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Statement of

Scott M. Albinson, Managing Director
Examinations, Supervision & Consumer Protection
Office of Thrift Supervision

concerning

Alternative Mortgage Products

before the

Senate Subcommittee on Economic Policy and
Senate Subcommittee on Housing and Transportation

September 20, 2006

Office of Thrift Supervision
Department of the Treasury

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

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I. Introduction

Good morning, Chairman Allard, Chairman Bunning, Ranking Member Reed, Ranking Member Schumer, and Members of the Subcommittees. Thank you for your continued leadership on issues affecting the mortgage markets and the important topic of Non-Traditional Mortgage Products. We appreciate the opportunity to discuss the views of the Office of Thrift Supervision (OTS) on alternative mortgage products and the risks these products may present to consumers, financial institutions, and financial intermediaries. An important aspect of the OTS's supervisory role is our ability to identify, monitor, and mitigate these risks.

II. History

Thirty years ago, a borrower would pay 8.9 percent to obtain a conventional thirty-year fixed rate mortgage. Less than five years later, the average rate for this loan had almost doubled to 16.8 percent. In the midst of that unprecedented rise in mortgage interest rates, several financial institutions (predominantly thrifts) began to offer two alternative mortgage products that foreign lenders were already successfully offering in other parts of the world.

The first of these products was an adjustable rate mortgage (ARM) that featured an annual cap, or limit, on payment increases. When rising interest rates caused a loan to exceed the payment cap, the borrower had the option to defer paying the additional interest. This deferral resulted in negative amortization of the loan's principal balance, i.e., the interest was added to the existing principal. The advantage of deferring payment of some of the interest owed was that it allowed borrowers to ride out a temporary payment shock caused by a rise in interest rates.

The second ARM product financial institutions began to offer did not allow deferral of interest. That loan allowed the borrower to pay interest at regular intervals until maturity, when the entire balance on the loan was due. The second ARM did not require amortizing payments. Interestingly, thrifts in the western United States adopted the first ARM product, with the option for interest deferral, while thrifts in the east adopted the ARM product that did not permit deferral of interest.

For about twenty years, thrifts offered these products responsibly to qualified borrowers seeking alternatives to the standard, 30-year, fixed rate product. These products provided borrowers payment flexibility and, in some instances, enabled borrowers to purchase homes based on their unique circumstances. In all cases, however, borrowers had to qualify financially for the full amount of the loan.

History has taught us that responsible and successful lending with alternative mortgage products requires a commitment to careful underwriting. This includes close attention to the ratio of the loan amount to the value of the property, and active and continuous risk management. Financial institutions must regularly interact with customers over the life of the loan so they understand how these loan products function. The long-term success of these products was critical to the thrifts that utilized them because the institutions held most of these mortgages in their own portfolios.

Our testimony focuses primarily on two types of alternative mortgage products, also referred to as nontraditional mortgages, that are prevalent in today's market. Both

products are ARMs. The first type is called an interest-only ARM and only requires a borrower to make monthly interest payments, often for an extended period. The second type, called an option ARM, offers the borrower a menu of monthly payment options from which he or she can select. These options typically comprise an interest-only payment, a payment based on 15-year amortization, a payment based on 30-year amortization, or a "minimum payment" that often results in negative amortization.

Calculation of the "minimum" payment is the most complex aspect of these option ARMs. For the first year, the lender determines the minimum payment by a marketing-driven "start rate," which is the rate typically advertised with these products. Current start rates average in the range of 1.0 to 1.5 percent, which is substantially below the conventional market rate for such loans. The "start" rate establishes what a borrower's monthly mortgage payment will be for the first year of the mortgage term. For example, on a $500,000 mortgage with a start rate of 1.0 percent and a 6.5 percent fully-indexed rate, a borrower would pay only $1,608 per month in the first year. A similar 30-year fixed rate mortgage would require the borrower to pay $3,160 per month, almost double the first year start rate of an option ARM.

If a borrower selects the minimum payment option, the monthly payment amount for an option ARM is typically insufficient to cover the interest owed. The difference between what the borrower pays and what the borrower owes in interest is added to the principal balance of the loan each month and can result in negative amortization. Each year the minimum payment resets to reflect the current principal balance and interest rate conditions. Option ARMs typically cap both the increase in the minimum payment from year to year as well as the total amount a loan can negatively amortize. The cap on the increase in the minimum payment averages 7.5 percent, which usually allows the borrower to continue to negatively amortize the loan during the option period. The cap on negative amortization usually ranges from ten to 25 percent of the original loan balance.

