**Panel 1: <u>Outlook for the U.S. Housing Market and Potential Impact on Banks and Thrifts</u>**

Has the housing market bottomed out or is there more to come? Representatives from the FDIC, the Financial Services Roundtable, private sector, and the National Association of Home Builders discussed home pricing dynamics in the U.S. and expressed different views on where the market is going. Participants agreed that the housing market is vulnerable to further deterioration, but views differed as to whether we are approaching stability in the market. Some saw the boom as bottoming out, while others stated that the market will continue to deteriorate and thought the bottom may still be months, if not years, down the road.

***See OTS National Housing Forum Transcript pages 9-29***

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**Keynote Speaker: The Honorable Henry M. Paulson, Jr.**
**Secretary of the Treasury**

Treasury Secretary Paulson discussed the importance of home ownership as a goal of uniting Americans across racial, ethnic and income lines. He noted that that minority home ownership rates have increased in recent years, as overall home ownership levels have reached new heights. Secretary Paulson observed that the OTS National Housing Forum is a way to help to formulate a forward-looking strategy for a vital part of the American economy. He discussed the importance of getting the right guidance in place to help people across America access home financing without taking unnecessary risks. The Treasury Secretary also discussed the importance of expanding opportunities for more Americans to buy homes, while ensuring that people do not become overextended and see their dream end in foreclosure.

***See OTS National Housing Forum Transcript pages 30-33***

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**Panel 2: <u>Challenges & Emerging Risks in the Home Mortgage Business</u>**

Numerous challenges and risks lie ahead in the mortgage markets, according to a second panel of experts. A bank regulator expressed concern about the quality of institutional stress testing, customer disclosures, promotional materials, the dangers of risk layering, and the problems that are attributable to unregulated or unsupervised mortgage originators. A banker expressed concern about new mortgage products that have made it difficult for investors accurately to quantify the value and risk of opportunities available to them. Also discussed was the challenge of increasing access to credit and expanding home ownership in America without unduly increasing foreclosures.

***See OTS National Housing Forum Transcript pages 34-55***

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**Luncheon Speaker: The Honorable Michael G. Oxley, Chairman**
**Committee on Financial Services**
**U.S. House of Representatives**

HFSC Chairman Mike Oxley discussed the importance of housing to the economy and to peoples' daily lives. He observed that housing prices have been unrealistically overheated, but remained bullish and expected a solid rebound in the housing market. The Chairman expressed encouragement that minority home ownership is increasing, although "not as fast as we would like." He also expressed the desire that the Committee add to its housing accomplishments in the next Congress by passing, among other items, GSE legislation, and flood insurance and homeowners' insurance reforms.

***See OTS National Housing Forum Transcript pages 56-61***

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**Luncheon Speaker: The Honorable Barney Frank, Ranking Member**
**Committee on Financial Services**
**U.S. House of Representatives**

Congressman Barney Frank indicated his interest in enacting GSE reform in the new Congress. He also discussed a number of additional housing related issues for the new Congress, including combating predatory lending and avoiding inadvertent redlining; creating more affordable housing to diminish homelessness in America; reforming HUD's Section 8 Housing Program and expanding the FHA program to increase eligibility for FHA mortgage insurance; integrating the Low Income Housing Tax Credit with other Federal and state programs; and overcoming what he expressed as "irrational negativism" to building more affordable housing.

***See OTS National Housing Forum Transcript pages 61-73***

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**Panel 3: Critical Consumer Protection Issues in Housing Finance Today**

The third panel discussed a number of mortgage-related consumer protection challenges faced by consumers. These include rising delinquencies among subprime borrowers; non-amortizing mortgage products leading to lower levels of home equity and payment shock; affordable housing issues; and rising foreclosure levels in various parts of the country. The third panel included representatives from two federal regulators, two consumer groups, and a banker. The panel discussed the role of government in protecting consumers in mortgage transactions, and providing access to affordable housing; the role of adequate disclosures and financial education in protecting consumers; and the role community banks play in housing finance and delivering affordable housing solutions.

***See OTS National Housing Forum Transcript pages 73-93***

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**Panel 4:** **Mortgage Fraud**

Innovations in mortgage lending have produced efficiencies that are often good for borrowers and lenders, but have also made the process more "abuser-friendly." According to the FBI, federally regulated institutions alone reported over $1 billion in losses due to mortgage fraud in 2005 with reports of suspected mortgage fraud doubling in three years. The fourth panel consisted of mortgage fraud experts providing insights into the main causes and types of mortgage fraud, who is harmed, and the magnitude of the problem. The panel concluded with a discussion of what can be done to identify and combat mortgage fraud, including a call for appraisal reform.

***See OTS National Housing Forum Transcript pages 94-112***

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**Office of Thrift Supervision**
**National Housing Forum**
**The National Press Club Ballroom**
**National Press Club Building**
**529 14th Street NW, 13th Floor, Washington, D.C.**
**December 11, 2006**

Transcribed by:
Dana A. Cohen
For
Alderson Reporting

Claude Rollin: Good morning. My name is Claude Rollin, and I'm with the Office of Thrift Supervision here in Washington, D.C. I want to welcome all of you to the OTS's National Housing Forum. Thank you very much for coming today, it's wonderful to see so many familiar faces in the audience. I also want to offer a special welcome to our C-Span and webcast viewers from around the country.

Before we begin the program this morning, I just have a few housekeeping announcements. First, please turn off your cell phones, pagers, Blackberries so that we don't have any unexpected disturbances during the program this morning. Any messages we receive for conference attendees will be at the registration desk just outside the ballroom, and if you need anything at all while you're with us today, please see one of the OTS hosts, who will be happy to assist you in any way that they can.

Now it is my great privilege to introduce the Director of the Office of Thrift Supervision, the Honorable John M. Reich.

Director Reich spent the first 23 years of his career as a community banker in Illinois and Florida, including 10 years as President and CEO of the National Bank of Sarasota, in Sarasota, Florida. He was then persuaded by his good friend, U.S. Senator Connie Mack, to come to Washington to serve on the Senator's staff, which he did for 12 years. From 1998 to the year 2000, he was Senator Mack's Chief-of-Staff, overseeing all of the Senator's offices and Committee activities, including those of the Senate Banking Committee.

In January 2001, Director Reich was appointed as a member of the FDIC's Board of Directors, and in November 2002, he was appointed Vice-Chairman of the FDIC. On June 7th, 2005, President Bush nominated him to be Director of OTS. He was confirmed by the Senate on July 29, 2005 as Director of OTS. Luckily for me, he still serves on the FDIC Board of Directors.

During his tenure at both FDIC and OTS, Director Reich has been a tireless advocate for community banks, and a champion of regulatory burden relief for the entire industry. Please join me in welcoming OTS Director John Reich.

(Applause.)

John Reich: Thanks, Claude. I have to give credit where it's due, and the fact is that with Claude Rollin, an FDIC attorney on detail to me at the OTS for the past three years as Project Manager for the inner-agency effort to reduce regulatory burden, the project known as EGRPRA, and Claude also serves as my Deputy and liaison to the FDIC Board, he was the creator, organizer and director of making this happen, and I want to acknowledge Claude's role, and express my appreciation to him.

Let me say a few words about OTS, you surely expected me to do that. As Director of OTS, I oversee an agency that is responsible for the regulation and supervision of more than 850 institutions with assets of approximately $1.6 trillion. And also 480 holding companies with consolidated assets of about $7.5 trillion.

Our supervised institutions are dedicated to helping Americans realize the dream of home ownership. Why has the Office of Thrift Supervision sponsored this Housing Forum, you ask? Thank you for asking.

(Laughter.)

John Reich: Basically for three reasons. First, there's obviously a great deal of interest nationwide in the housing market today. There's been some downward movement in housing prices in some regions of the country, a buildup of inventories, and considerable regulatory and legislative and public interest in the outlook for housing. The challenges of lending in today's market and consumer protection issues, such as mortgage fraud and predatory lending. It's important for all of us to have an informed sense as to where this market is headed.

Secondly, OTS has a vested interest in the housing markets, as the financial institutions that we supervise originate about one out of every four mortgage loans, residential mortgage loans today, and the portfolios of our institutions are dominated by mortgage loans.

Finally, there has been, for a number of years, an undercurrent of uncertainty about OTS and the future of the thrift charter, almost since the creation of OTS in 1989, and this forum is one of a number of opportunities that we intend to take to re-establish the prominence of the Federal Thrift Regulator as a significant player in the regulatory arena, and specifically a participant in the conversation on housing.

We have a strong and healthy constituency, a strong financial foundation, a highly professional and competent staff which we've augmented this year with the hiring of approximately 80 people, with plans to hire another 50 people next year. And so, these are the reasons behind our decision to organize this conference, and to invite a number of highly respected individuals from a number of organizations to discuss, and perhaps debate, some of the more important issues in housing finance today. One way or another, what happens in the housing sector will likely have a significant impact on our economy over the next few years.

I want to introduce you to some key folks at OTS. And some of them, I'm not sure where they're sitting, hold applause -- if you're inclined to applaud -- until I've introduced everybody. Scott Albinson, Managing Director of Supervision, could you stand, Scott? I want to introduce Laurie Quigley and Grovetta Gardineer and Montrice Yakimov, these three ladies are Assistant Managing Directors of Supervision, Laurie for Operations, Grovetta for Policy, and Montrice in the back of the room for Compliance and Consumer Protection. C.K. Lee? I believe is in the room, although I can't see him, is Assistant Managing Director of Supervision for Complex and International Organizations, and then I want to introduce you to -- thank you very much -- I want to introduce you to our regional management structure, they're sitting at the table in front of me, Jack Ryan is Regional Managing Director, he's the name and individual that many of you know, been in the banking industry for many, many years, was President of the Federal Home Loan Bank of Boston for awhile, head of Supervision for the Federal Reserve and we're delighted that he is Regional Director of the Southeast Region in Atlanta. Next to Jack is Fred Casteel who is Regional Managing Director for our Midwest Region, headquartered in Dallas, and next to Fred is Michael Finn, Mike is Regional Managing Director of our West Region, headquartered in San Francisco, Daley City, and next is Bob Albanese, Regional Managing Director of our Northeast Region in Jersey City, New Jersey.

Let me give you a brief overview of today's program. We've had a slight change in schedule at the beginning from what is in your program, the Secretary of the Treasury Paulson, who has graciously agreed to make some welcoming remarks will be delayed until 10:30 this morning.

We'll begin momentarily with a panel of leading economists and bank regulators, giving their unique perspectives on the outlook for U.S. housing markets, and their potential impact on banks and thrift. At approximately 10:30, we'll introduce Secretary Paulson, he'll speak for about 10 minutes, and then we'll take a short break. That'll be followed by a second panel of experts providing their insights on the current challenges and emerging risks in the home mortgage business, including some of the issues surrounding alternative mortgages.

At 12:10, we will break for 20 minutes, we'll depart this room to allow the Press Club to set up for lunch. Our lunch will begin in this room at 12:30 today, and during, at the end of the lunch, we'll hear from two distinguished speakers, Congressman Mike Oxley, outgoing Chairman of the House Financial Services Committee, and Congressman Barney Frank, the Chairman-designate of that Committee.

After lunch, another excellent panel will discuss critical consumer protection issues in housing finance today, and then our final panel will cover the growing problem of mortgage fraud in this country. At 4:30, I'll make some very brief closing remarks, and beginning at 4:45 we'll have a reception in the First Amendment Lounge where I expect to have a special guest with us, Federal Reserve Chairman Ben Biernacki plans to stop by the reception at 4:45.

So, I am pleased, I think we have a great program lined up, we have a great and diverse group of people here today, we have CEOs, senior level representatives from a number of banks, thrifts and other top mortgage lenders, we have homebuilders, realtors, leading economists, banking lawyers, lobbyists, senior level folks from Fanny Mae, Freddie Mac and Jenny Mae, also honored to have a number of agency heads and some key Congressional staff present, and finally we have senior level representatives from all over the bank, thrift and credit union regulatory agencies, as well as from the Department of Housing and Urban Development.

So, we hope that you find this day to be informative and a good use of your time, and we also hope that you have the opportunity to meet and talk with a number of our speakers, panelists and other conference attendees during the lunch and during the reception.

At this time, I'd like to introduce Scott Polakoff, who will moderate the day's events, including the first panel. Scott is a career bank regulator, come on up Scott, 22 years with the Federal Deposit Insurance Corporation, beginning as a bank examiner in Tulsa, Oklahoma, worked his way up with steadily increasing responsibilities in the management ladder in Dallas, Atlanta, New York, Washington, D.C., Chicago, and a year ago, I persuaded Scott to join me at the Office of Thrift Supervision as my Deputy Director and as Chief Operating Officer, so I'm pleased to introduce Scott Polakoff.

(Applause.)

Scott Polakoff: Well, it's a pleasure to be here today, I appreciate the opportunity to moderate the panel. For those of you who are looking at my picture on the two side screens, I want to emphasize that the camera does add 10 pounds.

When John gave me this opportunity to moderate a panel of four Ph.D.'s in economics, I was thrilled.

(Laughter.)

Scott Polakoff: But then I had an opportunity to get to know them better, and it is a fantastic group.

What I would like to do is tell you one brief story about my passion in this area, then I'm going to introduce these four speakers, and I'm going to sit down.

My brief story is, my wife Jackie and I purchased our first home in 1983 in Tulsa, Oklahoma, it was a brand-new home. We sold it in 1989 and came to the closing table, and we had to write a check for 10 percent of our original purchase price. So, I know passionately what it is like to experience home depreciation, and what it does to the younger generation, especially.

With that in mind, I am keenly interested in what our panelists have to say in this area, how it's going to effect the domestic economy, the global economy and our insured financial institutions. So, please allow me to introduce our four panelists.

First is Rich Brown, Rich is the FDIC's Chief Economist, a role he filled in 2003, after successful careers with the RTC, FSLIC and the Federal Home Loan Bank Board. As the FDIC's Chief Economist, he is frequently interviewed by the Wall Street Journal, Fortune, Business Week and CNBC. Richard earned his undergraduate degree from the University of Cincinnati, and his Ph.D. in Economics from George Washington University. And Rich has titled his presentation "U.S. Home Price Dynamics and Credit Implications for FDIC-Insured Institutions."

