

TESTIMONY OF

STEVEN L. ANTONAKES
MASSACHUSETTS COMMISSIONER OF BANKS

On

“The Home Ownership and Equity Protection Act of 1994”

Before the

FEDERAL RESERVE BOARD

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Introduction

Good afternoon Governor Kroszner and Director Braunstein. My name is Steven L. Antonakes and I serve as the Commissioner of Banks for the Commonwealth of Massachusetts. My office supervises nearly 260 state-chartered banks and credit unions with total combined assets in excess of \$225 billion and over 5,000 non-bank licensees, including over 2,000 licensed mortgage lenders and brokers. I am also chairman of the State Liaison Committee (SLC), making me the newest voting member of the Federal Financial Institutions Examination Council (FFIEC) and the Treasurer of the Conference of State Bank Supervisors. It is my pleasure to appear before you today.

My goal today is to provide you with my perspective as a state regulator on the subprime mortgage market and increasing number of foreclosures occurring in Massachusetts and across the country. I plan to discuss recent changes in the mortgage market; specific actions we have taken in Massachusetts to address these matters; efforts being coordinated by state mortgage regulators throughout the country to further improve mortgage supervision; and actions I believe the Federal Reserve could take under existing authority to further enhance consumer protection.

Recent Changes in the Mortgage Market

Along with the first significant slow down in the real estate market in many years and rising interest rates, we have seen a significant increase in foreclosures. However, unlike previous periods in which foreclosures rates have risen, the current spike nationally and in Massachusetts does not appear to be as closely linked to traditional causes such as job loss, health issues, or divorce.

Instead, the most recent rise in foreclosures appears to be largely rate driven. This is partially the result of consumers overextending themselves during the recent period of significant home value escalation. Current foreclosures are also the result of the seasoning of a growing number of subprime adjustable rate mortgage loans. Some or many of these loans also included interest only provisions or were written with reduced or limited documentation.

Improvements in technology and delivery systems, automated underwriting, increased competition, securitization, the development of the subprime market, and an explosion in product types has also resulted in greater availability of mortgage credit than ever before. This has led to significant increases in homeownership rates throughout the United States. These changes, however, have also had unintended consequences, including greater opportunities for unscrupulous companies to engage in unfair and deceptive practices.

Specifically, the evolution of the subprime market and the securitization of subprime loans, especially those with increased risk layering, helped create an environment of negligence in lending practices and increased borrower confusion. As the market began to turn, underwriting seemingly further weakened in a vain effort to maintain origination volume.

Some industry observers have referred to the current situation as a “broker problem”. Certainly, the sales and marketing practices of certain mortgage brokers need to be addressed. However, a mortgage broker is only as good as his or her ability to obtain funding for a loan. Moreover, the majority of loans now originated by mortgage brokers and lenders at the local level are in fact financed by Wall Street firms that operate at a global level. It is the dispersion of risk of a mortgage loan default that begins with a mortgage broker and ultimately ends with a Wall Street investor which created incentives for some actors to engage in weak underwriting and outright fraud. Finally, the problem should not be oversimplified. The unfortunate reality is

that others outside the direct lending process also contributed to these practices, including real estate brokers, appraisers, and closing attorneys.

Given recent headlines, some may forget that responsible subprime lending can prove to be very beneficial to consumers as they try to access the capital necessary to purchase a home. Moreover, an expanded variety of products and loan options increases the likelihood that a consumer will obtain a loan that best fits their unique financial situation.

Unfortunately, the pace of product innovation has exceeded the pace of consumer education and understanding. Existing disclosure requirements, however, seem geared more toward protecting lender liability than providing clarity for consumers. While market pressures will seemingly help resolve many of the unsavory business practices we have witnessed, significant regulatory and legislative changes are likely to follow as well. The significant challenge ahead will be to improve consumer protections and control procedures without significantly impacting credit availability in the subprime market or further burdening consumers beyond comprehension of the transaction before them.

Supervision of the Mortgage Industry and Massachusetts Efforts to Combat Foreclosures

My office licenses over 2,000 non-bank mortgage lenders and brokers. Last year, we conducted over 400 examinations of these entities. Examinations include a review of overall financial safety and soundness and compliance with Massachusetts and federal consumer protection laws and regulations. As a result of our examination and other supervisory efforts, my office issued over 100 enforcement actions last year against licensed mortgage lenders and brokers.