At the end of a contractually set period, typically five years, or earlier if the loan reaches its negative amortization cap, the loan terms recast to reflect current interest rates without any constraints on the increase allowed in the minimum payment. If a borrower has only made minimum payments, a recast can result in a substantial increase in the borrower's required payment. The increase will often range between 50 and 100 percent of the original minimum payment amount depending on whether interest rates have risen and whether the loan negatively amortized.

Over the last few years, many more lenders, particularly mortgage brokers and nondepository finance companies, have offered variations of the option ARM. The rapid growth in this market is attributable to several factors including rapid home price appreciation, intense mortgage competition, and a strong economy with historically low interest rates. In addition, many financial institutions sell, purchase, or securitize portfolios of mortgage products. New securitization markets and technology developments such as automated underwriting standards, automated valuation models, and credit scoring also contributed to growth in the mortgage markets.

Despite this growth, these newer alternative mortgage products only accounted for approximately 24.6 percent of the U.S. ARM market and an estimated 5.4 percent of the total U.S. mortgage loan market as of June 30, 2006. Newer ARM products remain prevalent on the coasts, with generally more limited adoption throughout the remainder of the U.S. In OTS-regulated thrifts, alternative mortgage product offerings are generally concentrated in a few large institutions. In fact, five thrifts account for approximately three-quarters of total thrift alternative mortgage product originations. Option ARM originations are further concentrated with four thrifts representing approximately 90 percent of all thrift originations. These four institutions have significant experience with this product since they have been providing alternative mortgage products to borrowers for more than 15 years.

Recent data on loan originations indicate that while option ARM originations remain higher than average, the trend among OTS-regulated thrifts is beginning to

decline. OTS-regulated thrifts account for approximately 59.5 percent of the total ARM originations. Of the population of mortgages originated solely by OTS-regulated thrifts, ARMs represent 36.8 percent while option ARMs represent approximately 6.5 percent. This is a decline from year-end 2004 and 2005 where option ARM originations were 11.3 and 10.2 percent of OTS-regulated institutions' mortgage loan originations, respectively. The trend is less clear for the entire mortgage market where option ARM originations totaled 7.5, 11.5, and 9.3 percent of mortgage originations for year-end 2004, 2005, and the twelve months ending June 30, 2006, respectively.

The influx of new lenders into the alternative mortgage market over the last several years also includes numerous inexperienced lenders that lack sufficient understanding of newer alternative mortgage products. Many of these new lenders also do not possess the same commitment to strong underwriting and to consumer welfare as more experienced lenders. While the original version of the option ARM is a traditional thrift product, we are concerned that rapid expansion and recent variants of these products coupled with the usage of untested new technologies have elevated the risk profile for these offerings. Over the last few years, as the availability of products and competition among lenders intensified, lenders began offering the option ARM to an increasingly broad demographic of borrowers. Many of these borrowers lack either sufficient understanding of the option ARM product or simply lack the financial wherewithal for products in which they are being qualified by unscrupulous lenders.

The fact that some lenders treat alternative mortgage products as a way to get a borrower in the door, rather than a product that affords financial flexibility magnifies concern with the proliferation of products such as the option ARM. Recent media accounts provide anecdotal evidence that some borrowers have indicated they did not understand the loan terms and ultimately are unable to afford these products in the long-term. However, analytical data indicate that the overwhelming majority of option ARM loans remain current. As of June 30, 2006, approximately 0.11 percent of all option ARMs were 90 or more days past due, compared to 0.16 percent for all ARMs and 0.38 percent for 30-year fixed rate loans. During the same period approximately 0.17 percent

of option ARMs were in foreclosure, compared to 0.18 percent for all ARMs and 0.2 percent for 30-year fixed rate loans. By comparison, high loan to value mortgage loans (96-100 percent LTV) of all types displayed the highest level of delinquency and foreclosure with approximately 2.91 percent 90 or more days past due and 1.5 percent in foreclosure. Since many mortgage loans are relatively recent originations and are not fully seasoned, however, it is uncertain as to whether credit quality will significantly deteriorate in future periods.

In December 2005, the federal banking agencies (FBAs) published proposed guidance on alternative mortgage products. Numerous comments were received, many of which were critical of certain aspects of the proposed guidance. The OTS fully supports the need to revise the proposed guidance based on these comments. We are currently working with the other FBAs to issue final interagency guidance that underscores our expectations for institutions, especially new entrants, to conduct alternative mortgage lending in a safe and sound manner.