To Rich's right is Bill Longbrake. Bill is Vice-Chair of Washington Mutual, Inc. and currently is on assignment with the Financial Services Roundtable as a senior policy advisor. While Bill's career includes stints with the FDIC and OCC and senior level positions, most of his career has been as CFO of Washington Mutual, and in 2001 he was named CFO of the Year in driving revenue growth by CFO Magazine. Bill earned his undergraduate degree from the college of Worcester, and his Ph.D. in Economics from the University of Maryland, and Bill has titled his presentation, "Is Housing Bottoming, or is There Worse to Come?"

To Bill's right is Alan Sinai. Alan is Chief Global Economist and President of Decision Economics, Inc., which serves over 300 financial institutions, corporations, governments and individuals worldwide. Alan is the recognized expert on monetary policy, and is a well-known professor, lecturer and author. He has won a number of forecasting awards, including the Top Forecaster, Wall Street Journal Survey for 2006, and the U.S.A. Today Survey for 2005 and 2003. Alan earned his undergraduate degree from the University of Michigan, and his Ph.D. in Economics from Northwestern University.

And to Alan's right is Dave Seiders. Dave is the Chief Economist and Senior Vice-President at the National Association of Homebuilders, where he's responsible for, among other things, forecast of housing and economic trends. He is a member -- I'm sorry, let me go back to Alan for a moment, I apologize for not telling you the title of his presentation -- "Unwinding the Housing Boom Prospect, Process and Potential Problems."

Continuing with Dave's introduction -- Dave is a member of a variety of economic forecasting panels, including Blue Chip and Consensus Economics, as well as the exclusive Conference of Business Economists. In the early 1980's, Dave was the Chief Policy Analyst for Housing Finance with President Reagan's Commission on Housing. Dave earned his undergraduate degree from LaSalle College, and his Ph.D. in Economics from the Pennsylvania State University. And Dave has titled his presentation, "Restoring Balance in Housing Markets." And with that, I turn it over to Rich.

Richard Brown: Thank you, Scott, good morning everyone. I'd like to focus my remarks this morning on some recent FDIC research into housing boom and bust cycles in U.S. metropolitan areas over the last 30 years, and what these results may imply going forward for U.S. home prices, housing market activity and credit quality at FDIC-insured institutions.

I'll begin by noting that the FDIC closely monitors trends in U.S. home prices, and mortgage lending practices as part of its risk analysis process. FDIC-insured institutions are extremely active in just about every facet of the mortgage lending business, and these activities have helped the industry to post record earnings for five consecutive years.

At this time, credit losses for the industry remain low by historical standards, while capital ratios remain high. And no FDIC-insured institution has failed in nearly two and a half years.

However, our experience in the late 1980's and early 1990's showed that banks and thrifts are subject to potentially large credit losses arising from boom and bust cycles in real estate. During the 1980's and early 1990's the U.S. experienced what analysts then called a rolling regional recession, that affected, in turn, real estate prices in the farm belt, the oil patch -- Texas, Louisiana and Oklahoma, principally -- the Northeast and Southern California. Now, much of the distress in these real estate markets was related to agricultural or commercial real estate, but in a number of these markets, there was also significant distress in residential real estate. So, this experience was the motivation for our recent studies of metro area home price trends.

Now FDIC analysts, like their counterparts elsewhere, noted early in this decade the emergence of a U.S. housing boom, centered in the Northeast, the middle Atlantic states, Florida and California. And with the exception of Florida, these were areas that had boomed in previous cycles.

In the first three years of this boom, home prices grew faster than incomes, than the fundamentals, which I suppose is the definition of a housing boom. For a measure of home price changes, as you can see here, our analysts used, looked to the OFHEO Home Price Index, or the HPI, which tracks average changes in the value of the same properties over time. And looking at the fundamentals of the market, our analysts looked at growth in disposable personal incomes, or simply the wherewithal that households have to make their monthly mortgage payments.

Now, after this boom was well underway, we witnessed an acceleration of home price increases in 2004 when growth in the home price index jumped up from 7 percent to 11 percent. We saw that acceleration go further in 2005, when the HPI increased by 13 percent. On average, the price of an American home rose three times faster than disposable incomes in 2005.

Now, in this accelerated phase, the boom remained generally centered on the east coast and the west coast, while the mountain west states also began to experience double-digit increases in home prices. So, from a risk management perspective, we naturally began to ask the question, "Does boom lead to bust?"

We understood early on that the trends that mattered were local trends, and two of our analysts -- Norm Williams and Cynthia Angel -- dived deep into the nearly 30 years of home price data that OFHEO has collected at the metro area level, and they asked three simple questions.

First, where have booms occurred? Second, where have busts occurred? And, does boom necessarily lead to bust?

Now, using the OFHEO data, they attribute a housing boom to any metro area that experienced at least a 30 percent increase, adjusted for inflation, in the HPI during a given three-year period.

Now, alternatively, they defined a housing bust as a 15 percent decline in home prices in nominal terms during a five-year period. Now, they used a 15 percent decline to define a bust because it would be enough to wipe out the equity of recent home buyers who made only a 10 percent down payment. It would also seriously impair the equity of those who had made a 20 percent down payment.

Now, the importance of equity impairment is amply demonstrated by option theoretic models of mortgage default. These models clearly show that the risk of default rises in a non-linear fashion with decreases in the equity position of the borrowers. And given that about two out of five first-time homebuyers last year effectively obtained 100 percent financing, a 15 percent home price decline could be expected to have significant adverse credit implications for mortgage lenders and investors.

So, applying these standard definitions for booms and busts over the period from 1978 through 1998, we observe first that movements in home prices tend to be long-term trends that play out over years.

This pie chart breaks down the outcome, the aftermath, really, of those boom periods, we see busts -- true busts, 15 percent decline in home prices -- are relatively rare events, only 21 such episodes were recorded since 1978, and in only 9 cases did these busts follow a boom period.

Housing booms have typically been followed by an extended period of price stagnation. Prices may actually fall, but usually by not enough to meet this standard definition of a bust. And as you can see from the pie chart, in 48 percent of the cases after a boom, prices fell in a least one year, and 35 percent prices never fell in any single year after the boom.

Now, where housing busts did occur, the 21 busts I was referring to, they were usually associated with episodes of severe local economic distress, such as the energy sector problems experienced in Houston and other parts of the Southwest in the 1980's.

This chart shows, for example, the 10 oil patch cities taken together -- these are cities that tend to grow faster than the U.S. over time, in terms of population growth, but as you can see in 1986, they experienced actual out-migration as the price of oil fell by half during 1986.

Now, these periods of out-migration and local economic distress are fairly disastrous for local communities. The good news, I suppose, is that other local economies are picking up the migrants, not all markets experience difficulty at this level, and of course, U.S. population continues to increase through the period.

Now, recent data, using the OFHEO Home Price Index, shows that as this U.S. housing boom begins to wind down with prices leveling off or starting to decline in some of the previous boom markets, the areas with the largest home price declines to date are once again those who are experiencing local economic distress. Of these 13 markets that fell by more than one percent, year over year in the third quarter, we see that most of them are in the upper Midwest, northern Ohio, northern Indiana, southern Michigan. And again, they're experiencing problems related to manufacturing in the auto sector that are not arising from the housing sector itself.

To be sure, other areas are heading for stagnation as well, we see slowdowns or price declines in the Northeast, middle Atlantic states, Florida and half the cities in California experienced quarter-to-quarter price declines in the third quarter, as well. And again, these are relatively small price declines to date.

Now, this finding that housing busts are rare is somewhat reassuring from a risk-management perspective, we need to keep in mind that periods of stagnation that typically follow booms can be lengthy and they're painful for homeowners, investors and real estate professionals. Measures of housing market activity, such as new home sales and new construction, tend to suffer larger declines than home prices themselves, and certainly we saw U.S. housing starts in October were down by more than 27 percent from year ago levels.

So, while stagnation is here, or at least near at hand for most of the previous boom markets, the fact remains that homeowners are very reluctant to sell at distressed prices during these episodes, unless they're forced to do so. And this helps to explain why home prices tend not to fall precipitously under a fairly wide range of economic conditions.

Now, at the same time, the FDIC analysis also points to two important trends that distinguish the current situation from our historical experience. First, is simply an increase in the number of boom markets to unprecedented levels -- from a then-record high 40 markets in 2003 to 89 markets in 2005, based on current trends it appears that the number of boom markets will peak this year at just over 100 markets. That would be three times as many boom markets as we experienced in the 1980's boom.

Second, are the sweeping changes that have taken place in the structure of mortgage loans. Since 2003, we've seen borrowers migrate toward adjustable rate loans, toward interest-only loans and payment option structures where monthly payments may start out low, but can increase substantially if interest rates rise, or as low introductory interest rates expire.

By some estimates, interest-only and payment option loans made up between 40 and 50 percent of mortgage originations in 2004 and 2005. And also during these years, we saw big increases in the percent of mortgages taken on by sub-prime borrowers, borrowers with low down payments, and persons buying homes for investment purposes as opposed to as a primary residence.

So, it's important to ask what effects these trends had on U.S. home prices in 2004 and 2005 during this price acceleration, and whether they are making home prices more vulnerable to downward pressure in this cycle compared to our historical experience.

Now, we're already seeing early signs of credit distress and portfolios of sub-prime adjustable rate mortgages, and also in non-traditional mortgage products. This shows some up ticks in sub-prime ARM foreclosure rates, both in Michigan where we said some of the markets are relatively -- home price appreciation has been slow, and home prices are now declining -- as well as in California, which we saw boom markets that are now significantly cooling off.

Here's another look that looks at the non-traditional mortgages that are included in non-agency, those are private label ABS structures. We're seeing that the 2005, the incidents of serious distress in the 2005 mortgage book is significantly higher at the 12 month level than was the case for the 2004 and the 2003 mortgage book.

Now, as higher interest rates push up monthly payments on adjustable rate mortgages and the most highly leveraged borrowers lose the benefit of large annual home price increases, I would expect to see these signs of mortgage credit distress continue to build.

That said, it also remains true that these mortgage credit risks tend to be spread around the system in a fairly efficient manner among MBS and ABS investors around the country, and around the world.

Mortgage portfolios are of course not the only area of exposure to the housing industry on bank and thrift balance sheets, we see that construction and development, or C & D lending also contains a large proportion of residential development loans, and these too have proven to be vulnerable to credit distress and a market downturn.

This slide shows that C & D -- let's go to this slide -- C & D loans, encompassing both commercial and residential development hosted double digit average non-current rates during and after the 1990 and '91 recession and the associated real estate problems in the Northeast.

Now, recently we've seen C & D non-current and charge-off rates remain quite low by historical standards, but we do see these portfolios growing rapidly. As you see in the left-hand chart here, they're growing at 29 percent year over year, they grew at 30 percent the year ending 2005. And while lenders have become more sophisticated in their approaches to underwriting and risk management in this area over the past 15 years, these are still loans where fairly substantial credit problems can develop when market conditions deteriorate.

Thanks, and I'll turn it over to my next panelist.
(Applause.)

William Longbrake: Good morning. I'm going to pause here for a moment while they get the presentation up on the screen.

Okay, well the title of my remarks are "Is the Housing Market Bottoming, or is There Worse to Come?" Well, the preponderance of prevailing opinion seems to be that it's bottoming. Certainly, that's the impression you get if you're listening or watching the financial press these days. Alan Greenspan recently opined, "The U.S. housing market appears to be stabilizing." In a recent Wall Street Journal dot com economic forecasting survey for November, economists by a two to one margin say that the worst of the housing correction is over, actually used the word "bust".

Ethan Harris, Chief Economist at Liemann Brothers was recently quoted, "We're nearing the end of the slowdown for most markets," and yes, Ben Biernacki, Chairman of the Federal Reserve has spoken on this topic as well, and I would put his comments in the category of "qualified optimism" or the proverbial "on the one hand, on the other hand". "The correction in the housing market could turn out to be more severe and widespread than seems most likely at the present."

And then a few believe that there's more to come. Jonathon Laing, who is a reporter for the Wall Street Journal said last Monday, "Housing woes may be in the early innings," baseball analogies were made popular by President Fisher of the Dallas Reserve Bank a few months ago -- Bob Toll of Toll Brothers said at a December 1st quote, "We continue to look for signs that recovery is imminent, but can't say that one is in sight," but then he was quoted a few days later -- and this is very recent -- that "we're bouncing along the bottom." So, I'm not sure that Bob Toll even is quite sure as to what's going on.

And then Jeffrey Gunlock who is with the TCW Group was quoted in the Wall Street Journal last Monday as saying, "I'm not a fatalist, but things definitely don't look good. All we can hope for is that job loss isn't so large that it really amplifies the housing slump and its impact on the economy."

Well, advocates of the "housing is bottoming" view really make their case based on the following: they point out that the National Association of Homebuilder Index is improving, that October housing starts were actually below consensus forecast for 2007, that mortgage purchase application activity is improving, that affordability is improving, that sales are stabilizing, both for new and existing homes, and prices are stabilizing and inventories are stabilizing.

Now, in a moment I'll examine the evidence for each of these seven beliefs, but first let me just say that where the housing market goes from here is important at two levels. The first level is the housing market itself, and whether the worst is over, or there is more to come. And the second level involves the extent to which housing problems have negative impacts on the rest of the economy.

If the linkages between housing and the rest of the economy are limited, the potential continued severity of the housing market correction will be of less importance, but if spillover effects in due course are significant, then the answer to the first level of analysis becomes very important. And just so you know where I stand, I place myself in the minority who believe worse is still ahead for the housing market, and I have anxiety, but not conviction that the spillover effects to the rest of the economy will be greater than soft landing proponents believe.

That said, let's go ahead now and examine the evidence. The National Association of Housing Homebuilder's Index improved from 30 in August to 33 in October. That is a fact, but I would just point out this is an diffusion index, and any value below 50 means that activity is decreasing, so what's changed is that the rate of decline has lessened, but activity is still decreasing.

New housing starts in October were 1.49 million, the consensus forecast is at about 1.65 million for next year. So, this is a true statement as far as it goes, but what if the forecast is wrong?