In addition to our normal examination activities, last year the Division launched over 90 surprise visitations of mortgage brokers predominantly serving low and moderate-income communities to focus upon stated income loans and any evidence that borrowers' incomes were inflated or that borrowers were purposely steered into loans they could not afford. As a result of these reviews, my office issued a number of cease and desist orders essentially shuttering companies found to be intentionally overstating income on reduced documentation loans or engaging in other types of deceptive practices. Some of the most egregious cases featured altered W-2s and pay stubs and outright admissions that income was purposely inflated or included income from individuals not listed on the mortgage application.

In September 2006, we issued an industry letter to all licensed mortgage lenders and brokers and all state-chartered banks and credit unions relative to reduced documentation loans stating that severe action will be taken should evidence of mortgage fraud be found. We also implemented emergency amendments to our regulations governing mortgage lenders and brokers. These regulations significantly expanded the types of prohibited acts and practices that constitute grounds for the issuance of cease and desist orders and license suspension or revocation.

In an effort to develop a comprehensive strategy to address increasing foreclosure rates, my office hosted a Mortgage Summit in November 2006 attended by nearly 50 individuals representing 29 government, industry, and nonprofit organizations. The stated goal of the Summit was to seek to address the increasing number of mortgage foreclosures across Massachusetts and to develop a statewide foreclosure prevention strategy that will put into place lasting measures to help consumers confronted with the loss of their homes.

Following the Summit, we established two Mortgage Summit Working Groups with one to focus on “Rules and Enforcement” and the other to focus on “Consumer Education and Foreclosure Assistance”. Each Working Group met every two weeks for three months before issuing their recommendations in April.

Massachusetts Governor Deval Patrick has taken steps to effect both short term and long term goals to improve supervision over the mortgage industry and protect homeowners. First, he directed my office to seek, on a case-by-case basis, delays in the foreclosure process from mortgage lenders and servicers for any Massachusetts homeowner who files a complaint with our office. The goal is to provide a short amount of time to allow my office to review complaints, refer homeowners to reputable homeownership counseling firms, and encourage mortgage lenders to utilize this time to work with homeowners who are unable to make their mortgage payments. While solutions may not be feasible in all circumstances, we are asking mortgage lenders to consider prudent workout solutions, including modifying loan terms and seeking to move borrowers from adjustable rate mortgages into fixed rate loans. To date, the Division has fielded calls from over 400 Massachusetts residents either in foreclosure or experiencing difficulty managing their mortgage obligations.

In addition, the Governor has also directed my office to immediately begin implementing the recommendations of the Mortgage Summit Working Groups. These recommendations include actions the Division can take under existing rulemaking authority; recommendations that will require legislation to be passed; and matters that will require the continued collaboration between government, non profit organizations, and industry.

Changes in regulations will result in increased net worth and bonding requirements for licensed mortgage lenders and brokers; increased licensing and examination fees for mortgage

lenders and brokers to support additional examiner hires and the staffing of a mortgage fraud unit; and increased experience requirements for licensed mortgage lenders and brokers.

Numerous bills have already been introduced in the Massachusetts Legislature relative to residential mortgage lending and the foreclosure process. The Patrick Administration supports and has testified in favor of bills to license mortgage loan originators and extend provisions of the Massachusetts Community Reinvestment Act to certain licensed mortgage lenders.

Last Friday, Governor Patrick filed legislation entitled, “An Act Implementing the Division of Banks Mortgage Summit Recommendations”. Specifically, the bill includes provisions to criminalize mortgage fraud; prohibit abusive foreclosure rescue schemes; amend existing state law to require a notice of intent to foreclose and a right to cure; prohibit a lender from making an adjustable rate subprime loan unless a consumer affirmatively opts-out of a fixed rate product and presents a certificate indicating that they have received homebuyer counseling; and establish a central repository of foreclosure information at the Division of Banks to enable my office to track foreclosure data by product, geographic region, and originator, broker, and lender.

Finally, many of the recommendations of the Mortgage Summit Working Groups will be implemented by building on existing partnerships, including reviewing and identifying false and misleading advertising practices; reviewing sales practices of real estate brokers and salespersons; improving the existing process of mortgage disclosure and pre and post closing consumer education; and creating a web site on financial education.

