The Impact of Non-Traditional Mortgage products upon the financial services Marketplace

Good Morning, Governor Olson and members of this committee. I am George Reynolds, Senior Deputy Commissioner of the Georgia Department of Banking and Finance. The Georgia Department of Banking and Finance has responsibility for a variety of financial service providers including banks, bank holding companies, credit unions, international agencies, mortgage lenders and brokers and money service businesses. This broad range of statutory responsibilities has given us a unique perspective upon the impact of non-traditional mortgage products upon the financial services industry. Our Department has a long-standing tradition of taking a market based approach to innovations in the financial services industry. Although concerns have been expressed by many regulatory agencies regarding the potential impact of these products, let us first recognize that innovation in the mortgage industry, like innovation in other areas of the financial services industry has broadened the availability of financial services and has permitted individuals who previously may have been excluded from home ownership into this market. We believe that innovations that encourage participation by low income, minority and other underserved groups should not be discouraged, provided that safety and soundness and consumer disclosure issues are appropriately addressed.

Our definition of non-traditional mortgage products is similar to that of the federal agencies in the recently disseminated guidance on non-traditional mortgage products; primarily including interest only and payment option adjustable mortgage products.

The Increasing Proliferation of Non-Traditional Products

The Department has observed in our supervised institutions an increasing trend of the usage of non-traditional products over the past 18 months, but has observed differing trends in these product offerings. In depository financial institutions, these products remain rare with the exception of bank holding companies that have mortgage company subsidiaries. Some of our larger banks are engaged in offering such products but these products are primarily used for high net worth borrowers that are using these products to provide financial flexibility and do not reflect safety and soundness concerns. The Department of Banking and Finance recently proposed modifications in our loan regulations that would permit financial institutions to utilize interest only features on mortgage loans for a period not to exceed 10 years, after which the debt would need to be placed on an amortizing basis. The Department believes that banks that have used these programs have done so in an appropriate and creditworthy manner. While the Department notes the recent federal interagency guidance proposed regarding these products and strongly concurs with many of the points raised by the agencies in this guidance, we need to recognize that insured depository institutions have extended limited volumes of credit in this area and that much of this activity is occurring outside of insured depository financial institutions.

The Department has noted over this period a marked increase in the volume of non-traditional mortgage product on the other end of the credit spectrum; in loans that could be characterized as subprime, that is to say loans with FICO or BEACON scores of 650 or less. These are credits that are primarily originated at licensed mortgage lenders and brokers supervised by the States rather than at insured depository financial institutions. The Department distributed guidance on our website that expressed caution regarding the usage of non-traditional products by marginal or inappropriate borrowers. Individuals using these products as a vehicle to facilitate homeownership, particularly to qualify for loans that they could not otherwise qualify for based on their current income, could find themselves facing difficulty as these loans become seasoned. In the current market environment of rising interest rates (and the impact of inflation appears to provide for the continuation of this trend) borrowers are faced with the prospect of rising loan payments. The real concern is that as borrowers are faced with the prospect of the implementation of principal amortization, the timing of which can vary depending on the structure of these obligations, that marginal borrowers are going to be unable to service their increased monthly obligations, and that non-performing loans and even increased loan foreclosures are going to be the result. Recent articles highlighting the increasing volume of mortgage foreclosures in the State of Georgia may be supportive of such a trend.

The Potential Impact of Non-Traditional Mortgage Products on the Mortgage Market

The increased proliferation of these products in certain high growth markets could have an impact upon the market itself. These products have become pervasive in certain markets, such as California and other areas of the country where increases in market values have pushed a large portion of purchasers into this product, in order to qualify for mortgages with their current incomes. The Atlanta market reportedly has the highest level of interest only loans in the country, estimated recently at 50.4 % of mortgage loans issued for purchases of single-family homes. [1] There is some concern that in the event of a material contraction in the real estate markets, that homeowners with little or no equity in their residences, due to these mortgage products, might choose to walk away from their obligations, similar to what occurred in certain gulf coast markets in the 1980's. The impact on the residential real estate market of a substantial volume of such properties having to be liquidated could be profound. If a material number of such properties were to come into the market simultaneously, it could depress residential real estate prices, impact the market for construction of new properties and impact the inventory of properties available for sale.

The factors relating to the increase in Non-Traditional Mortgage Products

While the volume of nontraditional mortgage products has been increasing, there has been a similar increasing market trend in the volume of low documentation and stated income lending in the mortgage market. The Department has noted a higher correlation between loans that combine these features (subprime, nontraditional lending products with low doc or stated income features) and the probability or likelihood of mortgage