Now, if you look back at the past experience, housing starts in the two previous major housing corrections fell 50 percent from peak to bottom. If you look at the current cycle, which peaked in January at about 2.3 million starts, that would mean falling to 1.1 to 1.2 million, so the correction so far is about 34 percent from the peak in January. If you go the full 50 million, it's that 1.1 to 1.2 million. There is one forecaster out there, it's David Rosenberg with Merrill Lynch, who does, indeed have -- not just for 2007, but also for 2008 -- 1.1 to 1.2 million housing start forecast. And I would just point out here at the bottom of the slide, you can come at this analysis from a different direction, you can look at what is the underlying fundamental demand for new housing formation by looking at demographics, household formation and trends in home ownership and other modifiers -- and when you do that, you come out with a number that over the long term looks like it's closer to a normal level of about 1.6 million starts per year. So 1.65, if that's for real, for next year would appear to be above the long-term normal trend level.

Mortgage purchase applications have risen 7.5 percent since August, but they're down 14.3 percent year over year. Definitely an improving trend, but it's possible that the improvement in the applications recently made reflect aggressive builder incentives and price reductions.

Affordability, yes, affordability is on the upswing, it bottomed in July at 99.6, it's now up to 107.6, but I would point out that for the period 1994 to the start of the housing, recent housing boom in 2004, this ratio averaged over 125, and we still have a long ways to go to get to that level.

New home sales are stabilizing, the October level was about the same as the July level, so we've been flat for several months, but if you look at this in a different way, you can see here that the rate of change in new home sales is about a negative 14 percent through October of this year, and if you compare it to the last major cycle which occurred in the late 1990's, the maximum decline was at 22 percent.  And you can see here it looks like the momentum is still in the direction that will perhaps test the 1990's maximum decline in home sales.

If you look at existing home sales, there was a very small up tick in October, very small, about one half of one percent, but again, if you look at the current graph of momentum, and then you compare it with that of the 190's, you'll see here about a 6.5 percent annual rate of decline in existing home sales through October this year, the maximum point was hit at almost 14 percent negative in the 1990's. More importantly, and this reaffirms what Rich said a moment ago, is that sales activity wants to hit the bottom, they went along the bottom and they were negative for 31 consecutive months. So far in this cycle, existing home sales have been negative for only five months.

Well, let's take a look now at prices.  Median and average prices rose in October for new houses.  That's true.  But monthly prices are not adjusted from X, and are notoriously very volatile in this particular survey.  The 12 month -- again, let's look at the graph here -- the twelve month rate of change -- I got ahead of myself here -- the twelve month rate of change is quite, still positive, you can see the six month rate of change is negative, and it suggests that further declines are ahead.

If you look at prices now for existing houses, the median pieces were stable over the last 10 to 11 months, not changing, and that's unambiguous.  You can look at that data. But early in a buyer's market -- and it clearly is a buyer's market, sellers are reluctant to accept lower prices, and inventories really are a better indicator of what's really going on in the existing housing market then prices themselves, prices do tend to be sticky.

Finally, if we look at inventories existing, sales inventories appear to be stabilizing, but that's not really the case, again if you look at the data here a little bit more closely. Inventories are up 31.5 percent year over year, and overall momentum -- as you can see from this chart -- is still in the direction of rising inventory-to-sales ratio.  And if you look at this in a different way, the traditional measure of sales to inventory on a monthly basis, you'll see there, the red line which is up there over seven months now, has stabilized over the last four months, but the momentum on the 12 month basis is still toward rising inventories.

Now let's take a look at new inventories, there's been a lot of commentary about how the inventories and housing starts are beginning to stabilize, but it's wrong just to focus on that inventory alone, because in the building of homes, there's really three different types of inventories -- there's the inventory of homes not started, those under construction and those completed. And when you look at all three categories you'll see that there's progression from starts to under construction to completed and if you look at the chart here, you'll see that each one of these lags starts to turn down, but notice they've turned down not below zero, but from a peak level rate of increase. So inventories on starts are still rising, just not at as rapid a pace as before.

Look at the completed ones -- inventory there actually has accelerated. That means that there's going to be a very large overhang of new homes for sale for quite some time to come.

So it really is wrong just to focus on starts alone, and it means here that the fact that the momentum is turned down is that the bottoming process has begun, but it still has several months to go.

My conclusion after examining the data is that there is worse to come, but the rate of decline has slowed, but further declines are ahead, and the bottom is probably still many months ahead. The lesson from history when you go back and look at previous housing cycles is that housing cycles, the correction period lasts three to five years. And you can see this in the chart of the OFHEO housing prices, note here the peak levels in the late 70's, again in the late 80's, and currently, but notice the red line which is adjusted for inflation, how it peaked at a higher level in this particular cycle than either of the two previous cycles.

So let me list eight reasons why it's different this time. Usually, you hear the commentary "it's not different", well there are eight reasons why it's different. Unlike the 80's and 90's when staggered regional housing recessions occurred, as Rich pointed out the downturn today is likely to occur in a more synchronized time frame.

Nominal inflation-adjusted national housing prices peaked at much higher levels in the current boom, the current low inflation environment means that as housing prices come down on an inflation-adjusted basis, the declines may be similar to the past, but the nominal declines are likely to be greater.

The fourth one, nominal house price declines erode equity, increase the likelihood of credit losses upon default, low and devalue ratios are higher on average today, which means less equity cushion, and loan devaluations have increased 4.5 percent since 2000. They're up to 42.4, that doesn't sound very high, but it's at the margin, it makes a big difference. If the housing market catalyzes a broader-based recession, employment and income will decline. Employment and income declines exacerbate credit losses, and could put further downward pressure on home prices. This raises the potential for a vicious downward debt deflation cycle, negative feedback.

The final reason, the potential for monetary and physical stimulus to bail us out this time is probably much more remote than it was in 2001.

So, will the housing market trouble spill over into the rest of the economy? Well, on this topic there is very little consensus. The forecast of different forecasters depends on whether and to what extent housing has spillover effects to the rest of the economy, and the limited spillover to date has emboldened soft landing advocates. But I would point out, if spillover effects do occur, there will be credit problems, and the housing recession will get much worse. The jury is out, but transmission lags are very long -- it takes a very long time for the housing market to unwind, and an even longer period of time for that to get translated into the general economy.

Here is one particular forecaster taking the OFHEO prices and extending it out for the next two years, this is the Merrill-Lynch forecast, has nominal housing prices down 5 percent in 2007, an addition 3 percent in 2008, he is not the most bearish, UBS has housing prices down 10 percent and just end on an upbeat note, the consensus forecast is for nominal housing prices to only be down one-half of one percent in 2008.

(Applause.)

Allan Sinai: Good morning, everyone. I don't think from a business and planning point of view I would raise any great cheery flags of optimism about the outlook for housing, construction and the financing around that space over the next year.

Housing is in a recession, it's the downside of one of the most incredible housing booms ever in the United States. There are signs that the worst is over, signs of stabilization, but unwinding the housing boom of 2000 - 2005, a boom fed by extraordinarily low interest rates, 8 historically low interest rates, and new, innovative methods of finance that caused housing activity to borrow from the future, it caused consumers to borrow into spending from the future, thanks to the leveraged finance on that wonderful asset, residential real estate.

History does not suggest that the adjustments in the aftermath of these booms are all that easy. So, I don't think it's quite that simple, despite the encouraging signs which we do see, and some optimism of builders and some flattening of home sales, traffic better, mortgage applications up, and the very, very positive fundamental this time which probably -- if it stays -- will get us through the episode, no further increases of interest rates, that is different from the past.

It's not so simple, because a kind of second shoe of this process is in train now, it's significant price declines in real estate -- in part because of extreme speculative highs in some areas of the country, and very high inventories relative of the history of single and new and existing homes relative to sales, ratios are very, very high compared to history -- there's an awful lot to work through. And these price declines through the new structure of the mortgage housing markets, and the way that leveraged finance has been used by borrowers, buyers and lenders -- unusually so over the past four or five years -- raises very huge risks to consumption, in turn to the economy, and then in turn back to housing.

So, the jury -- in terms of how we get through this episode for us -- will be out for a long time. We have to see how consumers react -- we're just beginning the process to substantial declines in the asset residential real estate, how that works through the financial system onto consumption and back into housing before we would signal, the coast is relatively clear. At the moment, there's a big black cloud over this whole issue.

Some re-observations right at the start, because it's inevitable that economists run out of time because we all speak too long. Housing and residential construction are in the bona fide recession, it's significant, we've been in a recession for almost 5 quarters now, it's well along. Rising interest rates, soaring home prices that reduced affordability, and excesses in the buying, building and financing of residential real estate far ahead of the fundamentals, long-run fundamentals combined, has set in motion the downturn. Now, we have falling home prices, declining values of assets collateral for lenders and buyers, presenting a potentially huge negative for the future of consumption, huge risk to the economy's expansion, therefore backed to housing.

On our research, this is an economics research, the U.S. economy is more vulnerable to trouble in housing this time around then perhaps any time in the last three or four decades. It is because of the new means and methods of mortgage and housing finance, the excesses and bubble-like housing activity that has existed in so many areas of the country.

There are early signs of an abating in the downturn that appear in traffic, builder expectations, mortgage applications, consumer sentiment, also some in new and existing home sales -- it's good to see that, maybe the worst is over on the spending side of the downturn, but declines are still likely to occur.

The second shoe of the process this time, which is the inevitable declines in home prices, sharply so given the levels to where home prices were bid. That is reducing the asset values of real estate collateral, around which so much focused lending, investment and borrowing has occurred -- that is now going forward, our biggest concern.

We have done quite a bit of research on the responses of consumption to the new methods of mortgage finance, that is, the cash-out financing, the reactions to capital gains, in this case, losses, and to household wealth and the real estate component of it, and we find very large propensities to consume in each of these areas. For cash-out financing, 41 cents on the dollar of extra financing from cash-out process, distributed over a year and a half, there distributor lags because it takes time. Twenty-eight cents on the dollar of capital gains on housing within a year, or capital losses, perhaps, within the year. Three cents of consumption per marginal dollar of reduced household net worth, stemming from declining real estate values spread over one to two years. These are very big propensities to consume in our econometric work which makes us very sensitive as we go forward in terms of the falling value of asset collateral in real estate, the clear inability to cash-out finance the way we have over recent years.

But, I have to say quite objectively, that these coefficients are estimated on the upside of the housing boom, we really have no experience with the downside of a boom like we just went through. So, technically -- and this is encouraging -- those coefficients, since they were estimated on history where we were booming, may be higher than they will turn out to be once we go through the downside. It is not necessarily symmetric -- up sides and down sides of business cycles. I don't think we ever saw anything like the housing boom we just had and the way in which it was financed, and the consolidation around the asset residential real estate by owners, borrowers and buyers. And so we don't think -- we think we're seeing for the first time the downside, and the evidence of what that means for these propensities to consume, out of cash-out financing, capital gains or losses in real estate and the balance sheet effect -- we really won't know until the episode is over.

But those large numbers do make us sensitive to the risk -- and that's what I want to emphasize here, the risk -- to consumption going forward of the price declines, depending on how big they are and what that might mean for the economy, and then even though now we see some stabilization in housing later on, how that could hurt the housing.

Well, I don't think I have to tell this audience much about the process of the housing boom. I think we all individually, personally have experienced and used this wonderful asset while prices were going up, and real estate as a funding mechanism. Is there anybody here who didn't? A very unusual phenomenon. The low interest rates set by the Federal Reserve to cushion the 2000 and 2001 downturn, one percent Federal Funds rate, and the declines in long-term rates that went with the prolonged low interest rates -- on purpose, to cushion the downturn, to prevent a big recession from coming downstream -- held up housing, and housing performed wonderfully to pull the U.S. economy back from what would have been a very, very bad downturn if it had run its usual course. Low interest rates work wonders for this space and this area.

But it wasn't just low interest rates, it was the then-innovative response of the financial institutions in the system. The inventions of new mortgage instruments and ways of diversifying risks selling off those instruments, and the price increases that raised the value of real estate and leveraged the use of it, along with the realization of all of us that we could tap into previously untapped equity and feed our consumption habits -- which in this country are proof of it, at all levels of the United States, Federal, state and local, private sector -- only not in the corporate sector this time around.

And so we think we saw an extraordinary boom in housing fed by this mechanism, very unusual in history. We think that it led to a lot more consumption that would have occurred otherwise, and because of the way this is counted, because the funds had come out of the mechanism of the leveraged finance of housing do not get counted as income, but we spent, out of those funds, 41 cents on the dollar of cash-out financing, 28 cents on the dollar of capital gains, 3 cents on an improvement and balance sheet. Because consumption went up off of this mechanism, and income as counted by the National Income and Product Accountants didn't go up. The savings rate went down, and probably turned negative, from this particular cause. Indeed, there's a lot of saving, because there's a lot more funds than just is what are used for consumption that do show up in household balance sheet. The NIPA definition of saving is really misleading, but that savings rate is negative, consumption grew and rose above trend, housing far in excess of what it might have done without the low interest rates and the method of financing, and we are going through an unwinding of that process now.

Well, we do see -- in terms of looking at the housing outlook for the year ahead -- some early signs of stabilization on the spending side of housing. And those have been noted here today. But the tentative improvement of the data is only recent, and it is too soon to draw a permanent conclusion on the state of the housing recession. Home prices have just begun to decline with the potential negative effects on consumption from declining real estate values yet to show up. Anecdotally, the stories are not pleasant about the declines in home prices. In the published data we have just begun to see, I think, the beginning of the year over year decrement in the price published data median and existing home prices, medium prices for new and existing homes and the OFHEO price data -- those are the ones that we look at the most.

The most likely prospect, and it is our baseline forecast, but in this area subject to a lot of uncertainty, I will confess it in terms of the probabilities we assess to this -- just 60 percent -- is that the housing downturn, the spending side of it, the GDP side of it, the worst of it is over in the housing areas. We expect further declines in home sales, housing starts and residential construction, but not at the same pace that we have had. Which was quite extreme here in the second half of this year, costing us maybe one percentage point of real growth in GDP. It is the spillover effects from the downturn in housing and declining asset values of real estate that concern us in terms of the potential negative effects on non-housing consumption, through less cash-out financing, more capital losses in housing, and a decline in the real estate wealth component of household net worth. Potential effects on consumption then on the economy then back, reverberating through.