Coordinated State Action on a Nationwide Basis

In recent years, state mortgage regulators have been working collaboratively to improve supervision of the residential mortgage industry. In addition to the extensive regulatory and legislative efforts, state regulators and state attorneys general have aggressively pursued unfair and deceptive practices in the mortgage market. Through several landmark nationwide settlements, state regulators have returned nearly one billion dollars to consumers. Building off of this experience, state mortgage regulators are working to further coordinate the ongoing supervision, examination, and enforcement of mortgage lenders and brokers licensed in multiple jurisdictions.

CSBS Nationwide Mortgage Licensing System

For over three years, state mortgage regulators have dedicated significant resources to the development of a nationwide database of mortgage professionals. The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) have contracted with the National Association of Securities Dealers to develop this system. Its implementation will provide a uniform application process for mortgage lenders and brokers operating across state lines, as well as a central repository of information about licensing and enforcement actions. I believe the database is essential to improve the existing regulatory framework and reduce fraud. I serve on the governing board of the database system and we are meeting weekly to ensure the system is operational by January 1, 2008. To date, 33 states have already committed to joining the system by 2009.

Nontraditional Mortgage Guidance and Proposed Subprime Statement

In Massachusetts, I have raised concerns relative to the increased marketing and availability of nontraditional mortgage loans since 2005. My office, in collaboration, with

banking, credit union, and mortgage trade organizations released our consumer brochure outlining the pros and cons of interest only loans and option ARMs in February 2006.

While I do not believe these products are inappropriate in all circumstances, I believe we can all agree that these products at one time had a very specific and limited utility, such as a wealth management tool. More recently, interest only loans and option ARMs have been more often used as a means of allowing consumers the opportunity to purchase a home that they would not otherwise. This is extremely troubling. Moreover, in my mind, there are very few instances in which a reduced documentation loan and its corresponding higher pricing structure is appropriate for first time homebuyers or those who marginally qualify for credit.

Guidance finalized last year by federal bank and credit union regulators on nontraditional mortgage loans also provides sound information to banks and credit unions relative to the credit risk and consumer protection issues that may arise when originating these types of loans.

Specifically, the guidance cautions lenders not to simply qualify borrowers based upon their ability to repay loans while introductory or interest only payments are required. Instead, the guidance notes that lenders should evaluate a borrower's ability to repay the loan at the fully indexed rate on a fully amortizing schedule as part of their overall underwriting decision.

The guidance also notes the need for enhanced communication with consumers to ensure borrowers comprehend the potential risks and benefits associated with interest only loans and option ARMs.

A significant weakness of the federal guidance is that it only applies to state and federally chartered banks and credit unions. However, in an effort to ensure a level playing field is maintained within the mortgage market and that the consumer protections within the guidance are enforced uniformly, state mortgage regulators through CSBS and AARMR developed

parallel guidance on nontraditional mortgage product risks applicable to non-bank mortgage lenders and brokers. Massachusetts was one of the first states to adopt the guidance. As of today, over 40 jurisdictions have either formally adopted the guidance or are finalizing the process to do so. Ultimately, we expect all 50 states to adopt the guidance in some form.

State regulators through CSBS and AARMR have also offered a strong endorsement of the currently pending proposed interagency Statement on Subprime Mortgage Lending. Once finalized, states are poised to adopt a parallel statement for non-bank mortgage lenders and brokers. I hope the statement will be finalized shortly. Again, we expect all 50 states to similarly adopt the statement on subprime lending.

Recommended Federal Reserve Board Amendments to Curb Abusive Lending

Based upon our experience, I would strongly urge the Board to use its rulemaking authority granted under section 129(1)(2) of HOEPA to address unfair, deceptive, and abusive lending practices.

Prepayment Penalties. The Board should limit prepayment penalty provisions under its authority to prohibit unfair and deceptive practices. For example, many consumers are facing a substantial payment shock associated with so-called subprime hybrid ARMs. Although many of these consumers can qualify for a refinancing into a fixed rate or adjustable rate loan at a lower rate, these consumers are often trapped into paying the substantially increased monthly payments due to a prepayment penalty that extends beyond the adjustment period. Therefore, prepayment penalties should expire at least 30 days prior to the first adjustment period for subprime adjustable rate mortgage loans.