[1] May 18, 2005 Business Week

fraud. The State of Georgia is well acquainted with mortgage fraud, having been the State with the highest level of mortgage fraud in the country in previous years. We are pleased to note that as reflected in the Eighth annual Mortgage Fraud Report by the Mortgage Asset Research Institute (MARI) that Georgia dropped from number 1 in the volume of mortgage fraud overall to number 3 in 2005. This impact appears to be due to a combination of factors including the passage of a mortgage fraud act in Georgia, increased criminal prosecutions and sustained efforts by the Department of Banking and Finance to remove bad players from the mortgage industry. The volume of subprime mortgage fraud has decreased in this State in even a more dramatic fashion, with Georgia dropping from the number 1 position in 2003, to number 5 in 2005. While mortgage fraud prevention and detection remain a strategic priority for our Department, (and we are not satisfied with our current position and will continue to work to decrease the occurrence of fraud), these improvements have occurred in a national marketplace where mortgage fraud is growing rapidly, with mortgage fraud SAR filings increasing from 9,539 in 2003 to 23,018 in 2005. We believe the trend towards non-traditional mortgage products, like the proliferation of low documentation and stated income lending, are practices which tend to facilitate mortgage fraud, since these loans have substantially lower payments early in the life of these loans and therefore may be easier to use a vehicle to facilitate mortgage fraud. It is important to utilize more robust verification and underwriting procedures on credits that utilize such features. The Department has increased expectations regarding the due diligence that lenders need to perform on loans purchased from mortgage brokers, including requiring greater underwriting testing on such loans, placing appropriate limitations on the use of stated income loans, and encourage the use of expanded internal controls and best practices regarding fraud prevention and detection. Some of these expectations have been in the form of enforcement actions which have been used in institutions which have not addressed deficiencies in mortgage loan underwriting and controls. The Department has referenced a report prepared by the Federal Financial Institutions Examination Council entitled The Detection, Investigation and Deterrence of Mortgage Fraud involving third parties: A White Paper as a recommended source of best practices related to preventing and detecting mortgage fraud.

The impact of Non-Traditional Mortgage Products on the Investment Market

One of the questions that obviously comes to mind when looking at this increasing market for nontraditional mortgage products is where is the secondary market for these products after origination? The Department has reviewed the portfolios of our banks and credit unions, and we have seen no indication to date of these institutions purchasing mortgage backed investments that include interest only or payment option products. These products are not commonly purchased by Fannie Mae or Freddie Mac, and the majority of financial institutions purchase mortgage backed securities from these GSE sources. It would appear that the secondary market for these products would include other financial service providers and entities, including a substantial volume of investors located outside of the United States. I believe that portfolios that contain subprime, interest only and option adjustable mortgage investments would create undue risk in the portfolio of an insured depository financial institution and the Department will continue to monitor investment activity in this area.

Recommendations regarding Non-Traditional Mortgage Products

The Conference of State Bank Supervisors drafted a comment letter to the Federal agencies in response to the proposed Interagency Guidance on Nontraditional Mortgage Products (Guidance). This comment letter notes the diversity in the businesses engaged in mortgage lending and the need to recognize the various business models, loan products and qualification standards for these various entities

We recognize as state regulators the need for full and timely disclosures to borrowers to provide information on the risks and suitability of these products. It is noted that the current methodologies for disclosures are inadequate to provide consumers with timely and meaningful information that fully describe the optionality of these products and the impact that increases in market interest rates and future principal payments could have on the consumer.

It is suggested that disclosures need to be moved forward in the decision making process that they be more specifically tailored to loan product being offered and that they involve modeling that is standardized between institutions so that consumers can validly compare product offerings. Since a substantial volume of mortgage lending origination involves nondepository institutions that are not subject to the federal agency Guidance, the States, as the primary regulators of these mortgage lenders, have a substantial role to play in encouraging these lenders to follow best practices regarding disclosures on these products and may also have a supervisory role to play if material changes are noted between these disclosures and the actual finalized loan terms. Disclosures should be sufficiently detailed to permit consumers redress if there are variances between disclosures and the final loan offerings at the closing table.

There are certainly questions as to whether the current approach regarding Truth and Lending disclosures can be tailored to fit the unique features and the complexities of these non-traditional mortgage products and provide meaningful disclosures to consumers. It is important to focus on a reasonable number of meaningful consumer disclosures to prevent consumers from becoming confused and to reduce the possibility of information overload.

I would strongly echo the recent comments of the Chairman of the Federal Reserve Bernanke regarding the need for enhanced and improved financial literacy and education to better prepare consumers to deal with the complexities of the financial service marketplace, optimize their credit ratings and credit standing and shop effectively for mortgage and other financial service offerings in the marketplace.

Finally, it is vitally important that market discipline in the secondary market provide certain underwriting and suitability standards for purchase of these products in the secondary market. While many trends in the marketplace such as low documentation loans, stated income loans and option adjustable and interest only features seem to run counter to the idea of increasing market discipline, eventually heightened underwriting and verification procedures by the secondary market could mitigate some of the risk concerns noted above. It may require some sustained and increased loss levels in the secondary market to affect such market discipline in the marketplace.

Care should be exercised to permit continued innovation and product development in the financial services marketplace. Rules, regulations and policies that could stifle innovation and impede the availability of credit to subprime borrowers or limit the availability of homeownership in high cost real estate markets should be avoided by federal and state regulators. It is our opinion that regulatory efforts should be focused on better educating the public on the potential risks involved with these non-traditional products and ensuring that appropriate underwriting and disclosure standards are applied by all participants in the financial services industry that offer these products.