If the negatives of the housing downturn spread no further than housing and some related areas in consumption -- which is a 60 percent assumption, not a highly confident assumption of the forecast -- then housing as a decrement to the U.S. economy will diminish, and the economy can continue in an expansion, although it will be an expansion, we think, that will be on the anemic side, about 2.5 percent growth over the next year, and that is for us the best case.

To get that, we have to get a continuing -- at least extended pause -- by the Federal Reserve where the Federal funds rate goes no higher than five and a quarter percent. To get that, we need crude oil prices not to soar or go up any more than the forecast we have, which is about $70 a barrel, and gasoline prices not to go above $3 a gallon. To get that, we need to see, still, a relatively tight labor market with a somewhat, perhaps, higher unemployment rate -- that's okay -- five percent by the end of next year, but if it rises a lot more and the labor market gives way, then disposable income will give way and the fuel for spending, which is more now than offsetting the potential hit from the reductions in the financing ability out of housing -- will give way and the consumer will give way, and the economy could well suffer a recession.

We do need to see continuing expansion in the rest of the world, that is helping U.S. exports, a declining dollar would help, that would help U.S. exports stay strong, the industrial sector stay strong and offset some of the weakness in housing.

For us, there are a lot of risks around this forecast, what I call the baseline scenario. They reside mainly around housing and residential construction and the impacts on consumption through the effects of the falling home prices, and what the declines in this asset -- residential real estate -- on which we are all leveraged to an extent I have never seen before in American history. We do need those home prices not to go down a lot. We are forecasting them to go down -- in terms of new and existing homes -- median prices as much as 8 to 10 percent year over year, we think we're in that process now, we'd expect to see that in the next three, six, nine months. Believe it or not, even with those declines, we think we can get that two and a half percent GDP growth forecast and watch housing activity bottom out over the next year, not pick up much after that, but bottom out over the next year and avoid the worst.

The -- never before have the published indices on home prices shown such large declines as we are forecasting -- hopefully we're wrong. I'm long on real estate -- believe me, I'd rather see it plus 8 to 10 percent than minus 8 to 10 percent. If the propensities to consume that I mentioned are what worries us off these declines and declines then in the market value of real estate, but if the labor market can stay firm, the unemployment rate relatively low, wage compensation hold up, workers are now beginning to catch up -- enough income can be generated to offset, or hit the consumption from the weakness that comes out of the falling home prices and the declining asset value of collateral and the implications of that.

Let me close with a few words in credit, because that is the third layer of effects in the process here. First one is the spending side -- home sales went down, starts went down, residential construction went down, now home prices are going down, that's the sequence in the cycle of how this process works. Falling home prices -- in terms of what it might do to the asset value of collateral will then affect consumption -- certainly negatively -- the question is how much, and then that will reverberate back to the economy. And as we get farther along in the process, there are sure to be credit problems, because there will be -- especially in the speculative excesses of the housing boom that occurred, and among the lower income families and some of the sub-prime lending -- bound to be bankruptcies, foreclosures, workouts, and credit issues not just in terms of housing itself, perhaps for some of the homebuilders, but also in some of the credit markets. There is always a credit effect with lags after you go through a big boom, and then go through the downside of that boom.
Thank you.

(Applause.)

David Seiders: Well, good morning. Dave Seiders, National Association of Homebuilders, it's been a long time. I'm told that, you know, the Secretary of the Treasury could show up at almost any moment, and if so, Dave is probably gone right quick, so I'm going to walk through my story very quickly, throw up a couple of pictures and then see where we go from there. I have plenty of time? We'll see, okay.

The same story told up at the Senate back in the middle of September, I was on a panel up there, joint subcommittee meeting, topic was "The Housing Bubble and its Implications for the U.S. Economy," and just to walk through my basic storyline -- first of all, there's no question we had an unsustainable housing boom, don't know when you would say it exactly started, I date it production-wise, latter part of 2003 and then running through most or all of 2005. The reason I knew it was an unsustainable boom was because the numbers kept exceeding my forecasts, which are based upon the right things, so we know we had unusual stimulus from the financing side, we had this massive influx of investors and speculators that were drawn in by price appreciation when it kicked into gear, so that ran things hotter and so forth and ultimately it was the price increases that primarily destroyed affordability, and then we started to see the whole thing start to unravel.

We've been in what I call, off the boom, a substantial correction process since somewhere in the latter half of 2005, it really is different from previous housing downswings in the sense that, you know, the ones that, say Bill talked about earlier is lessons from history -- early 80's, early 90's, so forth -- occurred in connection with bona fide economic recessions. And this time, so far, we've been avoiding recession, and in most of our forecasts we do avoid it and move ahead with decent job growth, decent income growth, output growth remaining sort of below trend for a bit, but doing pretty well, so forth and so on. Interest rate story, obviously, isn't very positive right now, this is a preface to our forecasting, I do expect the Fed to be steady, probably maybe even up to the middle of next year, maybe a little decline in short rates at that point. Long rates are behaving beautifully, a little uptake on Friday, but you know, I think they're pretty much range-bound now for awhile, we've got mortgage rates in the low six's and so forth, so I think it will be a good economic and financial market environment as we go forward, okay, with this correction process, has been quite dramatic with dramatic declines in sales, in housing starts, building permit issuance. Certainly the house price appreciation has been coming down quickly, some measures already showing negatives, year over year basis.

In terms of where we, I think we are right now -- and we've heard an awful lot about, you know, current, all these little current market indicators and what do they add up to -- I really do think they add up to a stabilization on the demand side of the single-family market in the fourth quarter of this year, or the monthly lows are going to be -- but I've got in my forecast, I'll show you in a second, bottoming out of home sales in the fourth quarter, condo market, still heading downhill beyond that point. Rental market, by the way, firming up. We don't even talk about that, but now the rental market is actually showing some improvement, and that's affecting our multi-family forecast to some degree.

So sales bottoming in the fourth quarter of this year. I've our production, our housing starts numbers bottoming out in the first quarter of '07. That's not very far away, all right? So, that's one that's out there that is a bit of a leap of faith, but that's what forecasters do, right? I've got to put all this stuff out, you know, so I might as well show it to you.

We know there are heavy inventories of unsold housing out there, both new and existing housing markets, certainly the condo market, heavily overbuilt, and that is going to delay the process of the starts rebound. So, what I really go is the starts hitting bottom, but staging a recovery phase the rest of '07 and through '08 that is still quite sub-par in terms of my estimates of sustainable trend activity. Those trends that we, soared beyond on the way up -- by the way -- when we had the unsustainable binge going on.

Residential fixed investment, you know the construction activity that follows the starts and other things that are in it, the housing producing piece of GDP, Brady even mentioned has been a major drag on economic activity second quarter, third quarter, will again be in the fourth, for sure -- we already know about the production side. I've got a lesser, but still pretty heavy drag on the economy in the first quarter of next year, and then by the middle of next year, that piece of GDP returning to about a neutral position in terms of whether it's subtracting from growth or adding to growth and so forth. Then beyond that point, sort of going back into a positive growth contribution with levels still below trend level. This is a game -- quite a game that we play -- with growth rates and levels and all of that kind of thing, but that's the way it pans out.

On the house price front, I do have, we do try to forecast the OFHEO House Price Index, and what I've got in there is about a one percent nominal decline in 2007 that translates into about three and half, two and a half, three and a half percent real house price erosion, then stabilizing and starting to show modest increases in '08 and '09 and so forth, still a below trend performance for the house prices once we hit the bottom point, okay?

So, and in that forecast there clearly will be some, the housing wealth effect through the consumer sector will not be as strong as it has been, but if it pans out the way I've described it, modest withdrawal of support to consumer spending from housing wealth, and it would occur beyond the bottom of the downslide in the housing production component of the economy which is the big head. So, in that sense, I think the economy can digest these various impacts.

Okay, very quickly. Home sales -- you may not want to believe this one, but that does show a trough in the fourth quarter of this year, and then a recovery beginning that stays well below trend. There is a natural uptrend to this series, it is dominated by existing home sales, they're both in here, so we've got well beyond sustainable pace of home sales in '04 and '05, for sure, a steep decline which I think we're near the bottom of, and then hopefully stage a recovery as shown there.

Single family housing starts, about the single-most important variable on the production side -- this is quite a correction, as you can see here, and we have in the second quarter which, by the way, these charts all show the two previous recessions, all right? Early '90's and the 2001 recession and my forecast run through 2008, history of forecasts divided by a line of current data.

This shows, you know, that the starts on the single-family side are falling quite sharply, I expect them to hit bottom in the first quarter of next year, and then start to stage a recovery process that again, stays well below what I would consider a sustainable pace going forward. So, it's up, but it's still below trend even out in 2008.

Multifamily housing, this is you know, units and structure with two, you know, two or more units in them, it includes both the rental market and the condo market. What we're seeing happening right now, after a major shift away from rental to condo in the last couple of years, we're now seeing the flow start to move back the other way, and it should, given the over-production of the condo side and what's happening there with prices and so forth.

Year to year pace down about 9 percent in 2007, but hitting bottom again in the first quarter of next year and then staging a -- quite a modest recovery -- condo market remaining, I think, quite weak through this entire forecast period. But rental starts are actually coming on already, so that's some source of strength in the housing forecast.

One you probably don't see much, manufactured home shipments, what we used to call mobile homes or HUD code-manufactured housing -- a story in its own right -- this is a market that got overblown by very unwise financing techniques back in the late 1990's, fell off a cliff, we had at the end of '05 what I called the Katrina Spike in shipments -- FEMA purchases, primarily -- fell back down to quite a low level, I see very little support for the housing sector from this component over the next couple of years. Year over year pace down about 7 percent in '07.

Total new housing units, new single family, new multifamily, manufactured homes all added together -- this is another way that I was trying to assess when I spoke to the Senate how much overproduction there was sort of by looking at this series relative to what I think is sustainable trend, all right? Which is roughly -- believe it or not -- about 2 million units per year, including the manufactured home component. So, this is coming down like a rock, as is the single-family component, and year over year basis, I've got this down 13 percent in 2007, but again it's hitting bottom in the first quarter of '07, and then staging this modest recovery phase, I would call it.

Another one you probably don't see much -- this is the residential remodeling market, annual numbers in real terms. What we call improvements are on the bottom part of those bars, that's additions and alterations to homes in place of major systems or whatever. Major piece of the economy, and really about 20 percent of that residential fixed investment total of the housing production piece. This one, this is another one of those brave things, you know, in terms of forecast -- this market is ordinarily slightly cyclical, not counter cyclical, but I've got it showing slow, persistent real growth in both '07 and '08 and it does help to support my overall housing forecast. One reason is the degree of housing wealth in the hands of America's homeowners at this point -- and I think it is going to hold up quite well -- so whether or not it's withdrawn through cash-out re-if's or home equity loans, I think it will be a support for the remodeling market going forward.

This is the bottom line for housing production, the residential fixed investment component of GDP and tremendous growth engine for the economy in, well coming out of the 2001 recession all the way through at least the middle of last year and then kind of topped out. As I mentioned the last couple of quarters have been heading sharply downhill.

Fourth quarter will be another major contraction, subtracting at least another -- you know, off the fourth quarter for '03 -- at least a percentage point, probably more. First quarter, another downstep, probably seven-tenths off of GDP, maybe eight, something like that.

Second quarter, more neutral and then going, you know, with the housing starts and the other components of the forecasts I showed you into this growth phase, beginning about the middle of 2007 and starting to do some GDP contributions to the positive side.

On the house price front, I mentioned what I've done with the house price index, this is the overall OFHEO index, has some deficiencies, obviously, but basic story here is I show both a nominal year over year change, and then the real counterpart where I'm using as a deflator my own forecast of the core PCE price index, the one the Fed focuses most heavily upon, and I do have in here, you know, nominal declines -- modest, but declining in 2007. We didn't get that in connection with the recession, deep recessions of the early 80's or the early 90's, but I think it is a good call now, and then the bottom line is sort of the real, the change in real house value, and that does show a more systematic, deeper decline. It still doesn't look that bad at all, clearly compared to the behavior of real values back in the early 80's or the early 90's -- maybe a little on the optimistic side, we'll see how this one pans out, but again, this is a different episode -- this is not an economic recession, and the interest rate story, I think, is quite positive going forward as well. So those are the things I'm counting on to keep the, you know, the forecast together that way.

I've not been hauled off, and I'll walk off of my own volition, thank you.

(Applause.)

Scott Polakoff: We have somewhere between two seconds and fifteen minutes to continue this dialogue. We have two microphones set up in the room and I invite any of you who wish to pose a question to this distinguished group of panelists -- I worked all weekend on a list of questions and none of them are that great, so I'm counting on all of you to come to my rescue.

(No response.)

Scott Polakoff: And I could have predicted this.

(Laughter.)

Burt Ely: Burt Ely, a question -- I think primarily for Bill Longbrake, but for the others also -- this has to do with the inventory figures and what's on the market: Does anybody have any sense of what I call, of how much hidden inventory is out there? That is, people who would like to sell, for whatever reason, but are just holding off from the market now because they see too many houses out there for sale, they're concerned about the weakness in prices, but if prices start to pick up, then a lot of this hidden inventory, this pent-up desire to sell will come onto the market. I know we saw that down in the Southwest in the 80's -- any sense of how extensive that is today?

William Longbrake: Let me take a quick first cut and then I'll turn to the other panelists who probably have a better understanding of the data.

Normally, the sequence actually is in the existing sale market, inventories begin to decrease as you go further and further into price corrections, because people hold out for a long period of time with the expectation of getting the price increase that they saw their neighbors get just a few months earlier. As time goes along, and they don't get action, many -- particularly the opportunistic sellers -- will withdraw their house from the market, so really Burt, it's almost the opposite effect of reductions in inventory coming from discouraged sellers who don't have to sell.

