



**Statement of
Robert D. Broeksmit, CMB
Chairman, Residential Board of Governors
Mortgage Bankers Association**

**Before a Joint Hearing of the
Subcommittee on Housing and
Transportation and the
Subcommittee on Economic Policy
U.S. Senate Committee on Banking, Housing
and Urban Affairs**

**“Calculated Risk: Assessing Non-Traditional
Mortgage Products”**

September 20, 2006

Good Morning Chairman Allard, Ranking Member Reed, Chairman Bunning, Ranking Member Schumer and Members of the Subcommittees.

Overview

My name is Robert Broeksmit and I am President and Chief Operating Officer of the B.F. Saul Mortgage Company of Bethesda, Maryland, a subsidiary of Chevy Chase Bank, FSB. Today, in my capacity as Chairman of the Mortgage Bankers Association (MBA) Residential Board of Governors, I am testifying on behalf of the thousands of MBA members who work day in and day out to help families realize their dreams of homeownership.¹

In particular, I appreciate the opportunity to participate on the panel this morning to discuss the “non-traditional” mortgage products that are available in today’s mortgage marketplace that have been developed by the lending industry in response to consumer demand.

In my testimony I will explain the background and use of these products, MBA’s position on several matters addressed in the recent guidance proposed by the Federal financial regulators – including underwriting, risk management and consumer information – and provide recent data on these and other products in the mortgage marketplace.

The term “non-traditional mortgage products” encompasses a variety of financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of many mortgage borrowers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers’ incomes. Other borrowers have used these products to tap their homes’ increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as “new,” many of them actually predate long term fixed-rate mortgages.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.

These products include fixed- and adjustable-rate loans that permit interest only payments, payment option loans or option Adjustable Rate Mortgages (option ARMs) that allow borrowers to choose among different payments each month, including an option that may result in some degree of negative amortization. In the view of some, non-traditional products also include loans that are characterized by streamlined underwriting. These loans forego some aspects of traditional mortgage underwriting in the interest of helping borrowers qualify for financing with less documentation.

I strongly believe that the market's success in making these "nontraditional" products available is a positive development, not cause for alarm. Although these products have been used to finance a relatively small portion of the nation's housing, they have offered and continue to offer new useful choices for borrowers who can benefit from them.

To be sure, as with all mortgage products, they must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. And as with other products, lenders must provide consumers necessary information on a product's terms so a borrower can determine whether the product matches his or her needs.

I would be remiss, however, if I did not point out that lenders have long experience underwriting adjustable rate products including option ARMs. These products are being effectively underwritten and managed today. Moreover, during the real estate and refinancing boom of the last several years, many, many borrowers have come to understand and effectively use these products to become homeowners. Many others have used them to refinance and flexibly manage their home equity as they manage other investments and needs.

The most recent data provided by the mortgage industry on loans made in 2004 and 2005 under the Home Mortgage Disclosure Act (HMDA) demonstrate the greatest and widest availability of mortgage finance in our Nation's history, which, in turn, has made possible record homeownership rates. The data show that borrowers in virtually every area of the Nation, of every race and ethnicity, and at every income level receive an array of credit opportunities as HMDA was intended to achieve.

Homeownership is near its highest level in history. As a result, Americans are building tremendous wealth. According to the Federal Reserve's Flow of Funds data, the value of residential real estate assets owned by households has increased from \$10.3 trillion in 1999 to \$20.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds \$10 trillion. According to the Fed's 2004 Survey of Consumer Finances, the median net worth for homeowners was \$184,000. For renters, it was \$4,000. Clearly, many homeowners have been successful in accumulating wealth, both by steadily

building up equity through their monthly payments, and through the impressive rate of home price appreciation we have seen in recent years.

More than a third of homeowners, approximately 34 percent, own their homes free and clear. Of the 66 percent of the remaining homeowners, $\frac{3}{4}$ have fixed rate fixed rate mortgages and only $\frac{1}{4}$ have adjustable rate mortgages. Many of the borrowers with adjustable rate loans have jumbo loans, indicating that they are wealthier.

In the second half of 2005, according to MBA's Mortgage Originations Survey, 65 percent of the dollar volume of loans originated were prime loans, 11 percent were Alt A, 21 percent were nonprime, with government loans accounting for the remaining 3 percent. Recently, cash out refinances have accounted for about 70 percent of refinances.

Also notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased from 3 to 2 percent. This compression has benefited borrowers in the nonprime market by providing rates that are closer to prime rates. The cause of this compression as well as the abundance of credit is the unparalleled number of loan originators that are competing for borrowers' business. These include mortgage companies, banks, credit unions and mortgage brokers.

Innovations in the mortgage market, resulting in the range of mortgage products available today are a key part of these successes. These products include both fixed-rate mortgages and the "non-traditional products" that we are discussing today.

As my testimony explains, mortgage default and foreclosure rates have been low historically with some increases in the past quarter, the second quarter of 2006. In the second quarter, all ARM loans had higher delinquency rates compared to the first quarter of 2006. Fixed rate mortgage loans (FRM) were either unchanged or saw a decline in delinquencies. The delinquency rate for prime ARMs increased 40 basis points (from 2.30 percent to 2.70 percent) and the rate for prime FRM loans was unchanged (at 2.00 percent). The rate for nonprime FRM loans decreased 38 basis points (9.61 percent to 9.23 percent), whereas the rate for nonprime ARMs increased 22 basis points (12.02 percent to 12.24 percent). MBA has not found evidence that non-traditional products are the cause of these increases. In fact, the evidence we do have from securitized non-traditional mortgages is that they are performing the same or better relative to more traditional products and have done so for a long time.

