Testimony of

Bradley E. Rock

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

And

AMERICA'S COMMUNITY BANKERS

Before the

Committee on Financial Services

United States House of Representatives

October 24, 2007

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Chairman, President, and CEO, Bank of Smithtown, Smithtown, New York
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Mr. Chairman and members of the Committee, my name is Bradley Rock. I am Chairman, President, and CEO of Bank of Smithtown, a $1.1 billion community bank located in Smithtown, New York, founded in 1910. I am also the Chairman of the American Bankers Association (ABA). The American Bankers Association, which represents community, regional and money center banks and holding companies, as well as savings associations, savings banks and trust companies, is the nation's largest banking trade association.

Upon completion of its merger with America's Community Bankers at the end of November, ABA will represent 95 percent of the industry's $11.5 trillion in assets, and it will speak for the vast majority of the industry's 2 million employees. At the same time, 83 percent of the new ABA's members will be community banks with less than $500 million in assets.

I am glad to be here today to present the views of the ABA and ACB on possible legislative initiatives to improve mortgage lending standards, particularly as they relate to subprime mortgages. There is no question that our country is going through a very difficult time as many homeowners struggle to meet their monthly mortgage payments. With falling home values throughout the country and a large volume of subprime adjustable rate mortgages with "teaser rates" being repriced to much higher rates, the situation is likely to get worse before it gets better.

Many forces combined to create the problems we face today. After the dot-com bust, money flowed into real estate, helping to fuel a boom in home prices. As home prices rose, non-traditional mortgage products became quite popular as an avenue for real estate investment and homeownership. In many cases, individuals were purchasing homes with the intent of "flipping" them – investing money into upgrades and then hoping to quickly sell at a significant profit. Others purchased houses as mere investment properties with the intent of renting them out to others and then selling once the property had appreciated. In other cases, loans were being made to first-time homebuyers who may not have fully appreciated or understood the terms of their loan agreement. Still others were simply cashing-out their equity by re-financing. With the frenzy that ensued, sound underwriting practices were often sacrificed – primarily by non-bank originators – for immediate gains.

The fallout of the mortgage markets has been very troubling to the banking industry – an industry filled with institutions that have existed for decades, and in the case of my bank, for nearly 100 years. It has been the actions of loosely-regulated non-bank lenders, and their fly-by-night operations, that have caused a lot of damage for consumers and for the industry. Many of these firms have already gone out of business, while others have begun restructuring their businesses. As bankers we intend to be in our communities for the next 100 years and beyond. Therefore, we know that we must be part of the solution, and we are very pleased to work with you, Mr. Chairman, and with the members of this Committee, on finding ways to bring mortgage lending practices back into balance.

While the Committee is considering legislative approaches, the banking industry has already initiated efforts to help. I know many community banks are stepping up their mortgage lending. In addition, the ABA and ACB, along with other trade groups, servicers, not-for-profit counseling agencies and investors, have formed the HOPE NOW Alliance which is dedicated to help keep Americans in their homes. The various members of the Alliance have agreed to adopt particular measures to improve process efficiency, create a sustainable funding model for quality phone and face-to-face counseling, develop standardized metrics to evaluating effectiveness, and work collectively with other HOPE NOW partners to overcome challenges that may arise. Several working groups within the Alliance are undertaking tasks designed to achieve these goals and will be meeting regularly in the months ahead to report on their progress. The Alliance encourages other industry participants to join this effort and the federal government has helped convene participants and facilitated ways to reach as many homeowners as possible and avoid unnecessary foreclosures.

Individual institutions have also taken significant steps designed to prevent the current problems from recurring in the future. For example, Washington Mutual recently unveiled a new disclosure standard that all mortgage brokers with whom it does business must follow. The standard is specifically designed to ensure that borrowers fully understand the terms of their loan agreement. It requires mortgage brokers to certify that they have disclosed to borrowers early in the application process key terms such as the loan amount, the loan term, whether the interest rate and mortgage payments may change, and whether a prepayment fee may apply.

A guiding principle for all of us should be the steadfast adherence to high ethical standards. Whether you are a banker, mortgage broker, mortgage banker, realtor, appraiser, developer, investor, or anyone involved in real estate and homeownership, high ethical standards should be the norm, not the exception. The damage caused by deceptive or unscrupulous sales practices extends beyond the consumer who is directly targeted to mortgage markets and the economy in general. As a bank, we are subjected to, and examined regularly for, compliance with a range of laws and regulations. I hold all my employees to high standards and the regulators make certain of it.

In addition to the overarching principle of maintaining high ethical standards, I would like to discuss several additional principles that the ABA and ACB believe should guide any legislative approach:

- Sound underwriting principles based on the borrower's ability to repay are needed in every mortgage loan. This will assure a vibrant market for ***any*** loan whether it be to prime borrowers or to near-prime and subprime borrowers.