Our intent is not to discourage alternative mortgage lending, but rather to ensure that it is engaged in safely, soundly and effectively. In particular, institutions should provide full, clear, and balanced disclosure of the risks to any potential borrower at the time the borrower is considering loan options. The OTS also supports baseline underwriting guidelines for all lenders that include certain prudential standards. Standards we support include qualifying borrowers at the fully-indexed, fully-amortizing loan amounts for option ARM products, providing full and balanced disclosure of the risks and benefits of product offerings, and implementing robust risk management practices.

III. Risks

Credit risk varies for all types of mortgages based on numerous factors including, borrower equity, creditworthiness, and income level, property values, loan terms, and economic conditions. Lenders must analyze each of these and other factors in order to manage risk. Additional factors that may influence underwriting include whether the

collateral is a primary residence, vacation home, or investment property and whether the loan is a purchase money mortgage or a refinancing. Financial institutions also face compliance, legal, and reputation risk for each product they offer. While alternative mortgage products expose financial institutions to all these risks, an institution's exposure to interest rate risk can be mitigated by transferring that risk to borrowers in exchange for elevated credit risk. However, the complexity of the payment options, amortization schedules, and rate structures require a strong commitment to clear and balanced disclosure to ensure the credit risks assumed by a borrower are in line with the borrowers ability to pay on the loan.

Borrowers may also be exposed to certain risks when obtaining mortgage loans. Rising home prices increase a borrower's equity cushion, while stagnant or falling prices erode borrower equity. The risks associated with an ARM also vary based on changes to the mortgage's interest rate index. The current economic outlook for price appreciation in certain markets as well as the rise in underlying interest rate indexes have contributed to concern about recent ARM offerings. Other lending practices, often referred to as "risk layering", include originating high loan-to-value loans, providing piggyback second mortgages, and lending to borrowers with low credit scores. While these practices can expand homeownership to consumers with weaker credit or related factors, they also increase the risk of default. Alternative mortgage products have one additional risk feature that can unduly pressure an uninformed borrower – payment shock.

Payment shock is the amount of increase in a loan payment when a loan payment adjusts. The size of a payment shock relates directly to the degree to which a loan can negatively amortize and the gap between the marketing-driven start rate and the underlying fully indexed rate. Intense competition in mortgage markets coupled with rising interest rates has widened this gap substantially. Many institutions have expressed concern about the current gap in rates, which is now nearing six percent. Historically, the gap has averaged three percent. Many thrifts have attempted to offer higher start rates to minimize the amount of negative amortization to borrowers, but are often unable to compete as business shifts to competitors with lower start rates. This marketing-driven

phenomenon strongly underscores our desire to have a level playing field among all market participants. This is in the best interest of consumers as well as financial institutions.

Absent careful underwriting and full and accurate consumer disclosure, a large gap between the start rate and fully-indexed rate can elevate payment shock and the risk of these products. This is particularly true when lenders do not conduct the necessary analysis of a borrower's ability to pay under varying economic scenarios. Lenders should succinctly outline the payment terms and schedule to ensure that a borrower clearly understands the product and its potential risks, particularly future payment adjustments.

An interagency survey conducted last year among major alternative mortgage lenders indicated that they were generally compensating for the risk of these products by imposing stricter underwriting standards, including higher equity or better credit quality. We also found that disclosures are not consistent as to the type and level of information provided to consumers, with the range of practice varying greatly. We remain focused on working with the other FBAs to establish guidelines for clear, balanced disclosures. Additionally, we support any initiative by the Federal Reserve Board to update Regulation Z specifically to address concerns with alternative mortgage products.

IV. OTS Supervisory Program

The OTS has designed and implemented a comprehensive supervisory program to oversee thrift institution alternative mortgage lending activities. We expect any institution offering these products to disclose the risks and loan terms to prospective borrowers, to adhere to safe and sound underwriting standards, and to manage the product risks. The OTS endeavors to maintain a strong supervisory presence while not stifling innovation or credit availability to responsible borrowers. The OTS is committed to providing examiner education, industry guidance, and consumer information and outreach to meet this goal.