World Savings, for example, one of the nation's 15 largest financial institutions with \$125 billion in assets, which makes residential loans in 39 states, has been originating, maintaining in portfolio, and servicing Option ARMs for the past 25 years. World reports that Option ARMs have been their core product ever since

ARMs were first authorized in 1981, and they now comprise 99 percent of their portfolio. They have been originating these loans, with extremely low losses, throughout interest rate cycles, recessions and home price declines.

World reports that their annual charge offs have averaged less than 5 basis points since 1981, which they believe is lower than that of virtually every other depository institution of size, including institutions that have made only fixed-rate residential mortgage loans. They indicate that their low charge off levels have been equal to or superior to those of Government Sponsored Enterprises, even though their core product has been the Option ARM while the GSEs have essentially held fixed-rate loans and benefited from greater geographical diversity. During the past quarter century, World reports that it has not identified a single delinquent loan in its portfolio, much less a foreclosure or loss, due to the structure of their Option ARM product.

Other lenders report similarly favorable experiences with non-traditional products.

Notably, there are many factors that contribute to the likelihood that a borrower may become delinquent. Some factors are not predictable and include unemployment, death in the family, divorce, medical problems and other life changes. What is predictable is that delinquencies peak in years 3 to 5 of the loan's life.

The number one cause of delinquencies and foreclosures is historically linked to employment. As we can see in the Midwest, states such as Ohio, Indiana, Kentucky and Michigan have lost a significant amount of manufacturing jobs. That combined with a higher rate of homeownership has contributed to the rise of delinquencies and foreclosures in these and other states.

We have indicated that over the last several quarters, a number of factors, including the aging of the portfolio, increasing short-term interest rates, and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and labor markets had kept delinquency rates from rising. As we see some increases in delinquencies and foreclosures, it is not surprising that nonprime borrowers are more susceptible to these changes.

It is important to remember that nonprime borrowers have always had higher delinquency and foreclosure rates, and lenders factor in these risks when making loans to nonprime borrowers. Additionally, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as they have in the past.

Notably, however, while non-traditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market.

Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent, while it was 25 percent in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and significantly better credit scores than nonprime borrowers who choose other products.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have higher credit scores and lower loan-to-value (LTV) ratios. Notably, these reports confirm that mortgage lenders understand that risk-layering requires lenders to contemplate mitigating factors. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high ARM share.

Because of the success of the industry in addressing the Nation's credit needs, particularly those of previously underserved borrowers, the debate today has shifted away from concerns about the availability of credit. Now the discussion at least in part concerns whether some of the many credit options available to borrowers are appropriate for them, whether they are appropriately underwritten and managed to minimize risk and whether borrowers are appropriately informed of the risks of adjustable, non-amortizing or potentially negatively amortizing products.

Some have even suggested that the industry should take on an undefined responsibility to determine the suitability of products for particular borrowers. Although MBA is examining this issue with its members, it is clear that the industry would oppose a vague and uncertain standard that would stem innovation and cause litigation that would increase costs to all borrowers.

At the end of last year, the federal financial regulators issued proposed guidance on non-traditional products. The guidance sought to ensure that sound underwriting, risk management and consumer disclosure accompanied these products.

In MBA's comments on the proposed guidance, several points of which are summarized in this testimony, MBA made clear that it believes that the creation of such guidance is a positive development given increasing consumer interest in these products and the increasing number of lenders offering them to meet consumer demand. Indeed, MBA emphasized that the proposed guidance identified issues that all lenders should consider in developing credit policies and oversight in originating such products.

At the same time, MBA pointed out that certain provisions of the proposed guidance were overly prescriptive, for example, in mandating specific

underwriting standards and suggesting a third-party oversight standard for Federally-regulated institutions. MBA also pointed out that the agencies did not sufficiently use the authorities of Board of Governors of the Federal Reserve System (Federal Reserve) to improve consumer disclosures for all borrowers. MBA expressed concern that these deficiencies would stifle mortgage product innovation and hurt consumers' access to homeownership financing.

In its comment letter, MBA said that the guidance should explicitly recognize that lenders have successfully offered these non-traditional products for decades and should not be disadvantaged in the marketplace from continuing to do so. Secondly, interest-only and payment-option loans are different products that require different underwriting standards and risk management practices respectively. Moreover, though defined as products, interest-only and payment-option provisions are actually *loan features* that, in and of themselves, do not inherently pose significant risks.

As the comment letter stated, mortgage lenders, operating within this country's sophisticated real estate finance system, respond to a number of influences in determining their ability to originate mortgages in a manner that is profitable, as well as safe and sound. The primary influence for lenders are the signals received from secondary mortgage market investors. A lender originating a large number of mortgages with an unacceptable level of risk will find itself facing significant price disadvantages in the market. These signals prompt lenders to alter product features, introduce new features and remove features that do not work. These product changes are immediate. In this manner, the private market can and does correct for excess risk more quickly than can a regulator who necessarily must move at a more deliberate pace. MBA believes that market signals have already addressed many of the concerns expressed by the agencies in the proposed guidance.

