts, such as the FHASecure product and various state and local efforts, can play a role in avoiding foreclosure. As I will discuss further in a moment, we support these efforts because foreclosure is generally the worst possible option for consumers, investors, *and* communities, and should be avoided whenever other viable options exist. Changes to existing terms, however, should not be made lightly, should be consistent with safe and sound lending practices, and should not be made when they are only delaying losses to investors and consumers. In short, we should pursue sustainable solutions.

Consumer protection regulations

Finally, the Board continues to work toward more effective consumer protection rules. We will soon begin extensive consumer testing to ensure that new disclosures are effective and comprehensible. Later this month, we will propose changes to the Truth in Lending Act (TILA) rules to require earlier disclosures by lenders and to address concerns about misleading mortgage loan advertisements.

The Board recognizes, however, that improved disclosures are necessary but not sufficient to address the problems. In addition to these actions, therefore, the Federal Reserve will exercise its rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA) to address unfair or deceptive mortgage lending practices. At the same time we propose the TILA rule changes on advertising and timing of disclosures, we will issue, for public comment, significant new rules that would apply to subprime loans offered by all mortgage lenders. In formulating our proposal, we are looking closely at practices in the subprime mortgage market, such as prepayment penalties, failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the failure to give adequate consideration to a borrower's ability to repay.

I can assure you that our proposed rules will be based on detailed analyses of the issues and our statutory authority to address them, extraordinary outreach efforts to gather a wide range of information and opinions, and attempts to balance the needs of adequately protecting consumers and maintaining responsible lending markets. The rules will reflect input obtained through public meetings in 2006 and a hearing that dealt specifically with these issues that I chaired this past June. We also considered nearly 100 comment letters, following the June meeting, and consulted with other federal and state agencies and our own Consumer Advisory Council. Finally, we have continued to meet with, and listen to informed opinions from, consumer groups, the financial services industry, lawmakers, and others to ensure that our proposed rules are likely to achieve the goal of adequate consumer protection without shutting off access to responsible credit.

Legislative Responses

Congress has expressed understandable and appropriate concern about subprime lending and the challenges in the mortgage market more generally. We commend leaders in Congress who are looking into these problems and wrestling with the challenges of addressing abusive lending while encouraging responsible lending.

The Mortgage Reform and Anti-Predatory Lending Act of 2007, which was passed by the House of Representatives last month, would extend additional oversight and consumer protections to the market. We were asked in today's testimony to comment on two issues, not addressed in the current version of the Act, that could be addressed through amendments or other actions.

Loan modifications

One issue is the possible legal exposure of servicers of mortgages who enter into loan modifications or workout plans. Because loan servicers play a critical role in implementing possible loss mitigation strategies, this is a timely and important question.

We believe that investors and servicers generally want to work with borrowers to avoid foreclosure. Prudent loss mitigation techniques that avoid foreclosure not only help homeowners, they are usually cost-effective for investors. Borrowers who have been current in their payments but could default after reset, for instance, may be able to work with their lender or servicer to adjust their payments or otherwise change their loans to make them more manageable. Working with borrowers before they experience payment problems has other benefits; for instance, late payments will not have affected such borrowers' credit scores, preserving a wider range of options including refinancing. Such proactive outreach by servicers may mean the difference between loan payment and default, particularly for lower-income families who may have little financial cushion.

Given the substantial number of resets expected from now through the end of 2008, it is in the interest of the industry to go further than it has historically to join together and explore collaborative, creative efforts to develop prudent loan modification programs and other assistance to help large groups of borrowers systematically. Such programs can streamline and speed the process of anticipating and addressing delinquent loans, reduce transaction costs, and provide guidance to borrowers and to mortgage counselors. Many servicers are, in fact, working with counselors who can play a crucial role in helping homeowners, many of whom do not even communicate with their servicers out of fear, embarrassment, or misinformation about their options. Loan modification programs should be a bottom-up approach designed to balance the needs of all parties, and we are encouraged by the progress being made by the industry in advancing such programs.

Because systematic approaches to dealing with troubled loans are often likely to lead to better aggregate investor returns than foreclosures, we are encouraged by industry efforts to pursue these approaches. When servicers modify loans, however, they may face potential litigation risk from investors because of their contractual obligations under the servicing agreements. One particular source of litigation risk, we understand, may be that different asset classes have conflicting interests. Therefore, we encourage ongoing industry efforts to agree to standards for addressing these issues. We are hopeful that the industry can resolve these conflicts on a consensual basis so that they do not preclude servicers from taking actions that are in the overall best interests of consumers and the industry.

More generally, the Board supports efforts by the industry and others to develop reasonable and standardized approaches to dealing with these challenges. Such approaches, when applied consistently and predictably, can reduce uncertainty and ultimately help the markets function. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower, but there may be instances when such arrangements are not prudent or appropriate. In trying to help homeowners, we must also be careful to recognize the existing legal rights of investors, avoid actions that may have the unintended consequence of disrupting the orderly functioning of the market, or unnecessarily reducing future access to credit. Provisions intended to immunize servicers from liability should be crafted to avoid creating moral hazard of parties disregarding their contractual obligations, which would ultimately have negative impacts for markets and consumers. Sustainable solutions, and not those that simply hide for the short term real repayment challenges, should be our goal.

Patterns or practices of violations

A second issue is the possible imposition of civil money penalties when the enforcement agencies find that there is a pattern or practice of violations. Penalties collected would be used to establish a trust fund for those consumers whose interests had been harmed but who lack a remedy in the event, for instance, that the responsible party has gone out of business.

The proper magnitude for any such penalties, or under what circumstances they should be imposed, is Congress' decision to make. As a general rule, the Board believes that penalties for any violation of law should be sufficient to deter the prohibited conduct, and also reasonably related to the injury caused by the violation. Penalties that are clearly articulated, and that reasonably match the magnitude of the violation, are the most appropriate and effective forms of deterrence.

We would recommend that the amount of such civil money penalties, if imposed, be given a ceiling as well as a floor because of the market uncertainty that can be introduced by open-ended liability. We would also suggest that some discretion in the actual amount of the penalty, within such a range, be given to the enforcing agencies. This sort of flexibility in enforcement would help the agencies adjust the punishment to fit the infraction.

The proposed increase in civil money penalties draws attention to the critical role that enforcement plays in ensuring compliance with the new responsibilities enacted by Congress. But the effectiveness of increased penalties can be diminished by a lack of enforcement resources. As Congress weighs the merits of the bill and possible amendments, we would encourage you to also look at the resource needs of the agencies that are authorized to take enforcement actions to ensure that sufficient resources for this important role are available.

Conclusion

The Board recognizes the magnitude of the challenges facing mortgage borrowers today. We understand the uncertainty and harm being experienced by consumers across the country as the housing market challenges continue. We are engaged in an array of activities to respond to these concerns. In coming weeks, we will propose new rules regarding advertising, the timing of disclosures, and practices that we find to be unfair or deceptive under our HOEPA authority, all of which we believe will offer increasing protection to consumers. We look forward to continuing to work with Congress to achieve sustainable solutions to challenges in the mortgage market.