Consistent with national trends, we have seen an increase in the number of thrifts offering alternative mortgage products. We currently use surveys conducted by on-site examiners and information from certain thrifts engaged in alternative mortgage product lending to conduct our off-site monitoring of these thrifts. We also subscribe to a national database that allows us to monitor the volumes and performance of alternative mortgage products for numerous lenders. However, with the increasing risk and prevalence of these products, we proposed in July 2006 to begin collecting key product information from all thrifts on a quarterly basis in the Thrift Financial Report beginning in March 2007. The items we propose to collect include total option ARM loans held in portfolio; ARM loans with negative amortization features; and total capitalized negative amortization. We view these as minimal elements for monitoring alternative mortgage products in OTS-regulated institutions.

As these products expanded nationwide, the OTS offered additional training, led by its most experienced examiners, to the rest of our examination staff. Our most experienced examiners have over 20 years of supervisory experience evaluating non-amortizing mortgage products. The focus has been on training examiners to: (1) understand the mechanics of non amortizing products, (2) analyze the growth in originations as new lenders began originating these products, (3) assess the primary risks to consumers – focusing on various scenarios to illustrate how "payment shock" can occur and the impact of negative amortization on the borrower's indebtedness; (4) review required federal consumer regulatory disclosures; and (5) communicate existing OTS mortgage regulations and supervisory expectations applicable to alternative mortgages.

The OTS has sent a consistent message about our expectations for savings associations that make loans with non-amortizing features. In June 2005, we issued a revised Examiner Handbook section on residential lending, re-emphasizing that institutions should fully understand and manage the additional risks that these alternative products can pose. The Handbook section sets forth the OTS's expectation for robust risk management practices that include strong management information systems, internal

controls, periodic reporting, and the need for enhanced servicing operations that mitigate any potential delinquencies.

As part of the examination of each institution, we began collecting data on the extent to which each institution originated and held nontraditional mortgage products in its portfolio. A particular concern was that new entrants may not have the level of expertise necessary for offering these products successfully, especially as rates are rising and there is an indication that home values and appreciation in certain markets are weakening or declining. To date, we have not observed broad, systemic, or excessive risk-taking by the institutions we supervise.

The updated Examiner Handbook emphasizes that examiners should focus on a savings association's underwriting standards to ensure that borrowers qualify for these loans. It also describes the risks that sharp increases in monthly payments can present to consumers and instructs examiners to consider the borrower's ability to repay after the expiration of the interest-only period. The OTS also encourages institutions to have strong management information systems to monitor deferred interest income to total income, the percentage of negative amortization loans in excess of the original principal balance, and other key risk metrics. The OTS carefully reviews this information during on-site examinations.

Our Examiner Handbook also instructs our examiners to carefully analyze loans where consumers are only making the minimum required payments. Examiners recognize that consumers who make the minimum payments are at risk if interest rates increase or they experience financial difficulties. The updated examination procedures instruct our examiners to determine and analyze the amount of mortgages within a savings association's portfolio that are negatively amortizing. This type of supervisory tracking allows the OTS to identify potential weaknesses in a savings association's policies, underwriting criteria, and related factors that may present risks both to the savings association and its borrowers. Such tracking also allows us to require corrective measures, where warranted.

Additionally, OTS examination procedures remind examiners to focus on savings associations' compliance programs to ensure that all loans comply with federal laws governing credit transactions. For example, OTS regulations prohibit a savings association from inaccurately advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of the loans it originates (12 CFR 563.27). Given the potential that consumers may not fully understand the benefits and potential risks associated with alternative mortgages, and the ever-growing range of options available to consumers seeking a mortgage loan, our examination procedures emphasize the need for savings associations to provide clear information to consumers regarding *all* of their mortgage products, including alternative mortgages.

The OTS also monitors and analyzes all consumer complaints during off-site monitoring and on-site examinations. We assess both individual complaints to ensure that financial institutions are not engaging in unfair or deceptive lending activities as well as trends or patterns in consumer complaints. The OTS has not identified a trend in consumer complaints regarding alternative mortgage products, nor have we received a material number of such complaints. The complaints we generally receive regarding ARM vary in nature and usually are aimed at the rate adjustment feature as opposed to the more complex aspects of alternative mortgages.

Beyond internal training and examination guidance, we have also communicated our regulatory expectations to savings associations through industry group meetings, direct communication with institution management, and other outreach efforts. We have indicated that alternative mortgages are not appropriate for all borrowers, particularly those with high debt levels who are using the product to purchase real estate they could not otherwise afford. We have also stated that institutions that offer these products must take steps to manage and ameliorate risks effectively through prudent loan structures and pricing, sound underwriting, strong risk management systems – together with complete disclosure of the benefits and the risks of these products.