The past 15 years has been marked by dramatic changes in mortgage originations which have significantly lowered the cost of homeownership for consumers and developed a broad range of products that meet a diversity of homebuyer needs. As I indicated, the evidence of success of these changes is the record high homeownership rate the U.S. currently enjoys.

Where guidance or law imposes a standard that is not aligned with mortgage markets, the net effect is to limit the ability of mortgage lenders to create viable products that respond to consumer demand. MBA believes that particular provisions of the proposed guidance threatened to do this, and we suggested certain clarifications and modifications in order to ensure that the proposed guidance met its stated goal of clarifying "how institutions can offer these products in a safe and sound manner," without disrupting mortgage market innovation or curtailing consumer access to financing.

We and our members strongly believe that sound underwriting, risk management and consumer information are essential to the public interest. At the same time we also believe that it is equally essential to assure a regulatory environment that serves and does not stem innovation in the industry. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. While expectations should be articulated, the details need not be prescribed. Also, while lenders must certainly assure that borrowers meet appropriate eligibility requirements, institution of an unspecific suitability requirement would not serve borrowers well; it would simply increase lenders' liability and borrowers' costs. Any new requirements in this area, therefore, must balance all of these imperatives to truly serve the public interest.

Accordingly, while MBA supports sound underwriting, risk management and consumer education, it does not support the imposition of overly prescriptive requirements or overly broad suitability requirements that risk stemming the availability of these and other products.

Also, while MBA has long supported simplification of the mortgage process and all necessary consumer information, to reach those who do not understand the products and process, it does not support the creation of a new disclosure regimen for these products alone without looking at those disclosures that already exist.

Consumers today face a pile of disclosures when they apply for and close on a mortgage. I wish I could say it all helped. There are already so many disclosures that consumers do not pay attention to what's being disclosed, thus defeating their purposes. Any effort at improvement needs to streamline the existing mandated disclosures as well as being comprehensive and well considered. Disclosure requirements should apply to all originators.

Finally, while any increases in delinquencies and defaults are an important concern, prohibition of particular products is not a solution, certainly not to the many borrowers who have used these products effectively to realize their dreams of homeownership and otherwise satisfy the financial demands that we all face.

Our simple message is that the mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from unparalleled choices and competition resulting in lower prices and greater opportunities than ever before to build the wealth and well being that homeownership brings to our families and communities. It must be permitted to continue to do so. Any consideration of new requirements in this area must be judicious and any such requirements very carefully conceived. We must also assure that borrowers fully understand the choices available to them and take full advantage of efficiencies in the market.

Background

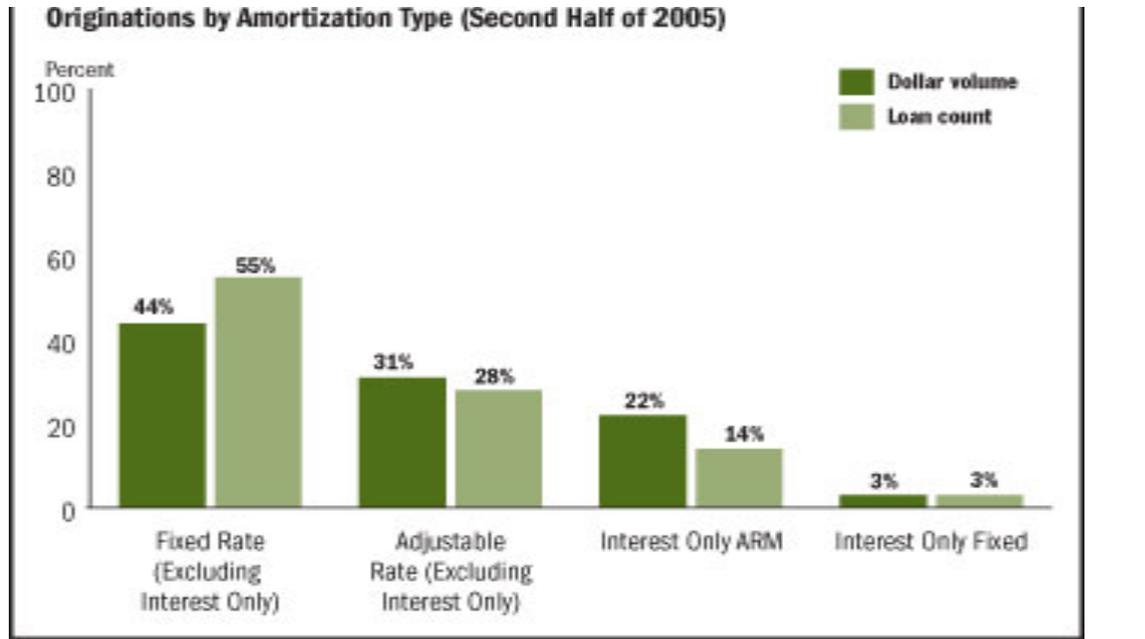
Non-Traditional Mortgage Products Have a Long and Successful History

Some define “non-traditional mortgage products” solely as “interest-only” and “payment-option” mortgages. Such a definition indicates that the key to the non-traditional label is the presence of a non-amortizing or potentially negatively amortizing feature. Ironically though, while currently being termed “non-traditional”, non-amortizing mortgages predate amortizing mortgages. In the United States, it was not until the creation of the Federal Housing Administration (FHA) in 1934 that the now ubiquitous 30-year, fixed-rate, amortizing mortgage gained nationwide acceptance. Prior to the FHA, non-amortizing 5-year mortgages with a balloon payment at the end of the term were the market norm.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. Notably, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance. More recently, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance. Both these points evidence the fact that the primary mortgage market has been constantly developing loan features that were “non-traditional” but also beneficial to consumers.