There's one other phenomenon that bears some close watching -- as everybody has pointed out, in previous cycles, nominal prices except in isolated markets never went down on a national basis -- that's probably going to happen this time around, in fact there's data that shows that that already is occurring. What if you get buyer psychology saying, "Hey, if prices might go down further, I'll sit tight and wait?" And wait for a better price. That actually could have a negative reinforcing effect on delaying sales and actually increasing price decreases.

David Seiders: There's a couple of things on the inventory side maybe I should mention, sound like they kind of undermine my own story, but they're worth talking about.

Three things, really, on the inventory -- first of all they're high, currently, and some of the numbers have been described. There are a couple of unknowns here, one of them is, we know that cancellations of home sales have accelerated a lot from, say, this time last year. The Commerce Department's numbers on inventories of new homes for sale -- once a home is sold, a sales contract signed, it's gone from their point of view. So, if a home stays with a builder because of a sales cancellation, new home sales cancellation, it's not in the Commerce Department's inventory numbers. So, we know that the uptrend in the inventory actually has been understated in the new home market.

On the existing home side, we know that an unusually large share of listings are now vacant single-family homes. That's a big distinction between vacant and occupied. Ordinarily, most existing homes on the market are occupied, so a seller turns out to be a buyer. Not in this case, and as a sort of a, part of the legacy of the investor or speculator boom over the last couple of years.

On Burt's question about the phantom or hidden inventory, what I worry about are homes that were taken possession of by the investors, held vacant and you know, they haven't yet put them on the market, so they're not in anybody's inventory numbers, but they're coming. Okay? And these are some of the reasons that I have -- although I do have a fairly near-term bottom to the housing cycle, I've got a -- I guess what I would call a -- fairly sluggish recovery, there's more inventory out there than is recorded, and one of the downside risks is that we don't really know how much.

Richard Brown: I would only add that the relatively lengthy period of stagnation that tends to follow these housing booms is the process of adjusting expectations on the part of sellers, so I think that what you're saying is accurate -- it takes years for sellers to, their very reluctant to part with their homes at distressed prices, and it takes awhile for the fundamentals -- that is, incomes, to catch up. That's what eventually re-equilibrates the market.

William Longbrake: Ellen, I think I saw you coming up to the microphone.

Ellen Seiders: Yeah, I have a question and I think this starts with Mr. Sinai. On your amounts of various things that go to consumption -- do you have any sense of the distribution across the income spectrum of those percentage, of those percentages, and what effect would that have on the stress on high cost and may we say predatory mortgages?

Allan Sinai: That is a, that's a very good questions because then in the aggregative work that goes on in these, and the model work, we can't deal with income distribution issues, and it could be that a lot of the spending in the financing cash-out and otherwise was from a lot of upper middle-class or affluent families who are well-cushioned on their balance sheet on the downside of the boom, as opposed to lower income families, but I think the lower income families that aggressively financed and the lenders that lent to them -- those are the ones that I believe there are some signs of distress in the data, and bankruptcies and foreclosures now, so for institutions who have been lending into low income family areas the loan devalue ratios and the ability to support the payments -- especially if the economy comes under stress is going to be a big problem.

I actually think the downside won't be as hurtful as the upside was helpful, and your question really points out one of the reasons that -- a lot of the ability to finance came from families with good balance sheets and relatively high-priced property whose loan devalue ratios weren't that high anyway, so I'm doubtful that we'll see on the downside the same propensities to consume that our data reveal occurred on the upside. But I don't know that, and that's why I'm so sensitive to the risks of downside issues and what you learn from asset price declines -- not matter what the assets are, stocks, for example -- is that the cascading effects of that when it gets rolling can be far beyond what anybody has seen and this really is an asset price explosion in real estate that was leveraged, I think, beyond belief in the history of our business cycles, that makes it a very dangerous, a very dangerous kind of thing as it unwinds.

William Longbrake: Allan, I'll just add a comment, I don't have any information specifically to the question you raised, but as I think the next panel may get into, the delinquency has been rising very rapidly on the sub-prime segment of the market, those tend to be somewhat lower income borrowers, and it will be a market that will bear some close watching because it seems to be the one that's at least at the front end of vulnerability, to see what indeed happens to those borrowers as the defaults perhaps accumulate in the sub-prime category down the road.

Richard Brown: I think it's kind of interesting now, also to look at, in terms of possible recession indicators. You know, the last recession we referred to as the corporate sector recession -- Main Street really didn't have a recession -- and the precursor was mass layoffs, you really saw them ticking up. You didn't see anything like that as a precursor to recession now, the corporate sector's doing terrifically right now.

Instead -- many analysts have said and I would agree -- that the next recession, if we have one in the next year -- would be a consumer sector recession, and I think the indicators to look at, the main indicator is retail sales, and it's a very interesting picture right now, the sectors of retailing that are very connected to homebuilding -- appliances and home improvement and things of that sort -- are hurting. Also discount retailers are hurting -- other parts of the retail sector doing pretty well, so it's sort of a mixed bag with retail right now, and certainly I think the sector to watch going into next year.

Scott Polakoff: While I wait for the next question, I want to introduce our Chief Counsel, John Bowman, who I think has joined us since John Reich introduced some other executives from ITS. Andre?

Andre Galeano: My question has to deal with speculators in the homeowners market, and I was wondering if the FDIC tracks home mortgages that are purchased by speculators rather than home occupiers. One of my favorite shows is "Flip this House" and "Househunting" -- I'm short on the real estate market right now.

Richard Brown: We make use of the same third-party data that I think all of our panelists do to look at investor purchases as opposed to purchases by, as a primary residence.

But I will say that purchases by investors are nothing new, that's what happens in a housing boom, and it was pretty pervasive in this cycle, and I think again, the financing environment being fairly permissive probably pushed it further in this cycle than in previous cycles, but that's part and parcel of a housing boom and the unwinding comes when the investors turn around and they want to sell rather than to accumulate.

Scott Polakoff: Do we have some other questions? Hi, Sharon.

Sharon Stark: Hi, I'm Sharon Stark from Steeple, Nicholas. All of you seem to have a pretty soft landing forecast for the economy, and I wonder if you can put a number on some of the second round effects of the decline in the housing market on consumer spending, I mean, we certainly all expect a slowdown, but to what extent, given the fact that there's so much leverage out there?

Allan Sinai: The, our numbers -- if this residential recession is not quite as bad as the average of the historical ones, kind of is bottoming out now and you have the price declines I talked about -- we're expecting to see, compared to trend, about a percentage point less growth in consumption spending in real terms. So, historical trend is -- over the last four years -- three point four percent per year, inflation adjusted. That's really amazing, actually. That's faster, I think, than the growth of our overall economy, per year, for the last 40 years, so that tells us something about our society, how much we spend, on average, year by year. So, we're thinking two and a half percent. For those who are in the consumer side of businesses, that would be kind of a lot of soggy businesses, it just wouldn't feel very good. So, it's costing, we think, about a percentage point of growth.

William Longbrake: The problem is that we just don't really know for sure what the transmission effects will be from housing into the rest of the economy. But if you look back at the dot com tech bubble bust, it was about 10 percent of the economy, residential real estate plus linked industries or about 10 percent of the economy, roughly speaking, overall. And if you go back to 1999, 2000 -- you heard much of the same kind of cautionary optimistic discussion that you're hearing this morning. And yet, that did morph into a generalized recession, it was albeit, a fairly shallow one because the consumer was never affected, but it was pretty ugly in terms of the stock market and other aspects.

There's nothing that I can see that would prevent that same kind of outcome in this particular case. You really have to have everything align itself very well in the sense that consumers do not pull back strongly, that the housing market does begin to recover -- at least stabilize -- early in 2007, but as all of the speakers have pointed out, the risks are enormous, and it could go easily in the other direction. And if it does begin to go to the other direction, then my comment was, you get into the negative feedback loop process where the general economy begins to go down, consumers spend less, but that morphs back into the housing market worst outcomes, and so on. So, we hope I think is that we don't have that outcome, but the risks are there.

Scott Polakoff: Sharon, thank you. Unfortunately, that has to be our last question, the Secretary is here, and we are going to vacate the podium. Thank you very much for your time and attention.

(Applause.)

John Reich: Ladies and gentlemen, it's my honor and privilege to introduce the 74th Secretary of the Treasury of the United States, Henry M. Paulson, Jr.

Secretary Paulson was nominated by George Bush, President George W. Bush on June the 19th, was unanimously confirmed by the United States Senate nine days later on June the 28th and was sworn in by the Supreme Court Justice, John Roberts, twelve days later on July the 10th. An impressively swift process.

Secretary Paulson is the President's leading policy advisor on a broad range of domestic and international economic issues, and anyone who is paying attention to the press lately, knows also that Secretary Paulson is quickly become one of the Administration's key players on a vast array of domestic finance issues.

Before coming to the Treasury, Secretary Paulson was Chairman and CEO of Goldman-Sachs. He joined Goldman-Sachs in 1974 in the Chicago office, became a partner in 1982, in 1994 he rose to the position of President and Chief Operating Officer and with the firm's public offering in 1999, he became Chairman and Chief Executive Officer.

Prior to joining Goldman-Sachs, Secretary Paulson was a member of the White House Domestic Council, serving as staff assistant to the President from 1972 - 1973. Secretary Paulson graduated from Dartmouth, was a member of Phi Beta Kappa, an All-Ivy, All-East and Honorable Mention All-American in football. He received an MBA from Harvard, he and his wife, Wendy, have two children.

Please join me in giving a warm welcome to Secretary Paulson.

(Applause.)

Secretary Paulson: John, thank you very, very much. Good morning to all of you, I’m delighted to be here today. It's, I would say one of the things that I'd heard about before I came to Washington, a number of former Treasury Secretaries and former employees at Treasury came to me and said, "You know, you're really going to enjoy working with the team at Treasury, they got first-rate professionals and throughout all of the Bureaus." And that's one of the things that I've found, so it's something I'm pleased about, and in that regard I would just say I've got two of the leaders of our domestic finance team with me today, and I think a number of you already know them, but we have Bob Steele who's our Undersecretary and Amil Henry who are here for, the Assistant Secretary for Financial Institutions, Bob and Amil, why don't you raise your hands?

(Applause.)

Secretary Paulson: Now, they will be staying after I leave today, and they're going to be involved in a number of our decisions as it relates to your industry, so very much involved in the industry, and one thing we know is how important your industry is to this country, and to homeowners all over America. And it's a very topical question for me, right now, everywhere I go, questions about, "Mr. Secretary, when do you think the retail market is going to turn up? The residential market for homes?" And since I've got a good number of experts here today, I'm not going to answer that question for you, okay?

(Laughter.)

Secretary Paulson: Let me say, at Treasury, we're charged with keeping America on the path of long-term, sustainable growth. And increasingly that task requires a global outlook. Tomorrow, I will head to China to participate in the first meeting for the strategic economic dialogue. A number of Cabinet secretaries and agency heads will be in the delegation, and will be joined by Ben Biernacki of the Fed.

The Strategic Economic Dialogue is a forum for discussing China's successful integration into the global economy, and making sure that China stays on the path of market-based reforms. We're also very interested in making sure that the benefits of trade are shared equally between our two nations.

We'll be discussing the importance of sustainable growth in China, which improves the balance of trade. We'll discuss ways to continue opening China's market to trade, competition and investment. And we'll discuss our common interest in increasing energy efficiency, energy security and strengthening environmental stewardship.

The benefit of the Strategic Economic Dialogue is that we can meet with senior Chinese leaders who have responsibility for a range of subjects, and consider these questions comprehensively. Rather than issue by issue, we can look at all of the items on the agenda, and have conversations that really try to move the ball forward, again taking a long-term approach, but also having a vehicle where we can deal with some of the most pressing issues on each side -- on the Chinese side and the U.S. side -- so we can keep, make sure we have enough confidence that we can continue to keep moving forward on the long-term issues. And, you know, we're going to be talking about currency, the rule of law, intellectual property -- all of the issues that have become a familiar part of our relationship with China.

I'm looking forward to the trip, I think it will be a good discussion that lays the groundwork for important progress down the line.

Our outlook toward China, the way we manage the relationship, has to be a long-term one. There is a tendency in Washington to want to get immediate answers, but a relationship this important will have consequences for our economy and for our nation over many generations. The work we do this week and at future meetings should all be with an eye toward building a cooperative relationship for many years. More and more the people of China are realizing the benefits of a market-based economy. And as long-time practitioners of market economics, Americans have a lot of expertise to offer.

From the founding of our country, Americans have worked to achieve big dreams, to improve their lives and the lives of their children. They have looked to the market to find a good job, to finance their ideas, and of course and to realize the epitome of the American dream -- home ownership.

Home ownership is a goal that unites Americans across racial, ethnic and income lines. President Bush is particularly pleased that minority home ownership rates have increased in recent years, as overall home ownership levels have reached new heights. And throughout the Administration, we continue to look for ways to increase access to capital and financing so that people who work hard and save can one day walk across the threshold of their very own home.

The value of mortgage products in the United States as you all know has grown very significantly. As of September, outstanding mortgage debt totaled roughly $12.8 trillion, an increase of more than $5 trillion since the beginning of the decade. And today's mortgage-backed securities is comprised a marketplace that has a great deal of liquidity.

The daily trading average of agency-backed securities is nearly $244 billion, up from $38 billion a decade ago -- a huge increase. Fostering a robust lending industry and mortgage securities marketplace is an essential mission of the Treasury Department, and you'll hear more about that from Bob and Amil later today.

The housing sector makes significant contributions to our economy, as we all know. Residential construction accounts for about five and a half percent of GDP, or three-quarters of a trillion dollars in spending, and it directly accounts for about three percent of total employment in the United States.

Activity in the housing sector helped to drive our recovery out of a recession in 2001, and from 2003 to 2005, housing activity added about a half a percentage point to overall GDP growth each quarter. This year, activity in the housing sector has slowed down, but the overall health of our economy continues to be strong.

Our rate of growth for the last several years, particularly in the housing industry, had not been sustainable -- I think you all knew that. As you all know, we've had a correction in the housing industry, and we are in the process of transitioning to a more sustainable growth rate. Fortunately for all of us, we have a diverse economy, and consumer spending, the service sector and corporate profits remain strong. And I believe that our economy remains strong -- unemployment is low, jobs are being created, you saw the latest jobs number, a very good jobs number, and we've had more than 7 million new jobs created since August of 2003. And wages are rising, which means more Americans are realizing the benefits of a stronger economy.