- Consistent standards are needed, particularly to bring non-bank mortgage originators up to the standards applied to bank originators.

- Legislation should create as little disruption as possible for the marketplace. Extreme care needs to be taken not to saddle banks – which generally had nothing to do with the current problems – with more burdens which inevitably impede ***all*** types of lending. Moreover, access to credit at the lowest possible cost relies upon an effective and efficient secondary market for mortgages.

Mr. Chairman, while we are still in the process of evaluating the Mortgage Reform and Anti-Predatory Lending Act bill sponsored by you, Mr. Miller, Mr. Watt, and other members of your Committee, we recognize that it provides an essential starting point from which all interested parties can work. We appreciate the fact that we have been consulted on aspects of this legislative proposal. We will be having lengthy discussions with our member banks about your proposal and can provide you with additional feedback on specific components of this important legislation. Thus, what I hope to accomplish in my written statement is to lay out key principles that should be incorporated into any legislation. We pledge to work with you, Mr. Chairman, and this Committee to enhance the workings of the mortgage lending system. The efforts I described above indicate how serious the banking industry takes the current problems in the mortgage market and they demonstrate how dedicated we are to finding workable solutions.

Let me turn to the principles that I've outlined above.

I. Sound Underwriting Principles Based on the Borrower's Ability to Repay are Needed in Every Mortgage Loan

Any legislation aimed at addressing the recent problems experienced in the mortgage market should focus first and foremost on sound underwriting standards. Mortgage lenders rely on a variety of borrower characteristics when determining whether or not to submit a loan for underwriting approval. However, primary emphasis should be given to the most important characteristic – ***the borrower's ability to repay the loan.*** Mr. Chairman, we agree with you that creditors should be required to make a reasonable determination, at the time a mortgage loan is made, that the borrower does in fact have the capacity to pay back the loan.

The ability to repay standard has consistently served banks well, and the federal banking agencies have taken steps to ensure that banks employ this standard as part of sound underwriting. They first issued guidance on subprime lending in 1999 and expanded it in 2001 to emphasize that lending standards should include well-defined underwriting parameters, such as acceptable loan-to-value and debt-to-income ratios and minimum acceptable credit scores. Mr. Chairman, these are principles your legislation would apply to all originators.

In recent years, innovation in the mortgage industry allowed for the creation of new products, making it possible for previously underserved borrowers to get loans. The banking regulators recognized that the evolving marketplace required additional regulatory direction and they produced additional guidances in 2005, 2006, and 2007. Each of them focuses on underwriting standards rather than mortgage products themselves. Banning products only stymies innovation. Strong underwriting allows banks to offer products to a diverse range of customers while ensuring that those customers get products that meet their particular financial needs and situation.

Thus, it is critical to distinguish between a bad product and bad use of a good product. Reform should not focus on eliminating particular mortgage products but rather on ensuring that all mortgage products abide by the simple, but highly effective, ability-to-pay standard. The legislation introduced presents concepts such as presenting consumers with a "range of mortgage loan products 'appropriate' to the consumer's existing circumstances." Such broad concepts are subjective and will lead to much litigation, likely driving up cost to both lenders and consumers. Imposing a duty of care requirement is reasonable, but it must be based on objective standards centered on the ability to pay.

We must be careful not to stymie innovation, but rather to stop the unfettered experimentation by non-bank originators. Of course, regulatory guidance only applies to insured depository institutions, which leads me to our second principle relating to consistent standards.

II. Consistent Standards are Needed, Particularly to Bring Non-Bank Mortgage Originators Up to the Standards Applied to Bank Originators

Banks have long been subject to the Truth in Lending Act and the Home Owner's Equity Protection Act (HOEPA) amendments thereto, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Fair Lending Act, among other consumer protection laws. These laws require numerous disclosures relating to mortgage loans generally, and especially so-called high-cost loans, as well as restrictions on fees and other terms for high-cost loans. Additionally, continually updated regulatory guidance is enforced by the banking agencies, including those recently promulgated on nontraditional mortgages and subprime mortgage lending.

Independent mortgage brokers are not subject to the breadth of consumer protection laws and regulations with which banks must comply and, importantly, a regulatory system does not exist to examine them for compliance even with those laws, such as the Real Estate Settlement Procedures Act (RESPA), which do apply to them. In addition, because of the nature of their jobs, independent brokers may not have the same level of interest in the quality of the loan they process. Once the loan closes and the independent broker is paid, he or she has no further financial interest in, or responsibility for, the loan or obligation to the borrower, although most want to preserve their reputation for long-term relationships.