Some lenders, at the forefront of responding to consumer demand for product diversity, began to offer, in addition to ARMs, interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without a threat to their safety and soundness. It is therefore prudent to look to the practices of lenders respecting non-traditional mortgage products but not to impose prescriptive requirements that would force them to change proven standards and disadvantage institutions from effectively participating in this market.

Consumer demand for interest-only mortgage products is significant, as is demonstrated by MBA’s 2005 Mortgage Originations Survey. Many consumers today have learned how to effectively use these products and the tradeoff between long-term certainty and higher rates versus future rate uncertainty and lower initial rates. Notably, some consumers prefer fixed products just as they prefer investments with a fixed rate of return. On the other hand, others have opted for lower initial rates mindful that they would move or refinance before rates adjusted uncomfortably.



Source: MBA Mortgage Originations Survey

If lenders are hampered by overly prescriptive underwriting standards, it would restrict the availability of these products by some of the mortgage lenders that have the longest experience in offering them. MBA believes such a curb on consumer choice would be an extraordinarily unfortunate development.

Types of Non-Traditional Products

Interest-Only and Payment Option Mortgages

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards, and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed to make amortizing payments during the interest-only period.

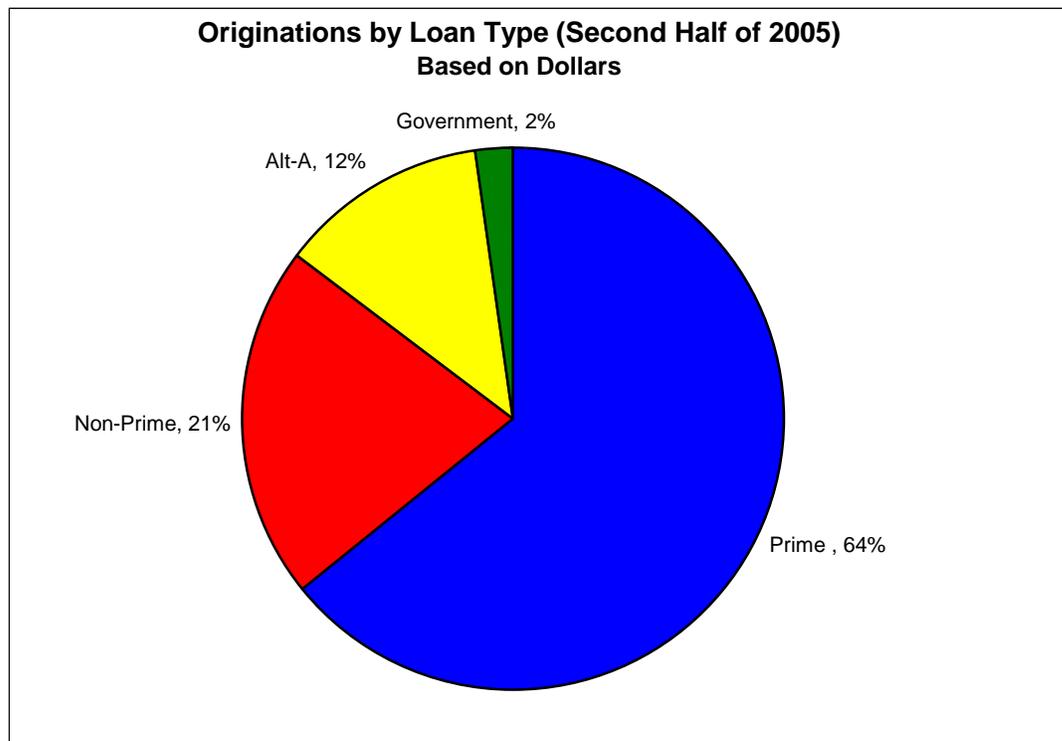
A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule; an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10-25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

In light of these differences, the same attention and policies should not apply to both products. MBA submits that if this matter is to be addressed, any guidance should explicitly recognize that these products or features are different and that any guidance on credit policy and underwriting should not treat the two products the same.

Alt A and other Reduced Documentation Loans

Reduced documentation loans, such as “stated income” loans, have been offered for well over a decade and have grown in popularity with borrowers in recent years, as MBA’s Midyear 2005 Mortgage Originations Survey demonstrates:



Lenders have been able to accommodate consumer demand for these “Alt-A” products because tools have been developed that can accurately gauge risk

without requiring certain documents to be provided by the borrower. As credit history data and credit scoring models have become more robust and predictive, mortgage lenders have been able to lower costs and streamline processes for certain borrowers while effectively managing any additional risks these products might pose.

II. MBA's Comments on Proposed Guidance

As I indicated, in response to proposed guidance from the Federal financial regulatory agencies of December 29, 2005, MBA provided extensive comments. The following summary outlines MBA's position on key issues relevant to "non-traditional" products.