Your discussions throughout the day will help us to formulate a forward-looking strategy for a vital part of the American economy. From a Treasury perspective, we want to make sure that we have the right guidance in place to help people across America access home financing without taking unnecessary risks. Expanding opportunities for more people to buy a home is a good thing, but we do not want Americans to become overextended, and see their dream end in foreclosure. These are important decisions that we will have that have a real impact on people's lives.

I appreciate your work to help more Americans achieve the dream of home ownership, and I look forward to learning about your views. Thanks again to OTS for bringing this forum together, and thank you all very, very much and enjoy the rest of the day. Thanks.

(Applause.)

John Reich: We certainly thank the Secretary for taking his time the day before he is scheduled to depart to China for a few days -- we know he is very busy and we appreciate his time.

We are going to take a break when I finish talking, and I’m told that I’m supposed to linger here for about two minutes.

(Laughter.)

John Reich: So, when I finish talking, we are going to take a break for just a few minutes, and then we will reconvene here in about ten minutes. It's about quarter of eleven, and the next session will run until 12:10 and we will then take a break and clear this room for 20 minutes and reconvene until 12:30. So, you're now free to go, thank you.

(Recess 10:49 a.m.)
(Reconvene 11:04 a.m.)

Scott Polakoff: We need to get started again, I've a very important message to share with the audience. For any of you that are returning to your tables and possibly picked up one of these fancy bottles, blue bottles of water, beware when you open it, because I think someone shook all of the bottles before they put them out there.

(Laughter.)

Scott Polakoff: If I could take a moment to introduce one other executive from OTS, Kevin Patrasic is our Managing Director for External Affairs, Kevin, raise your hand, please? So, if you have any questions, always feel free to give Kevin a holler, okay? Thank you for returning from the break.

I'm going to introduce Scott Albinson. Scott is the Managing Director with OTS and has responsibility for examinations, supervision and consumer protection. He has over 20 years experience with OTS and its predecessor organization, and is the agency's representative on the Bozzel Committee on Banking Supervision Accord Implementation Group. Scott, take it away.

Scott Albinson: Thanks, Scott. I thought you were going to talk about my past in more detail, but I appreciate that.

After hearing that last panel, I'm not sure where we start. Certainly the news was somewhat depressing in nature, I can't say that our panel is going to be much more optimistic in many respects, although we may have a little bit more positive news to share with you.

The panel that it is my pleasure to introduce today will be focusing on challenges and emerging risks in the home mortgage business. And we have, unlike the last panel with four Ph.D.s, we have kind of an eclectic group here today.

We do have our representative Ph.D. economist, however, we also have a regulator and two bankers with varied backgrounds, so it should make for a pretty interesting panel.

The first panel talked about housing prices, sales, construction activity -- we're going to focus on the mortgage markets and lending activity.

To my right, to my immediate right, is David Berson. He's chief economist of Fannie Mae company, David manages Fannie Mae's economics department, which is responsible for forecasting and analyzing the economy, interest rates and the housing and mortgage finance markets, as well as advising the Chairman and Operating Committee on finance, economic, tax and housing policy issues. David has a Ph.D. in Economics from the University of Michigan.

To David's right is Kathy Dick. Kathy is Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency. She serves as OCC's principle advisor on systemic risks facing the national banking system, and she also chairs the OCC's National Risk Committee.

To Kathy's right is Lew Ranieri. Lew is the founder of Hyperian Equity Funds. Lew also serves as Chairman and CEO of Ranierian Company, a private investment advisor and management company. He is Chairman or Director of several companies, including American Financial Realty Trust, Capital Lease Funding, Incorporated, Franklin Bank Corporation, Rexon Realty Associates Group, and Root Markets, an internet banking, or internet-based marketing company.

And then to Lew's right, all the way down at the end of the table is Bob Broeksmit. Bob is President and Chief Operating Officer of B.F. Saul Mortgage Company, that's Chevy Chase Bank's residential lending subsidiary. Bob serves on the residential Board of Governors of the Mortgage Bankers Association, and chaired that group until recently. He also served on the Mortgage Banker's Association's Legislative and Nominating Committees.

Now, I'd like to turn my attention, just for a moment, and give you a brief overview of the mortgage markets and how they're performing. I think you heard Bill Longbrake ask the question, "Are we at the bottom of the housing slump? Or will we continue downward for awhile longer?" And certainly the data seems somewhat mixed. But it absolutely has major implications for the mortgage finance markets.

Looking at mortgage loan activity, single-family mortgage originations have declined, reflecting slowing sales and recently interest rate increases. However, refinancing activity remains surprisingly strong, suggesting many ARM borrowers are refinancing their rising rate adjustable rate mortgage loans. According to the MBA, the refinance share of U.S. mortgage originations is up over last year from 48 percent of originations in 2005, to more than 51 percent of originations so far in 2006.

Also, from the MBA, delinquency rates for prime, sub-prime, FHA and VA loans have all increased in recent quarters. All ARM loans had higher delinquency rates, however fixed rate loans, their delinquency rates have been relatively unchanged in recent quarters.

CNN Money and New York Times recently reported that late payments on sub-prime loans have surged -- you heard a little bit about that from the last panel -- based on current performance, 2006 is on track to be one of the worst ever years for sub-prime loans. Sub-prime mortgage originations have climbed, however, to 626 billion at the end of 2005, from just 120 billion in originations in 2001.

Early payment defaults are up. Many of these early payment defaults are within the sub-prime mortgage sector. According to Credit Swiss, early payment defaults -- that's, they define early payment defaults as loans that become 60 days or more delinquent in the first four months of the loan's life -- early payment defaults have been rising since the middle of 2004, and according to their data, they see early payment defaults across a range, a broad range of credit scores, they see early payment defaults much higher for stated income loans, as opposed to full doc loans, full documentation loans.

They see early payment defaults much higher for purchase loans, versus refinance loans, and also for those loans that have a piggy back second mortgage present as well. A review of loan performance data reveals some surprising and then some expected results. On the surprising side, prime condo loans are performing better, with lower rates of delinquencies and foreclosures than are prime loans for a single-family detached mortgage loans.

Prime ARM loans are performing better than prime fixed-rate loans. The third quarter 2006 overall delinquency rates for prime mortgages actually declined from 2004 and 2005 levels. In contrast, as I mentioned, the sub-prime sector within the mortgage markets has delinquency rates have risen sharply.

Now for some expected results that you could probably guess, refinance loans are generally performing better than purchase loans. The states with the highest rates of delinquency for both prime and sub-prime loans were Louisiana and Mississippi -- both states still suffering from the shocks of hurricanes and flooding.

Indiana and Ohio followed suit with the next highest delinquency rates. Both states are heavily dependent on the manufacturing sector.

Now, I'd like to turn my attention to important regulatory development that will kind of set the stage for much of what we have to talk about during this panel discussion today.

The agencies, the Federal banking agencies, together with the NCUA on October 4th issued final, Inter-Agency Guidance on non-traditional or alternative mortgage products. This is a significant development that bears some talking about as we look at the mortgage markets.

In tandem with that guidance, we also issued final guidance on home equity lending, that's a supplement to a May 2005 Inter-Agency issuance. And lastly, we issued proposed consumer illustrations for non-traditional mortgage products.

The guidance describes sound practices for managing risk, as well marketing, originating and servicing alternative mortgage products. It specifically addresses concerns associated with deferred pay mortgage products, so-called interest-only and pay-option ARM mortgages. It sets forth supervisory expectations for institutions that originate or service alternative mortgage loans, including establishing prudent lending policies and underwriting standards that include considerations of a borrower's capacity to repay the loan. It recognizes that an institutions underwriting criteria are based on multiple factors that are jointly considered in the qualification process, and that a range of reasonable tolerances may be developed for each factor. It also reminds institutions of the importance of setting the start rate for alternative mortgage products in a manner that is consistent with prudent risk management practices, since a start rate substantially below the accrual rate for the loan may lead to negative amortization.

The guidance talks about risk layering. This is where financial institutions layer multiple products together, or bundle multiple products together that increase -- in sometimes in exponential fashion -- the risks associated with alternative mortgage products. We remind institutions that they should perform adequate underwriting analysis when layering products, including products such as alternative mortgage loans, reduced or no documentation loans, loans without customer income verification, or a combination of any of these products, combined with a second mortgage.

The guidance talks about portfolio and risk management practices as well and reminds institutions that they should have strong risk management practices, capital levels commensurate with risk, adequate allowances for loan and lease losses, strong systems and controls for establishing and maintaining relationships with third parties, and lastly there's a significant section on consumer protection issues that indicates institutions should have, and implement, programs and practices designed to ensure that consumers receive clear and balanced information to help them make informed decisions while shopping for and selecting an alternative mortgage loan. Providing this information to consumers serves as an important supplement to disclosures required under the Truth-in-Lending Act, Reg Z and other laws. Such information should apprize consumers, among other things, of the potential for negative amortization, whether pre-payment penalties apply, and the costs associated with reduced documentation mortgages.

Now, I'd like to turn things over to our distinguished panelists. First, David will talk about lending patterns and product composition, followed by Kathy who will talk about risk areas in the application of the Inter-Agency Non-Traditional Mortgage Guidance from a regulator's perspective. Then Lou will discuss implementation of the Inter-Agency Guidance from a banker's perspective, and also discuss secondary market and securitization issues. And lastly, Bob will address credit risk dispersion and ratings agency issues. David?

David Berson: Scott, thank you. They didn't give me any training on this, but excellent.

It's a pleasure to be here today, I'm a link between the first panel of economists talking about the housing market and this panel talking about more mortgage market things -- it certainly doesn't make me the missing link -- but as an example of the link, I think the last question or near to the last question from the previous panel was on sizing the investor's share of the market.

Well, my first chart here shows data from long performance, with the investor share of purchase originations. Now, we know this is a lower bound of the investor share because it doesn't include private placement mortgages, it doesn't include home sales in which there is no mortgage at all, and there's probably at least one household out there that wasn't exactly truthful on their mortgage application and really was going to be an investor all along but didn't tell us.

What does this show? And we also have the second home share on here. It says that at the beginning of this year, the investor share of the mortgage market rose to about twelve and a half percent, and when you include second home buying, it was about 23 percent of the mortgage market, a record level for both. Data through the third quarter suggests some falloff, particularly in the investor share, but the investor share of purchase originations still remains very high, and we anticipate that this will continue to decline and in our forecast of the housing mortgage market, one of the big determinants of a decline in those markets next year is a further falloff in the investor share of the market in 2007.

Now, if we look at the share of investor purchases and the impact in the housing market, one of the things that we can see is a clear positive correlation between investor buying of homes and increases in prices. Now, this chart shows a cross-sectional diagram for the second quarter of the year, between the purchase -- the investor share of purchase originations -- and home prices. A clear upward relationship. As the investor share goes down, we anticipate that it will put downward pressure on home prices. This is particularly important for those parts of the country that have had very significant investor shares, because in fact, even independently of a downturn in the economy, it could mean that home prices would decline.

We also see a significant positive relationship between the use of adjustable rate mortgages and home prices, and the linkage here is affordability, but the linkage is also with investor uses of ARMs. Investors are far more likely to use ARMs than owner-occupants.

I've got a couple of maps that show home price gains. The first is over the last five years, and the red areas of the map are the areas that have had home price gains that have at least doubled over a five year period of time -- and you can see, California, Nevada, Arizona, Florida, this area, New England -- very strong home price gains. But much of the middle of the country has much softer price gains, gains of maybe 20 to 50 percent over a five year period of time -- perhaps still stronger than average, but not that much faster than the rate of income growth.

But if we compare this to what we've seen over the last one year, now the red areas are different. There's no area in the country over the one year that has had doubled prices, but it's still indicating the very fastest gains, and the very fastest gains have moved basically to the Northwest and the inter-mountain west, still a little bit in Florida, but the greens -- the areas that have the weakest home price gains -- and particularly the dark greens, which are areas of the country that have seen home price declines, have increased over the country. We can see the areas with home price declines over the last year -- New England, around the Boston area, the upper Midwest, particularly Michigan and northwestern Ohio, northern Virginia and California, all of which are experiencing -- at least in part, in some locations -- declines in home prices over the prices over the past year. So, we don't have to wait for the declines to come, they're already here. And because this is a four quarter change, this is the smooth measure of home price gains. If we looked at one quarter changes annualized, we'd see many more areas of the country that were declining prices.

Now this chart shows data from Fannie Mae's home price database, and we divided into quintiles -- areas that over, a four quarter growth rate over time. Areas that have seen very fast growth, moderate growth and then, perhaps, declines. The red areas, or the red on the chart shows the areas of the country, the number of areas of the country that have had home price declines. And indeed, for much of the last 30 years, we've had some areas of the country in which home prices declined. What's unusual is the period in which there is no area in the country in which there are no home price declines, but in fact over much of the last five years, we've had periods of time in which there were no home price declines.

The latest data, though, suggests that the home price declines are picking up again, we're not back to the historical average, but we're close. The other thing to note on this, the top part, the black are areas with home price gains over 20 percent. Unusual increases, certainly, the last time we saw a big increase, or a big share of the market with home price gains of this amount was back in the inflation-driven late 1970's, and certainly inflation was not the cause of the double-digit gains in recent years, but that is retreating as well -- there are very few parts of the country today that have home price gains over the last year that are 20 percent or more.

One of the other things that we've seen happening over the last several years is a significant shift in the composition of MBS. The agencies, Fannie and Freddie and Ginnie have seen a diminished portion of the market, private label MBS issuance, which is the light blue, has increased substantially over the last several years as home price gains have increased, and as the ARM share of the market has increased.

Now this chart shows some of the characteristics of the mortgage market broken out by sub-prime, Alt-A, jumbo and prime conventional performance. What are the most important things in this chart?

Number one, the ARM share has picked up substantially, particularly for the sub-prime market where year to date in 2006 over 92 percent of sub-prime loans were adjustable rate, it's also high in the Alt-A market. Interest-only ARMs last year were almost 37 percent of the sub-prime market, this year year-to-date about 22 percent, also very high in the Alt-A market, although it's come down in 2004 -- over 50 percent of Alt-A loans were interest-only.