OTS senior analysts have developed and presented mock board meetings to bankers and banker associations on consumer protection issues and risk management issues that they should consider in connection with alternative mortgages. These presentations highlight existing OTS mortgage regulations and examiner guidance applicable to alternative mortgage products including sound underwriting that analyzes the borrower's ability to repay. Additionally, these presentations remind institutions about required consumer disclosures and emphasize the need to provide useful and educational information on the benefits and the risks associated with alternative mortgage products.

In 2002, the OTS issued broad guidance for consumer protection programs that outline the components of an effective compliance program. This guidance requires savings associations to monitor and assess their compliance with various consumer protection, civil rights, and public policy laws and regulations, and take appropriate corrective action to remedy identified violations or operational deficiencies.

This guidance defines "compliance risk" and advises savings associations that failure to ensure compliance with laws and regulations exposes the institution's earnings, capital, and market viability to risk. Compliance failure also jeopardizes investor and customer relationships. The guidance reminds institutions that violations or nonconformance with laws, rules, regulations, industry practices, internal policies and procedures, ethical standards, or customer service goals also exposes the institution to fines, civil money penalties, litigation costs, payment of damages, diminished reputation, reduced franchise value, and diminished consumer trust. Through the guidance, the OTS advises all institutions to develop and maintain compliance management programs that are commensurate with their size and complexity. The guidance also directs institutions to establish monitoring, assessment, and corrective-action systems to ensure a sound compliance risk management environment. This is critical when originating alternative mortgage products, where potential risks to consumers are elevated in comparison to less-complex mortgage products.

V. Interagency Supervisory Activity

The federal bank regulatory agencies have engaged since last summer in developing interagency guidance on appropriate risk management and consumer disclosure practices for alternative mortgage products. The agencies published the draft guidance for public comment in December 2005. Because of the intense interest, the agencies extended the public comment period 30 days beyond the original 90 days. The agencies received a full range of comments. The majority stated that the guidance was too prescriptive and that institutions should have more flexibility in determining appropriate risk management practices. Several commenters confirmed the OTS's observations that alternative mortgage products have a successful history as products that offer borrowers payment flexibility. Many of the commenters were concerned that the guidance would stifle innovation and result in a decline in credit availability for qualified borrowers while not addressing the agencies' consumer protection concerns.

Comments from consumer organizations, individuals, and community bankers argued the opposite point that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These comments observed that alternative mortgage products contributed to speculation and unsustainable appreciation in the housing market. They expressed concern that severe problems will occur during an economic downturn, slowdown, or reversal of housing price appreciation. Some also argued that these products are harmful to borrowers who may not understand the associated risks.

Two state financial regulatory trade organizations also commented on the proposed guidance – the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR). They subsequently committed to working with state regulatory agencies to distribute similar guidance to the financial service providers under their jurisdictions. On June 7, 2006, CSBS, and the American Association of Residential Mortgage Regulators (AARMR), issued a press release confirming their intent to offer guidance to state regulators for licensed residential mortgage brokers and lenders. They noted their interest in mitigating the potential for inconsistent regulatory

treatment. According to the Mortgage Bankers Association, mortgage brokers originate between 70 and 80 percent of all mortgages that come to depository institutions. The OTS welcomes CSBS, SFRR, and AARMR's commitment to a level playing field. Without their commitment, the proposed nontraditional guidance would be hampered significantly given the growing role that mortgage brokers, finance companies, mortgage companies, and other state licensed lenders play in providing credit to consumers nationwide.

The agencies considered and addressed many of the commenters' concerns in redrafting the guidance. The agencies expect to release the final guidance shortly. The guidance will clearly articulate the risk management and consumer disclosure expectations concerning these products, while recognizing the need for flexibility for regulated institutions in meeting the legitimate credit demands of those seeking to purchase a home.

The OTS believes that an institution's underwriting standards should recognize the risk associated with alternative mortgage products, including the potential impact for payment shock. An institution's underwriting criteria are generally based on multiple factors. Thus, an institution should consider these factors jointly in the underwriting process. The criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes. Accordingly, industry guidance should provide that for all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed, fully amortizing rate. This approach should mitigate the financial risk of potential payment shock to the borrower as well as underscore the appropriate use of these products as financial flexibility tools, and not as affordability products.