A. Underwriting Standards

MBA believes it is appropriate that lenders identify the primary credit policy and underwriting concerns that lenders should consider in developing loan terms and underwriting standards. Mortgage lenders, though, are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Therefore, it is not appropriate for specific credit policy criteria or thresholds to be prescribed.

Traditionally, the establishment of underwriting standards is the responsibility of a Federally-regulated institution itself. Certainly, the experience of many such institutions, which have offered non-traditional mortgage products for decades, has demonstrated an ability to develop safe and sound underwriting standards.

Qualification Standards

In developing qualification standards for non-traditional mortgage products, lenders should account for possible risks associated with the non- and/or negative amortizing features of a mortgage product. Mortgage lenders that have successfully offered these products have used credit reports, credit scores, and sophisticated modeling to ensure that the non-amortizing features of non-traditional loans are mitigated with features that reduce risk.

While MBA agrees that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA also does not favor the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. Such an approach is far too prescriptive and will force lenders to apply credit policies that would disadvantage products of various terms in a manner which is inconsistent with their risks. For instance, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a

3/1 hybrid ARM with a 27-year amortization starting in year four (3), despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product. A key risk factor of any hybrid mortgage is the initial length of time during which the interest rate is fixed, an interest-only payment is required, or a loan does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes. Also, any qualification standards must differentiate between interest-only and payment-option mortgages; lenders differentiate the two products in underwriting.

Negative Amortization

MBA also does not favor any requirement that the repayment analysis for products permitting negative amortization include the initial loan amount plus any balance increase that may accrue from the negative amortization provision, assuming the borrower makes only minimum payments during the deferral period. MBA believes such an approach establishes a severe and inconsistent standard not applied to other products.

Such a standard effectively requires underwriting to a worst-case scenario that is not standard practice for other products with variable rates, such as a hybrid ARMs, where a borrower's interest rate (and therefore payment) is fixed for a number of years and then adjusts annually within certain prescribed caps. If a lender establishes an underwriting standard qualifying a payment-option borrower at the fully-indexed rate, it is inconsistent to then additionally assume the borrower will make only the minimum payments and qualify the borrower a second time. Lenders do not underwrite to a worst-case scenario where the interest rate increases to the lifetime cap at the first adjustment. This type of standard would not reflect actual performance by experienced lenders and would preclude some borrowers who could benefit from the product from qualifying for it.

Mortgage lending today need not rely solely on rigid debt-to-income (DTI) ratios because automated tools and advanced risk modeling have allowed lenders to go beyond simple thresholds to appropriately qualify borrowers that exhibit risk mitigating characteristics, such as a high credit score or sufficient cash reserves. MBA believes that effective regulatory guidance in underwriting should not include prescriptions to specific credit policies that a lender should adopt. Lenders should be advised to continue to consider the length of the interest-only period in determining whether or not to qualify the borrower on the interest-only payment or the amortizing payment.

Credit Scores

MBA does not believe that lenders "should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process." Credit scores

have proven to be highly predictive of a borrower's capacity and intent to repay a debt. While no mortgage lender should consider only one factor in underwriting any mortgage, MBA is concerned that the term "over-reliance" can be defined too narrowly as requiring the consideration of other less predictive underwriting tools.

Collateral-Dependent Loans

MBA does not favor overly broad restrictions on "collateral-dependent loans" that go beyond the current guidance concerning the consideration of collateral in underwriting the mortgage. For example, a so-called "collateral-dependent loan" with a low LTV to a borrower with a high credit score would not create undue financial risk to a lender.

Risk Layering

MBA supports the view that lenders should adequately account for all risk factors on loan products they offer. For example, the Loan Terms and Underwriting Standards section of the proposed guidance did an excellent job of enumerating some of these risk factors. Federally-regulated institutions with experience in these products have done a good job in managing the various risks that accompany their products and, to date, MBA has not been given any indication that problems exist with their ability to adequately identify risks and establish mitigating factors.

Reduced Documentation

MBA does not believe that reduced documentation loans are incompatible with non-traditional mortgage products. Mortgage lenders do and should continue to prudently assess the risk for reduced documentation loans and look to other risk mitigating factors. Where a lender uses a credit score, especially in conjunction with an automated underwriting system (AUS), for this purpose, MBA believes that a lender is using strongly predictive indicators of general creditworthiness.

Reports from MBA members indicate that portfolios of non-traditional mortgages typically have higher credit scores, lower LTV ratios, and/or other risk mitigating characteristics. Additionally, credit scores are obtained from third-parties beyond the influence of the borrower or any party to the transaction, which means these scores are generally free from fraud or misrepresentation. Credit scoring has enabled lenders to protect the performance of the mortgages they originate while relaxing reliance upon strict income verification requirements or rigid debt-to-income standards.

MBA believes that reduced documentation loans, such as stated income, are generally accepted only if there are other mitigating factors, such as lower LTV and other more conservative underwriting standards. MBA understands that lenders often find that customers with a long history with the bank request these

mortgages for their convenience and many mortgage lenders apply reasonableness tests to stated-income loans.

Simultaneous Second-Lien Loans

Simultaneous second-lien mortgages have been developed by MBA members in response to market demand. Mortgage lenders have been able to meet this demand and manage the higher risks associated with lower borrower equity, even when the combined loan-to-value (CLTV) is up to 100 percent.