Moreover, in Massachusetts, the definition of points and fees for High Cost Home Loans includes the maximum prepayment penalty that may be incurred under the terms of the loan as well as the prepayment penalty incurred by the borrower to refinance a loan made or held by the same creditor. Including prepayment penalty amounts in the definition of points and fees provides greater protection to consumers. Therefore, I also recommend that the Board amend its definition of points and fees at 12 CFR 226.32 for all High Cost Home Loans by adopting language similar to the Massachusetts High Cost Home Loan regulations at 209 CMR 32.32(2)(a)1.

Finally, the Board should use its broad authority under HOEPA to ensure that all creditors abide by prepayment penalty limitations applicable to them, whether federal or state laws. In Massachusetts, both the Division and the Office of the Attorney General deem any violation of a consumer protection law, including federal law, to be a violation of the Commonwealth's Unfair and Deceptive Acts and Practices Act (G.L. c. 93A). Similarly, the Board should consider any violation of a federal or state consumer protection law applicable to the conduct of the creditor to be an unfair or deceptive act or practice. With regard to prepayment penalty provisions, I would encourage the Board to adopt the following language:

It is an unfair practice to make a mortgage with a prepayment penalty provision that violates any federal or state law limiting prepayment penalties.

States have traditionally been the forces of innovation in the area of consumer protection. In addition, as with the case of predatory lending and other laws, states have reacted quicker to market conditions than either Congress or federal regulators. By specifically deferring to state consumer protection and lending requirements such as prepayment penalties, the Board can grant greater flexibility and responsiveness to its unfair and deceptive acts and practices regulations.

Escrow for taxes and insurance. Some subprime lenders have marketed their products by stating low monthly payments that do not include taxes and insurance. While it is common for most prime lenders to escrow for such payments, most subprime lenders do not escrow for taxes and insurance. The Board should require escrows for taxes and insurance for all subprime mortgage loans with the ability of the borrower to affirmatively opt-out. If the Board elects not to require escrows for such loans, I would recommend that lenders be required to inform the consumer of the absence of the escrow and the estimated tax and insurance payment obligations. Requiring escrows for subprime loans will not negatively affect consumers or the types of credit available. In fact, tax and insurance escrows reduce the risk to the lenders and assignees since the risk to the lien status is lowered.

“Stated income” or “low-doc” loans. As noted above, stated income loans have existed for many years as a niche product targeted to the self-employed. However, in recent years, stated income loans, and reduced documentation loans generally, have grown significantly and have been marketed heavily to subprime borrowers. Stated income loans usually carry a higher rate for the borrower. In the vast majority of applications, there should be no reason why income can not be verified. Accordingly, I believe stated income loans are inappropriate for many borrowers.

The Board should consider adopting a rule whereby consumers qualifying for subprime credit would normally receive a thirty-year fixed rate, fully amortizing, full documentation loan. An affirmative opt-out and completion of independent counseling would be required for a subprime borrower to apply for a subprime loan which either features an adjustable rate, negative amortization, or less than full documentation of income. If the Board decides not to limit stated income loans to subprime borrowers, I would encourage the Board to require the lender to

inform consumers that they are being offered a stated income product and they may qualify for a lower rate if they can document their income.

Unaffordable loans. As stated above, my office strongly supports the nontraditional mortgage guidance issued last fall and issued parallel guidance in January applicable to all licensed mortgage lenders and brokers. This guidance was drafted in cooperation with CSBS and AARMR to tailor the federal guidance to non-depository institutions. We also support the proposed statement on subprime mortgages. Both of these address concerns relative to underwriting a loan based on a low introductory or “teaser” rate or on a non-fully amortizing payment schedule. These underwriting practices result in initial low monthly payments for a borrower which they may be able to afford, but which later result in substantial payment shock when the interest rate resets or when the interest-only period ends. I would recommend that the Board require lenders to underwrite all subprime and nontraditional mortgage products based on the fully indexed rate or on a fully amortizing payment schedule.

Conclusion

In closing, my comments have delineated to you the actions the Commonwealth of Massachusetts has taken or is in the process of taking to address changes in the mortgage market and increasing foreclosures. I have also outlined the specific actions taken or in process by state mortgage regulators on a multi-state if not nationwide basis. Finally, I have identified areas where I believe the Federal Reserve Board can act under existing authority. I firmly believe those suggested actions are both doable and would enhance the protections for all consumers. I encourage your sincere consideration of the actions being taken by individual states and the states as a whole as well as those proposals within your current jurisdiction.

Thank you for your invitation to testify.