Mr. Chairman, your legislation seeks to address these inconsistencies in part by requiring all mortgage originators to be licensed and registered, and by imposing a net worth or bonding requirement. While we understand the principle here, we are very concerned about the level of regulatory burden that licensing and registration will add to banks, which already meet high ethical, regulatory and examination standards. We are also concerned that without supervision of non-bank originators, registration and licensing will not be effective – and may, in fact, give customers the impression that there is an appropriate level of oversight when there is not. In addition, the bonding requirement for non-bank brokers is insufficient to back the volume of lending undertaken.

We believe that independent mortgage brokers play an important role in the mortgage lending industry. However, it is essential that all brokers be honest, trustworthy, and reliable. We must ensure that consumers receive credit on fair and equitable terms. It is vital that they be served by legitimate lenders with appropriate levels of regulation.

We agree, Mr. Chairman, with your assessment in your *Boston Globe* article:

> Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis. At every step in the process, from loan origination through the use of exotic unsuitable mortgages to the sale of securities backed by those mortgages, the largely unregulated uninsured firms have created problems, while the regulated and FDIC-insured banks and savings institutions have not. To the extent that the system did work, it is because of prudential regulation and oversight.[1]

It is important to bring other originators up to the same level of scrutiny as already exist in the banking industry.

III. Legislation Should Not Disrupt the Marketplace

With any legislation, the potential for unintended consequences exists, and I want to express some of our concerns. First, legislation should be carefully crafted so as not to disrupt the vibrancy of the prime market. The current problems in the mortgage market have largely been confined to the subprime market and the prime market has been affected to a much lesser extent. Moreover, prime mortgage loans comprise the vast majority of the total mortgage market. In fact, a recent survey by the Mortgage Bankers Association indicates that roughly 77 percent of all mortgages currently outstanding are prime.[2] Efforts to ensure sound underwriting standards must take care not to impose additional

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

[2] National Delinquency Survey from the Mortgage Bankers Association, Q2-07. (Data as of June 30, 2007)

paperwork or other costly burdens that would reduce the amount of credit generally, and particularly to the prime mortgage market and where lenders are adequately regulated.

It will be equally important to ensure that a market is maintained for qualified subprime borrowers as well. The development of the subprime market has been of great assistance to many previously underserved populations, and subprime lending is a vital source of credit to many individuals who would not have access to loans without it. Much of the lending that we do in our communities is not to those businesses or individuals with the highest credit scores. Rather, there are many subprime borrowers that are just as deserving of loans and who should not be denied the opportunity to own a home simply because they do not qualify for a prime loan.

Second, while we understand your intention to address the role of securitizers in the mortgage process, Mr. Chairman, care must be taken to avoid disruption of this key channel of mortgage finance. The fact is that the secondary market plays a critical role in allowing broad access to mortgage financing to the widest number of people at the lowest possible interest rates. It is imperative that this market continue to be active and vibrant.

Third, I would be remiss if I did not mention a concern that I have heard from many bankers about the additional paperwork burden that may result from additional legislation. It is no surprise to this Committee that banks are struggling under the weight of increasing levels of regulatory burdens, many of which do not serve the objective of making the nation's banks operate more soundly or to provide meaningful protections to consumers. These burdens have a particularly deleterious effect on community banks like mine. They raise costs and place unnecessary strain upon our ability to serve our customers.

It is critical to recognize, Mr. Chairman, that banks, particularly community banks, are already strained to the breaking point under the weight of thousands of pages of regulation, guidance, and other mandates. In fact, the very future of community banks is threatened by high regulatory costs. As these costs increase, more and more community banks are being driven out of business by government and forced to sell.

It would be unfair to saddle these institutions – which generally had nothing to do with the current problems – with more burdens. Imagine the reaction of a community bank, which never made any of the types of loans that caused the problem, to new regulatory burdens. In fact, many banks tried to warn local consumers against "toxic" types of loans and had to watch as those consumers took on obligations they did not understand and apparently could not resist. Should that bank now have to go through the burden of having individuals in that bank licensed and subject to standards in the same way as freestanding mortgage brokers? Note that many bank employees are likely to have other responsibilities within their organization and make only a limited number of mortgage loans. We hope to work with you to minimize whatever burdens may result from enactment of this legislation.

Fourth, the legislation imposes a new nationwide requirement that existing leases be honored by a creditor in the event of foreclosure. Lenders work hard to minimize the impact on renters in the unfortunate incident of a foreclosure. This can be a complicated process as it involves state and local law. We are concerned about adding a new federal requirement and the impact that such a requirement will have on a creditor's ability to return a foreclosed property to the marketplace. This provision may in fact slow that process leading to further instability for those properties and the neighborhood.

Conclusion

Mr. Chairman, we appreciate the efforts that you and the other members of this committee have undertaken to find long-term solutions to the problems in the mortgage markets. The ABA and ACB – and all our member banks – want to be part of the solution and we stand ready to work with this committee to effect positive change.