MBA does not support rigid guidance that would prohibit interest-only and payment-option features on simultaneous second-lien loans when the CLTV is 100 percent. Such a strict prohibition does not allow lenders sufficient flexibility to manage risks by offering these loans where there are other risk mitigating factors. Also, interest-only and payment-option mortgages should in any case not be treated the same in this regard. MBA members report that CLTV policies are typically different for interest-only products than for payment-option products.

The risk of a simultaneous second mortgage to a Federally-regulated institution depends on what the institution does with the second trust. If the second trust is sold or insured, then the risk is much more comparable to that of an 80 percent LTV loan. Furthermore, a lender that originates an 80 percent first trust has no guarantee that a borrower will not subsequently obtain a second trust of 20 percent of the property's value from a different lender.

Lending to Nonprime Borrowers

MBA agrees that lenders should carefully consider the *Interagency Guidance on Nonprime Lending* (issued March 1, 1999) and *Expanded Guidance for Nonprime Lending Programs* (issued January 31, 2001) when determining the credit policies under which non-traditional mortgage products will be offered to nonprime borrowers.

Non Owner-Occupied Investor Loans

MBA notes that interest-only mortgages are a "traditional" loan feature in investment property lending. MBA therefore believes that that a 100 percent CLTV interest-only investor mortgage should be permitted. In such cases, a mortgage lender may apply other risk mitigating credit policies to such a product that would address any risk factors.

MBA's view is that borrower equity is one of many factors a mortgage lender should consider in evaluating the risk of a particular mortgage loan.

B. Portfolio and Risk Management Practices

Concentrations

MBA believes that lenders should pay particular attention to those products in their portfolios that may carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there may be a problem.

MBA does not support the imposition of strict concentration limits by loan types, third-party originations, geographic area, property occupancy status, high LTV loans, high debt-to-income (DTI) ratio loans, loans with potential negative amortization, loans to borrowers with credit scores below established minimums and non-traditional mortgage loans with layered risks.

The proportion of loans with certain characteristics should be monitored, but immediately stopping the pipeline of loans with certain features is impractical and unnecessary for many lenders. Large mortgage lenders with several origination channels and who actively sell loans may have difficulty ensuring that the concentration limits are not exceeded in changing markets. Such concentration limits also may be unnecessary if an increase in a portfolio's risk in one line is offset by a decline in risk in another area.

MBA believes that lending institutions should work with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolio.

Controls

MBA agrees that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate and that non-traditional mortgage products may require controls that others products do not. MBA has asked the regulatory agencies to clarify that such controls are not expected in those cases where the loan is sold without recourse.

Third-Party Originations

MBA believes that mortgage lenders should have "...strong approval and control systems to ensure the quality of third-party originations..." but believes that the requirement that Federally-regulated institutions ensure that third party originators (TPOs) are originating in "...compliance with all applicable laws and regulations, with particular emphasis on marketing and borrower disclosure practices," if interpreted literally, is too expansive. Holding a lender responsible for the marketing practices of TPOs is significantly beyond current industry practices and beyond these institutions' reasonable ability to comply.

When mortgage lenders use TPOs, they are essentially outsourcing some portion of the origination process to a separate mortgage professional. As such, they do not have the same ability to monitor employees of the TPO as they do their own employees. Lenders do not have the same ability to oversee the employees of TPOs as they do their own retail staff. Moreover, such a standard is not in place for traditional mortgage products and should not be implemented for non-traditional mortgage products.

Mortgage brokers and many loan correspondents are governed by state law and regulated by state agencies. These agencies have the jurisdiction and authority to subpoena records and audit these state-regulated entities. Mortgage lenders, even those who are federally-regulated, simply do not have the legal authority to enforce state or federal laws.

An unintended consequence of such a requirement in guidance applicable to federally regulated financial institutions would be to disadvantage Federally-regulated institutions in comparison to other mortgage lenders in working with TPOs, if such institutions are forced to implement invasive monitoring procedures not required by other mortgage lenders.

Secondary Market Activity

MBA does not agree with the assertion that the voluntary repurchase of loans constitutes “implicit recourse” requiring risk-based capital be maintained against the entire portfolio. Regulators should not treat loans as subject to recourse where contract law does not require it. Under this requirement, a Federally-regulated institution would be hampered in its ability to repurchase mortgages for business reasons.

MBA notes that the secondary market takes positions on the current and expected performance of non-traditional mortgage products through pricing and decisions by rating agencies, such as Standard & Poor’s June 20, 2005 announcement of changes to its ratings criteria. Secondary market feedback can mollify concerns of excessive risk.

C. Borrower Information Concerning Non-Traditional Products

MBA strongly believes that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. As indicated, many consumers understand the array of products and have used them appropriately to their best advantage.

On the other hand, MBA recognizes that it is possible that some consumers may not fully understand the features of some of the interest-only or payment-option mortgage products they are considering and that reasonable improvements to current disclosure requirements may be warranted.