Negative amortization loans, very big in the Alt-A market, almost a third of Alt-A loans this year were negative amortization loans.

Non-owner occupied, up to 10 percent in the sub-prime market, about a quarter in the Alt-A market, and even in the prime conventional market, almost one-sixth were not owner-occupied.

Full doc, that share has gone down as well. It's now just under 50 percent in the sub-prime market, it's gone down, fortunately, in the Alt-A market, but it was over a third. But in the prime conventional market, the full doc share is also under 50 percent. Scott talked about the layering of risk -- these are the risk layers.

The share with simultaneous seconds -- in the sub-prime market, over 50 percent. In the Alt-A market, in the Jumbo market, over a third. The concern is the loans that have several of these characteristics.

How about just in the sub-prime market? And I'll just talk about a couple of things here. Number one, the ARM share in the sub-prime market has gone up according to this data, which is a little different data source then the previous chart, for year-to-date 2006, 80 percent were ARMs, most of the ARMs we'll see in a minute were two twenty-eights in the sub-prime market, which means they're fixed for two years, and then they adjust for the remaining 28 years.

So, let's say that you took out a sub-prime loan in 2005. In 2005, the average ARM rate in the sub-prime market was 7.18, but the average first reset cap was almost 250 basis points, so in 2007 if you get a two twenty-eight, you'd have the 7.18, plus nearly two and a half as an increase, you'd see an increase -- you'd get a letter from your mortgagor saying that your mortgage rate would be going from 7.18 to about 9.75 -- that's a pretty big jump.

The sub-prime share of originations has climbed to a record in recent years. Almost 25 percent of one to four family mortgage originations, what we call single-family mortgage originations have been sub-prime over the last three years.

Now, an interesting question is, how many loans are going to reset and when? Now this chart shows the share of loans by type: sub-prime, Alt-A, Jumbo, and Fannie/Freddie that will reset, the ARMs will adjust. And you can see that with Fannie/Freddie the agency loans, they adjust only gradually and they never adjust very much, because a significant portion of the business that Fannie and Freddie do is fixed-rate. Jumbo increases over time, but a lot of the Jumbo loans are the intermediate-term ARMs, that three-ones, five-ones, ten-ones -- so they adjust over time. But look at the sub-prime. By 2008, almost 70 percent of all of the sub-prime loans will have adjusted at least once. That's a significant increase in that portion of the market.

How about the dollar amounts of that? Again, we've broken it out by loan type. This year, we estimate that over 400 billion of loans will adjust upward, by next year another 680 billion, and since a lot of those loans, once they adjust, will adjust again next year, next year should be about 1.1 trillion, '06 and '07 added together that will adjust. And you can see it going up over time. Again, a substantial portion of this will be coming from the sub-prime market.

Distribution of MBS by issuer -- sub-prime MBS has gone up a lot, as has Alt-A, the other has gone up much less, the other is primarily Jumbo and what else would there be? I guess that's probably it.

Almost done. Distribution of product type -- by sub-prime and by prime conventional conforming. In the Fannie/Freddie sphere of things, about 80 percent of the loans that we purchase secure ties are fixed rate, and an almost exactly equal percentage -- 80 percent, 81 percent -- are two twenty-eights, in the sub-primary, you can see in these sub-prime loans, very few are fixed rate, only 7 percent of sub-prime loans are fixed rate, all of the rest are adjustable rate loans of one sort or another.

Then if we look just at investor loans -- we'll tie this back to the first chart I gave. Investor loans in the private MBS market have been tilted more in recent years towards the higher rate or riskier products. The reddish color here are the fixed rate, and that share has gone down, the products with the higher risk -- particularly negative amortization, the blue here -- have gone up substantially. But even in the conventional prime conforming market, investor loans have been increasing in the riskier products. Blue here, and negative amortization loans, red are no negative amortization, but are ARMs. And the yellow are the fixed rates, those that have the lowest risk.

So, let me sum up by saying that over the last -- really the last two and a half years -- we've seen a significant increase in the usage of products by investors that are riskier, and we've seen a big increase in investor borrowing. We've also seen a big increase in sub-prime lending, and again that sort of lending has been increasingly using the riskier, non-traditional mortgage products. So, with that setting the stage of what the mortgage market today looks like, we'll turn it over to the other members of the panel. And Kathy, you're next. Thank you.

(Applause.)

Kathryn Dick: Thank you, David, thank you, Scott and Director Reich for the invitation to participate in the Forum today. As Scott mentioned, my role, or responsibility here this morning is to share with you a perspective on what the supervisors will be doing as we go out and take this new, non-traditional mortgage guidance and implement it in the institutions we examine.

As Scott mentioned, there are four Federal agencies that have signed onto this guidance, and each agency of course will be responsible for implementing the guidance with their respective institutions.

At the same time, the four agencies work together frequently on Inter-Agency Guidance, and have processes both in the public domain as well as shall we call behind the scenes where we work together at staff level to make sure we have consistent application of the guidance to ensure that as questions arise in the industry about interpretation, that we can get those questions answered and get conclusions and better understanding about the terms of the guidance out to the industry.

I'm going to walk you through what we do at the OCC to give you a flavor for how we're implementing the guidance, but I think what you'll find is that the work we're doing is very similar to what's being done in the other agencies. I'd also like to then just spend a minute talking about a few of some of the key findings -- what are examiners identifying as areas of the guidance that will probably require some sort of change in business practice in the industry.

Not surprisingly, whenever we have new agency guidance or new guidances issued, this really spurs a discussion between examiners and the bankers they supervise. We use experienced examiners at the OCC to supervise our largest institutions, and those banks -- we have teams of examiners that will work full-time on various business areas -- so for instance, in mortgage banking, we'll have examiners in the largest companies that do nothing but look at the mortgage banking activities of those companies.

So as they take this guidance, they'll look for how it is terms of the guidance change the expectations in the industry right now, and then work with institutions to identify where there may be gaps between their current business practice and the guidance.

Of course developing policy is only the first step of getting new guidance out in the public domain, the second step as I mentioned was implementation and ensuring that we have a keen understanding both between ourselves and the industry of what those expectations are.

This particular piece of guidance is based on some sound principles that, as Scott mentioned, speak to a couple of different areas of mortgage banking, in particular what we've referred to as non-traditional mortgage products, or those that defer payment either of principle, and sometimes interest.

The supervisory principles in the guidance, then, really are the framework for where examiners start in looking at the business activities of the companies they supervise. We have longstanding guidance that directs the activities of mortgage banking operations, so again with respect to the non-traditional, we're really looking for where these products and the activities in the banks might differ from a traditional mortgage product.

The framework, then, for starting the examination process follows the guidance, and starts by looking at loan terms and underwriting, the portfolio risk management practices of the institution, and then also the customer protection features of this guidance, which speak to communication with the customer as well as disclosure.

As Scott mentioned, one of the reasons this guidance is so important to us as regulators is because of the very statistics that David just shared -- the growth in this market, and a market that, and a product that was traditionally was sort of a niche product for a small group of customers is now being marketed to a much broader range of customers, and again then our examiners need to ensure that the risks associated with this product are clearly understood by the customer, as well as clearly understood and carefully managed by the bank.

The implementation timeline at the OCC and again, I think this will be similar to other agencies is as follows: We issued the draft proposal of the guidance in December of last year, and that initial implementation, or initial, excuse me, production of that proposed guidance then was the starting point for our examiners to engage in a discussion with bank management about this particular product.

So, essentially for a good twelve months now, we've had examiners in these companies talking to their bankers about those bankers that use non-traditional mortgages about the products they offer, who they offer those products to, the terms of those products and how they manage the risks associated with them.

We encouraged our examiners in all of the large companies -- which, again, this market tends to be dominated by a handful of large firms -- to ensure as we implemented the final guidance this Fall that again, they followed up with bank management to make sure that there was a good understanding of what the principles were included in the guidance.

Typically, what happens when we issue new guidance -- such as the non-traditional mortgage guidance -- is that the bankers start by conducting their own self-assessment. They look at their own risk-management practices, they look for where there might be exceptions or gaps between the practices they have in place today, and what their supervisors expect with respect to these new standards.

So that's the process that's really being undertaken right now -- our examiners, excuse me, our bankers are in the process of looking at their own practices, and then highlighting where it is they see differences between the practices they have in place, and what they understand these expectations to be in the new guidance.

Our examiners, then, can use those self-assessments to start their work in the institution, as they look at where there are higher profile issues. Scott mentioned that I'm responsible for advising our senior management on risk, and clearly where there's gaps between practice and expectation is where we'll want to focus our attention.

So, we'll have our examiners then working right now to take the guidance, to boil that down into examination procedures -- which we hope to have out to our full examination force early next year -- and then they'll take that template of examination procedures and use that to do the supervision work in the companies.

So, the self-assessments are underway, the examiners and risk specialists at the OCC are working on this template of examination procedures, and then starting mid-next year, early next year, we'll have what we call horizontal work done at these large companies that are offering non-traditional mortgages.

What that means is that we'll take a team of examiners -- and this will be what could call a rotating team -- so we'll take our examiners with the most experience in mortgage banking and send them out to these institutions and using this template they can look at what are the practices in each of the institutions, and again look for common areas of either inconsistency with the guidance, or perhaps, again, areas where there's some questions about interpretation. So that horizontal process will start next year, and again will be a useful tool, both for the OCC, but also as well for the other regulators as we have ongoing discussions about implementation of the guidance.

The objective, then, of that examination is really for examiners to ensure that the practices that we see in the industry are consistent with our expectations. And those practices that we'll be looking at focus on a couple of key areas.

The first one is really the quality of loan underwriting, and as Scott mentioned, there's a number of specific areas that we talk about in the guidance that we think are very important with respect to non-traditional mortgages.

One is to consider the payment, or to consider the impact, excuse me, of payment shocks -- how does that affect, again, the underwriting decision that's being made by the institution? The analysis of repayment capacity is a very important one. In this case, in the guidance we've made it clear that our expectation is for borrowers, excuse me, using these products, the bank needs to do an underwriting analysis that considers the fully indexed rate as well as full amortization of payment. So, we'll be looking again at the practices that are in place in the institution.

This is important because, again, with respect to negative amortization loans, we need to make sure that the consideration of repayment capacity takes into consideration an amount that may exceed the original balance of the loan.

Examiners will be looking at whether or not there's any new products, or changes in the terms for non-traditional mortgages that are offered by these institutions. They'll look for, as well, consideration as I mentioned of customer protection -- what are the types of communications that are taking place with the customer, are the disclosures timely, are they balanced, do they provide information about both risk and benefit?

And then we also have included in the guidance standards or expectations for portfolio risk management, and that includes a number of different aspects of managing the risks that are facing the bank as they're engaged in non-traditional mortgages. This would include things like control of concentrations for a bank with a large portfolio of non-traditional mortgages, only to make sure that they can understand that concentration, and again the types of risks that might pose to the institution.

Oversight of third parties, as you all are very well aware, there's a number of parties that can be involved in the mortgage origination, production, service and process. We have set an expectation in this guidance that our financial institutions will provide proper oversight of this relationship with a third party, so they'll need to make sure that they understand who they're doing business with, they've done the appropriate due diligence, and then again, have the processes to monitor those activities on an ongoing basis.

Activities in the secondary market are very important because, again, this can pose risk to the financial institution. So we'll expect our institutions, again, to have a contingency plan for any changes in demand in the secondary market, we'll expect them to consider the potential for an increase in loan re-purchases, and what that means, again, from a funding standpoint for the financial institutions. And we have expectations in the guidance about stress testing and the importance for an institution to understand how changes in interest rates, changes in employment, changes in the local economy may affect the performance on their non-traditional loan portfolio.

And then finally our examiners will be looking at the management information systems that are used by the institution to manage the portfolio of risk. This will include things like what types of information are reaching the senior levels of the institution, does it appropriately reflect the risk? Again, there's a number of risks that arise from these products, there can be credit risks, market risks, liquidity risks, operational risk, reputation risk for a bank that's involved, again, in either third-party originations, or selling into secondary markets.

And then finally our examiners will look at the adequacy of the capital and allowance to support the risk-taking activities in the institution.

So what kind of issues are examiners finding right now as they look at non-traditional mortgages? Well, with respect to loan terms and underwriting there's four areas where we seem to have the most inconsistency between practices in the industry and our expectations in the Guidance.

The first is that customers are not consistently qualified at the fully indexed rate for some products. So again, our expectation is that as banks underwrite things like payment-option ARMs that they use the fully indexed rate, but not the teaser rate to qualify a borrower.

The second is that customers are not consistency qualified assuming a full amortization repayment schedule. Again, taking things like the negative amortization loans, the expectation is that full amount would include any potential for negative amortization that may exist within the loan structure.

The third area, under loan terms and underwriting is that lenders are not including the amount that may accrue from negative amortization in that initial repayment analysis, so again, very similar to the second one that I mentioned of consistently qualifying based on the fully amortized and repayment schedule, and fully amortized and repayment amount.

And then the fourth issue is that lenders are underwriting products intended for sale into the secondary market that may not be consistent with the products that they retain on their balance sheet. In the guidance, we made it clear that our expectation is for an institution to have clear underwriting standards, and those standards should apply whether they retain the loan on balance sheet, or sell it into the secondary market.

There's two areas with respect to portfolio risk management that we have found some inconsistencies. One, we believe that bankers need to expand the policies they have for these risk-layering practices. As David mentioned, that can include things like the use of stated income, it can include things such as simultaneous second liens. What I'm saying is that the policies we're seeing in place in our institutions right now we do not believe are satisfactory to ensure that the risks are appropriately managed, and that's a general statement about a population of institutions, but clearly then an area where we expect bankers to make progress.

And then the stress-testing we see within the non-traditional mortgage portfolios is the second area in portfolio risk management that we believe needs improvement. I would note as one who spends a great deal of time examining banks that stress-testing is a challenge for financial institutions, not just in this area, but in many areas of risk management. But it's important here, because again we have a young market, a new market where we don't have a lot of history, and we believe it's a very prudent risk management practice for institutions to have sound stress-testing of these portfolios.