Industry guidance should also provide standards for institutions that purchase alternative mortgage products from third parties. Financial institutions should have strong systems and controls in place for establishing and maintaining relationships with

third parties, including procedures for performing due diligence. The proposed guidance establishes criteria for the third party relationship including, entering into and maintaining relationships with third parties; providing third party compensation that does not provide incentives for weak underwriting or disclosure standards; establishing systems and procedures to monitor whether third parties are complying with agreements made with the institution; and implementing appropriate corrective action if a third party fails to comply with applicable agreements, policies, or laws. The OTS believes that such guidance is important, particularly as depository institutions increasingly use third parties as a pipeline for mortgage originations.

The federal banking agencies continue work on important consumer protection standards for lenders, advising institutions to provide information to consumers that: (1) aligns with actual product terms and payment structures; (2) covers risks areas (such as payment shock and negative amortization) and potential benefits (such as lower initial monthly payments) in a clear and balanced way; and (3) provides clear, balanced, and timely information to consumers at crucial decision making points.

Beyond the interagency guidance, the agencies are working on providing additional direction on ways financial institutions can provide useful information about the benefits and risks of alternative mortgages. As you know, Regulation Z requires all lenders to provide the Consumer Handbook on Adjustable Rate Mortgages (CHARM brochure), which is published by the Federal Reserve Board and OTS. The OTS is collaborating with the Federal Reserve Board to update the CHARM brochure. The updated brochure will continue to inform consumers about ARMs, including issues such as negative amortization and payment shock but it will also provide additional information on specific types of alternative mortgages, such as payment option and interest-only ARMs designed to help consumers make informed choices.

The OTS is also working closely with all the federal bank regulatory agencies to develop a consumer publication focused on interest-only and option ARMs mortgages. This publication advises consumers on how these products work, the potential for large

payment increases, and the impact of negative amortization. Additionally, the publication provides consumers with a series of questions they can ask their lender to ensure that they clearly understand the product before agreeing to the mortgage.

VI. Conclusion

Alternative mortgage products have a long history in the thrift industry. Our examination staff is well trained to monitor the trend in alternative mortgage products, to identify and correct weaknesses in underwriting, and to prevent or end abusive lending practices. Historical experience with these products shows that they require a serious commitment to full and balanced disclosure, careful underwriting, and active risk management, including regularly and continually interacting with customers. Alternative mortgage products are a viable method to deliver credit to qualified borrowers. When used correctly, these loans boost home ownership and provide borrowers a method to manage cash flow during times of interest rate volatility. When provided to unqualified or uninformed borrowers, the results are the opposite. The risks of foreclosure, borrower loss, and financial institution loss increase exponentially.

The OTS fully supports efforts to finalize and publish interagency guidance on nontraditional mortgages and already supervises institutions to insure that they follow the sound principles and practices. The OTS is also dedicated to providing an updated CHARM booklet and guidance on consumer disclosures for alternative mortgage products. Additionally, OTS staff participate in several initiatives and programs to educate consumers about alternative mortgage products.

Given the highly competitive nature of the alternative mortgage market, consistent standards and principles applicable to all market participants will help level the playing field and reduce competitive distortions. Nonetheless, it is important to note that the potential risks of these products have in the past, and can in the future, be appropriately managed by well-run institutions. We do not want to stifle innovation, nor unjustifiably restrict the flow of credit, especially during the current housing market. To achieve those goals, the OTS is actively supervising its institutions for weakness in

underwriting and consumer disclosures. The OTS will also continue its efforts to promote awareness and understanding of alternative mortgages among consumers. Promptly addressing abuses and poor risk management practices will ensure a steady flow of credit to qualified borrowers in the future.

The OTS believes that the continued success of the alternative mortgage lending market relies on the realization and continuation of several key principles. Market participants should implement sound underwriting practices that include qualifying borrowers at the fully-indexed, fully-amortizing amount of the loan for option ARM loans. This will mitigate the potential for payment shock to the borrower as well as mitigate the use of alternative mortgage products as affordability products, ensuring borrowers have the ability and capacity to repay the loan at the outset.

In addition, there must be full, clear, and balanced disclosure of the benefits and risks of alternative mortgage products at the time the borrower is considering loan options and at settlement. Efforts to communicate with and educate the consumer concerning the features, benefits and risks are essential. Lenders should provide appropriate, ongoing, and conspicuous disclosure on monthly borrower statements indicating the effects of negative amortization. Lenders should also implement robust risk management practices and management information systems to monitor conditions and originations made through third parties.

For the OTS, responsible lending by financial institutions along with informed decision making by borrowers is the cornerstone of a robust mortgage market. We are fully committed to supervising the safety and soundness of U.S. housing financing while ensuring consumers receive clear and balanced disclosures that permit them to make informed decisions.