It is in the interest of mortgage lenders to assure that their customers are provided necessary information to facilitate their understanding of these products. Because there is no single, uniform, mandated disclosure for non-traditional products, many lenders have developed their own disclosures to inform borrowers about the characteristics of these products. As indicated, many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of non-traditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

While mortgage markets are functioning well and serving consumers, as indicated, some borrowers still find it challenging to understand the array of products. While an overhaul of our education system to make financial literacy a priority is a long-term goal, MBA believes steps have to be taken in the short term. These steps should be directed toward three areas to improve borrower understanding and help them get the best prices possible:

- First, borrowers have to be provided effective tools to educate themselves about the mortgage process.
- Second, consumers need simpler, more user friendly disclosures about mortgage loans in order to shop and compare.
- Third, consumers need to be urged to shop more intensely, comparing mortgage offerings from lender to lender.

MBA's research has shown that homebuyers, particularly first-time homebuyers, rely on a trusted advisor, who may have an adverse incentive, to help them through the complex process of buying a home and getting a mortgage. Too often, MBA believes, these new buyers, and particularly minority first-time homebuyers, either contact only one lender or mortgage broker, or are referred by a real estate agent to only one lender or broker while shopping for a mortgage. Borrowers more experienced in the process are generally more likely to seek additional rate quotes.

MBA believes that borrowers need to educate themselves about the mortgage process – so much so that MBA created an educational Web site about the mortgage process for consumer use at www.HomeLoanLearningCenter.com that also offers Spanish language information. In addition, MBA is committed to working to put together a meaningful mortgage disclosure or disclosures that contains relevant, easily understood information that a consumer can use to shop and compare mortgage loans. MBA believes that armed with a basic understanding of the mortgage process, an ability to compare loans, and a willingness to shop, a consumer will be in a far better negotiating position when trying to get a competitive home loan.

MBA cautions, however, that any attempt to establish or improve disclosures for particular mortgage products, including non-traditional products, must be comprehensive and take into account the present system of required borrower information and disclosures. This necessarily would include consideration of the patchwork of non-Federal disclosures and how to present beneficial information in a form and format that will best serve and not overload borrowers. MBA would suggest that such an effort be undertaken on a comprehensive industry-wide basis so that consumers are informed of product features, while choosing their mortgage, in a consistent manner.

As indicated, in response to the proposed interagency guidance, MBA stated that it believes that the best method for achieving the above objectives is for the Federal Reserve to use its regulatory authority under TILA to improve and standardize disclosures following a regulatory process where key stakeholders from the mortgage industry have a meaningful opportunity to participate. The FRB should work closely with HUD to assure that any changes are consistent with any efforts at RESPA reform.

Notably, one initiative currently underway is the FRB's proposed study to include consumers and lenders for the purpose of developing and testing consumer regulatory disclosures that was detailed in the Federal Register on March 15, 2006. The proposed study can assist the process of improving disclosures to benefit consumers.

Another initiative is HUD's effort to reform RESPA to simplify and improve the settlement process. If the FRB chooses to exercise its authority under TILA to

simplify and improve consumer disclosures, the FRB and HUD should coordinate their efforts to assure that they are complementary and accomplish their goals in a manner that truly improves the mortgage process.

III. Data on the Market Today

The market for home mortgages has changed radically in recent years. Home prices have increased dramatically, presenting significant affordability challenges in many parts of the country, and the industry has responded by providing flexible and affordable loan products. This same increase in prices has presented opportunities for borrowers to tap into the increased equity in their homes to meet a range of educational, health, housing and other needs. Largely as a result of increasingly sophisticated underwriting tools, risk based pricing permeates the industry. At the same time, technology has improved underwriting and risk management capabilities, enabling the industry to better serve the needs of borrowers with less than perfect credit.

Homeownership is at near record levels, and it is increasing the most among minorities. The homeownership rate in 2005 was 68.9 percent, the rate for African-Americans was 48.2 percent and for Hispanics 49.5 percent. According to MBA's data, at the end of 2005, prime loans accounted for 76 percent, nonprime 13 percent, and FHA and VA the remaining 11 percent of outstanding loans.

Mortgage default and foreclosure rates have been low with some increases in the past quarter, the second quarter of 2006. In the second quarter, ARM loans had higher delinquency rates compared to the first quarter of 2006. Delinquencies for fixed rate mortgage loans (FRM) were either unchanged or saw a decline in delinquencies. The delinquency rate for prime ARMs increased 40 basis points (from 2.30 percent to 2.70 percent) and the rate for prime FRM loans was unchanged (at 2.00 percent). The rate for nonprime FRM loans decreased 38 basis points (9.61 percent to 9.23 percent), whereas the rate for nonprime ARMs increased 22 basis points (12.02 percent to 12.24 percent). MBA has not found evidence that non-traditional products are the cause of these increases. In fact, the evidence we do have from securitized non-traditional mortgages is that they are performing the same or better relative to more traditional products and have done so for a long time.

While foreclosure rates are greater in the nonprime market than in the prime market, the numbers are far less than some have suggested. Let me emphasize again the importance of market growth when interpreting delinquency and foreclosure numbers. According to HMDA data, in 2000, there were 8.3 million applications for mortgages to buy a home. In 2004, there were 9.8 million applications for purchase mortgages. When the market is growing, even if the foreclosure rate remains constant, there will be an increase in the number of

foreclosures. However, too frequently some market analysts point to an increase in the number of foreclosures as a problem in and of itself, when in fact it simply may reflect a constant or even declining foreclosure rate in the context of a growing market making more families homeowners than ever.

In the second quarter of 2006, the foreclosure inventory rate for nonprime loans was 3.56 percent. While this rate is greater than the prime market rate of 0.41 percent, nonprime borrowers by definition present greater risks of default than prime borrowers. Indeed this difference in default rates accounts for the mortgage rate differences between prime and nonprime loans.

Compare these differences to the foreclosure inventory rate for nonprime loans in 2001 peaking at 9 percent. The latest numbers tell a good story about lenders' ability to manage risk and the wherewithal of nonprime borrowers. In any case, those who would fix on a relatively low foreclosure rate as a reason for over-regulating the nonprime market risk denying the overwhelming majority of nonprime borrowers the prospect of homeownership.

MBA's National Delinquency Survey showed that the delinquency rate on one-to-four unit residential properties stood at 4.39 percent at the end of the second quarter of 2006, down 2 basis points from the first quarter, and up 5 basis points from the second quarter of 2005.

MBA also found that the economy and housing market decelerated in the second quarter of 2006. Although labor markets remained strong, the pace of job growth slowed, as did the home price appreciation rate, which has decreased in response to higher interest rates and rising inventories of unsold homes. In fact, some states experienced home price declines in the second quarter.

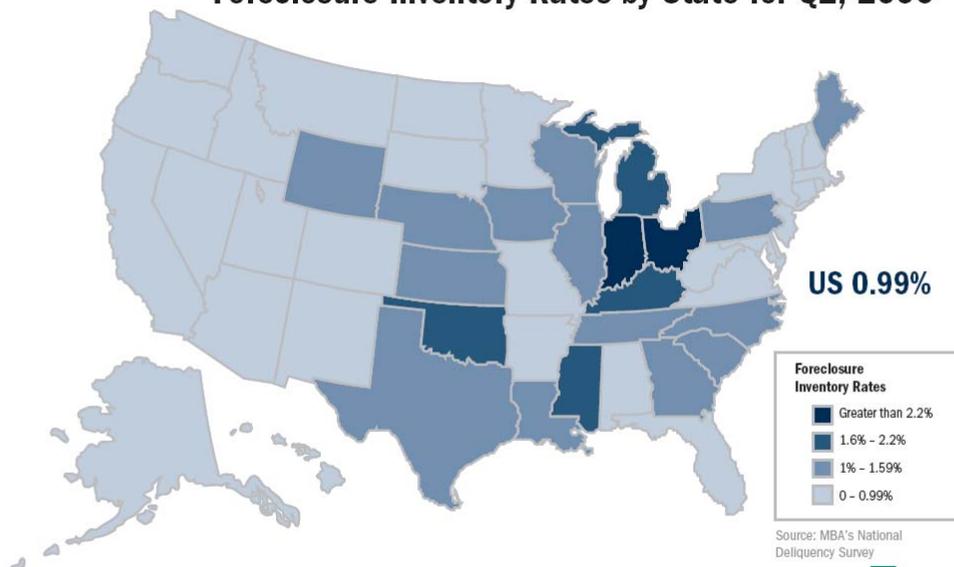
In previous quarters, MBA indicated that a number of factors, including the aging of the loan portfolio, increasing short-term interest rates, and high energy prices had been putting upward pressure on delinquency rates. To this point, generally healthy economic growth and labor markets have kept delinquency rates from rising. However, we are seeing increases in delinquency rates for nonprime loans, particularly for nonprime ARMs. Again, it is not surprising that nonprime borrowers are more susceptible to these changes.

Going forward, MBA expects some further slowing in the economy and the housing market. As a result, MBA expects modest increases in delinquency and foreclosure rates in the quarters ahead.

State- to-State Differences

There are significant differences in foreclosure rates among the states reflecting local economic conditions including job losses as illustrated by the map below.

Foreclosure Inventory Rates by State for Q2, 2006



IV. Conclusion

Mortgage credit is the lifeblood of the housing industry. Artificially constraining this flow will reduce the ability of prospective homeowners to purchase homes. Absent overregulation and the imposition of unworkable solutions, the range of mortgage products and the “risk-based” pricing prevalent in the mortgage lending industry will continue to expand access to credit and continue to contribute to the highest levels of home ownership in American history. At the same time, a dynamic and competitive market will continue to provide ample borrowing opportunities.

To reiterate, MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest in connection with all mortgage products. At the same time we also believe that it is equally essential to assure a regulatory environment that serves and does not stem innovation in the industry. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. Any rules in this area, therefore, must balance all of these imperatives to truly serve the public interest.

As I said at the beginning of my testimony, our message is that the mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from unparalleled choices and competition

resulting in lower prices and greater opportunities than ever before to build the wealth and well being that homeownership brings to our families and communities. It must be permitted to continue to do so. Any consideration of new requirements in this area must be judicious and any such requirements very carefully conceived. We must also do our best to assure that borrowers fully understand the choices available to them and take full advantage of the market.

The market is working but it is not invincible. There is a very real conflict between any potential benefits of state and local regulation of this sector of the economy, and the many benefits that have already been achieved through vigorous competition among lenders active in this sector. Additional restrictions impose a cost. They reduce the flow of credit and the array of choices to borrowers who would otherwise have access to them, by reducing the ability or willingness of some lenders to lend, reducing competition and its benefits.

Again, I appreciate the opportunity to testify and I look forward to answering your questions.