With customer protection, there's two areas that we see presenting, probably, the greatest challenge for the industry. One is that the customer disclosures, in our opinion, are frequently not complete or comprehensive, and are sometimes provided to a customer too late in the process. If the decision's already been made about the mortgage, it's going to be difficult, I think, for a customer to fully appreciate some of these disclosures. Rather, we would like to see the disclosures made earlier in the process, while the customer is still making a decision about the type of loan they would like to use to make the home purchase or refinance.

The second area where we find inconsistency with our expectation and practice is with respect to some of the promotional materials that are used with these non-traditional mortgages. Frequently, we find the promotional materials still focus primarily on that initial teaser rate, and do not provide the customer with enough information about the payment and the rate that will be used after that teaser period has ended. As David mentioned, we have a lot of these loans that are forthcoming with respect to re-sets, and the better a customer can understand what the impact of that change in rates will be on their own financial situation, I think the better and safer these business, these non-traditional mortgages or the business practice in mortgage lending will be.

So, in summary we have a sector of the mortgage market -- as we've noted -- a sector that is growing very rapidly, that we believe requires attention by the regulatory community as well as the financial institutions that are involved in these non-traditional mortgages.

We expect this business to continue growing, and as such, we want to make sure that the risk-control framework is good for customers, it's good for banks, it's good for the communities they're there to serve.

We have our banks underway right now, conducting their self-assessments, and our examiners will use that as the starting point for the work they'll be doing as they start to do more comprehensive examination work next year.

And it's also important to remember that examination requires the application of judgment. We include within our guidance standards, principles for how we believe this business should be conducted, but it will up to examiners to take those principles and boil those down into assessments of practices within individual institutions.

So, both within our own Agency, and across the regulatory community, we use processes -- as I indicated -- at the staff level to do what we can to make sure that that consistency applies throughout the institutions we supervise. We have a working group at the staff level that meets on a regular basis, they're the ones who pulled together this guidance, and they continue to meet and discuss any interpretation issues that arise, and again, certainly will be there to talk about any consistent application of the guidance that may be at issue.

We will be using these initial examinations to benchmark, if you will, what the practices are in the industry, and then again very carefully watching for trends in this market, because as we have a growing market, it will be important for us to look for anywhere where they may be business practices that are straying, if you will, from what we consider safe and sound lending.

So, I think you, and we'll pass it on to Lew.
(Applause.)

Lewis Ranieri: Thank you. I'm going to start off by making a comment which I made recently when I was talking to senior management of the Office of the Controller because I sometimes get carried away with my zeal on some of these topics, so I will tell you that in looking at all of these changes in the last two years -- which are staggering -- you have to keep proportionality. Just because we have things going on that we aren't particularly happy with, we have to step back and realize that it is not the totality of the mortgage market we're talking about, it is largely, mostly in the '05-'06 vintage, so it's mostly stuff of the last two years that we're referring to, so we're not playing Chicken Little, the whole housing market is not falling apart, we're just talking about serious issues, mostly of the last two years.

One of the little-noticed roles that Fannie and Freddie played in the market was as a sort of gatekeeper. Whether loans were Prime, or Alt-A, or Sub-prime, whether they are conforming or non-conforming -- everything was always written on agency-standard documentation. If it wasn't done to agency-standard docs, nobody bought it, and that acted as, in effect, a form of control and gatekeeper on what you could and could not do. That standard has completely gotten pushed aside. The rise of innovative mortgage products, coupled with enthusiastic investor support and consumer demand for affordable loans in a period of historically high housing prices has created an extraordinarily powerful private mortgage-backed security sector. By private mortgage-backed security sector, I'm basically talking about the mortgage-backed security sector that is not relying on underlying agency collateral.

This new market is unfettered in its enthusiasm, and unchecked by today's regulatory framework. How can I say that? It's because the Inter-Agency Task Force can't touch it. It draws from the capital market as its source of supply, so these loans are not going to portfolio lenders. They're -- 80 percent of loans today are generally originated by mortgage brokers -- it's a very different process then in the old days when most loans were made by a loan officer in a regulated institution who had to live with the result of what he was doing, whereas now, 80 percent of these loans are made by a manufacturer who frequently is not at the end of this process.

So, the gatekeepers of old, being the Inter-Agency Group in this room, and Fannie and Freddie have, to a degree, moved aside, and we have a quasi-gatekeeper in the rating service, and in the end, the real gatekeeper in this housing explosion and this explosion of affordability profit products -- that's the euphemism -- I don't even know if he's in the room. I went through the guest list to see if anybody from the SEC were here and I didn't notice a name -- and I don't mean to offend anybody, maybe the SEC is present -- but they weren't on the list. And in the end, that's the regulator of the capital market. That is the one who can touch this stuff and make a difference, and I'll talk about that in a minute.

In the past, the investors could understand and have faith in the underlying value of mortgage-backed securities. They were comprised, predominantly as you know, of fixed-rate -- or what we used to call "vanilla products" -- and there was no layering. One of the two principle rating services in a presentation last week told us that 52 percent of all of the securities they rated this year had, again the euphemism, "affordability products" within them.

Today, the transparency of the past has been obscured by a massive proliferation of new products, and as a consequence it is very difficult for investors -- institutional and otherwise -- to accurately quantify the value and the risk of the opportunities available to them -- IO's, Option ARMs, 80-10-10s, stated income, low doc, no doc, ABMs, automated evaluation models, forty-fifty year loans -- create instruments which can be combined in an innumerable combination and permutations. One of my favorites is the IO ARM, an interest-only or let's say a neg am ARM, combined with a simultaneous second as stated income and an AVM. Now, what that means in English is: I have a neg am loan, with a simultaneous second so it starts virtually at 100 percent loan-to-value, so almost any neg am puts it over 100, stated income which one of the great regulators now calls "liar loans", so we're not really sure what the guy's income is, and then if we use an AVM, we're not really sure what the house is worth, I mean, so you can understand why some of us become a little nervous at that process. And the combinations, as I said, can carry this into many layers, and then the advent of the CDO as a major distribution method, so that the RMBSs or MBSs get traunches or are frequently included in CDOs, and sometimes to really compound confusion, you can take traunches of CDOs and combine them into another CDO and I'll, again, talk about that in a minute as well.

I guess my point is that the mandated level of disclosure -- and I'm talking about for the capital markets -- has not kept up with the mortgage product innovation, making the risk levels in RMBSs neither readily apparent, nor easily quantifiable by investors of all forms, and I'll talk to that. Rating agencies, I believe, are struggling to keep up with this, having now been cast into the role of quasi-regulator which they don't want to be, but whether they like it or not, they're frequently the person in the middle. The standards for disclosure are being applied -- I would say -- haphazardly, and in the risk section of filings, occasionally they fail to mention the most obvious risk issues -- and I'll give you an example in a minute.

Therefore, transparency -- which is an expected norm is all regulated securities, securities markets -- such as the stock market, the stock market couldn't function without transparency. Investors are used to getting data. In the corporate bond market you're used to getting the data which allows you to do a deep dive on the corporation. If there's a guarantor, the data that allows you to do a deep dive on the guarantor. A market like the mortgage securities market needs the same thing. Historically, it wasn't so important, because we had agency collateral. And we had the norms that the agencies were imposing on the market. But in this big new world, where over 50 percent of securities this year have these types of loans in it, it's essential to require transparency, for the sake of both parties, both the homeowner and the investor.

Let me give you a couple of examples, so you won't think I'm totally off my rocker. I recently read a prospectus -- this is within the last two weeks -- of a very large, noted issuer of sub-prime loans, whose stock in trade is an 80/20 -- that's a basically 80 percent loan to value with a simultaneous 20 percent so it's in effect, a 100 percent loan-to-value. And in the risk section of his offering -- which by the way was not tiny, it was page 16 to page 36 so, I mean, there was a lot of risk section -- the problem was in that entire risk section, there was no mention of a combined LTV. Nor was there any mention at all of a silent second. So, you could read this whole sixteen some-odd pages, and it talked about a lot of risks, but it didn't mention the real risk that I would tell you was the risk in that security. It was the layering. Nobody said boo. It was a public security.

Now, it's not that the SEC is not trying. Within the last year we have Reg AB which -- I am not sure what AB stands for, it probably means asset-backed, but I'm not sure that that was exactly what AB meant -- but in Reg AB, in the free writing, we now get the offering circular, and we get a form of the loan tape. That's really, really important -- it at least gives us something to work with. But the problem is, it's creating a two-tiered market. In one of our companies which is a big asset manager, we spent over a million dollars to purchase the software to be able to re-engineer this stuff backwards, and we have a very expensive staff of people who can work with that data, who can work with the term sheet, who can work with the form of the loan tape we can get, but this is a public securities market -- it's not a private-placement market like the old days. This stuff doesn't just get sold to money managers. It gets sold to the public, it gets sold to foreign investors, who I will tell you, don't have a clue to ask for the free-writing stuff, and if you gave it to them, wouldn't know what to do with it -- this is supposed to be a public securities market. It's supposed to be equal information, equally available to all. Otherwise, it's not a public market, it's like the old private-placement market.

And that is the current state of affairs, I'm not criticizing the SEC, I think that was a tremendous advance forward. But it has its own implication, as to who can and can not, in fact, knowingly play with this stuff.

I'll give you another instance. An issuer recently found out that his senior loan administrator was playing with the docs to get better elevations out of the rating service. And he 'fessed up to the problem, he found it, nobody else did, and bought back all of the loans that were in the security. But that makes somebody like me ask, "Well, wait a minute. How did it get through the system?" You know, how did it get out there in the first place? There's supposed to be checks and balances, and the answer is, we rely much too much -- in my opinion -- on reps and warrantees. And, I agree we need the reps and warrantees, but it can't simply be reps and warrantees -- if you look at so much of this new stuff, we don't know about it until it happens, when the security underperforms, when you see it's unnaturally underperforming, the first question you say is, "Wait a minute, guys, what's in here that's making this behave?" As the investor, who's my agent? Who's going to go pull the loan tape, and make sure the loan tape is exactly the same as what really went into this thing? Where are the checks and balances in this new system that we built? Why is it a new system? Because we don't have a bunch of -- this is all new stuff, it's not agency collateral. It's new loan types that have had no testing.

So, if this is done by a big institution, with their reps and warrantees and their own internal, you know, audit and auditing and whatever -- I feel pretty good, you know, most of the time. Or at least I could have an argument. But that isn't the whole market. The whole market is done by, there's a lot of stuff that does not have the girth of a large institution with its mandated internal auditors and external auditors and everybody and his uncle trying to make sure they don't get themselves in trouble. The whole market doesn't work that way.

Let me give you an example, or let me give you one of the reasons that I'm concerned about this -- remember proportionality, I'm not saying the house, the building is falling -- many of our institutions have been whole loan buyers for over 20 years. It's become, for us recently, very difficult to buy whole loans. Mainly because the kickouts have become so high. We normally buy whole loans, we under-, the process is you buy them, you underwrite them later, and you, you know, you have an agreement with the seller. We normally kick out four or five percent, that's pretty typical.

Increasingly, lately we've been kicking out more and more loans, and then recently we just took the Inter-Agency Guidance and programmed it in, just to see what happened. We started kicking out 30 and 40 percent of some of these loan pools, and these are from reasonable originators, loan originators. Well, you can't do business that way. The fact is, you know, all's we'll do is have an argument and never get anywhere. So, we and others have recently just stopped buying whole loans. Because we can't do business with each other.

I asked one of these guys who I've done business with for most of my career -- I said, "Well, what do, if we now gotta go away, and we want to because the risks are not something we want, what are you doing with this stuff?" He said, "Ah, don't worry, we'll put them to securities." Okay? That's not an answer -- as somebody who thinks he had something to do with creating the securitized market -- I wanted to hear.

Now, I was talking about talking about the RMBS into CDO into CDO two -- you know, one of the questions you ask is with some of the most noxious forms of these problems you've heard about, layering -- who buys it? You know, who buys the subordinated traunches, who are the, you know, who's the guy who's taking all of this risk, since most of this stuff is in effect self-insured by the subordination of creating the traunches.

The answer is, in many cases it's nobody. It's no person, it is a thing. Because you take the subordinated traunches of the CMBS and then you stick it into a CDO, which tends to obfuscate -- because all of the disclosure you'd have in the RMBS becomes lessened by the fact that this is a smaller proportion in a CDO which is not a creature of the mortgage market, it's generally a creature of the corporate bond market, as an example, and if you want to see differences in disclosure in the risk section, just look at the disclosure in the RMBS and the disclosure in the CDO.

And those CDOs are not normally, or not largely sold to mortgage geeks. They're generally sold to non-mortgage investors, to some degree. Retail -- which really gives me the heartburn -- as well as foreign buyers.

Now, imagine then taking the support traunches of this CDO and putting it in another CDO, further diluting the information flow. Well, think about the likelihood of that third derivative buyer really understanding the risks entailed in what he just bought. Now, sure, somebody says, "Well they buy the senior traunches." Well, I know, I buy senior traunches. But I like senior traunches to remain what they got rated, you know, I like AAA to stay AAA -- just because it doesn't become worth zero doesn't make me happy if it gets downgraded -- so, my point here is that we've had an explosion of creativity. All of these classes of new products really work -- they have appropriate uses. They have inappropriate uses when applied to certain constituents. They can -- in many cases -- be combined to create a series of risks that I think, at least in my opinion, become intolerably -- I know there are arguments on both sides, and Robert is probably getting ready to throw one of the glasses at me, he said he had to come up after me to make sure he protected the Association after I talked, I realize that, so I acceded to let him come behind me -- but the, I'm not arguing that these products do not have value, that they cannot be used correctly. What I am arguing is for something that I do not believe you can take the other side of. That no public securities market can long exist if it does not have true transparency. And we, I will argue vociferously and be prepared to defend -- do not have true transparency. This outgrowth of the last two years has obfuscated the real risk quotient in many public securities.

(Applause.)

Robert Broeksmit: All right, I knew this would happen.

(Laughter.)

Robert Broeksmit: Five Ph.D.s in Economics before me, then a regulator telling me they put out some rules that nobody's following, then the guy who created the mortgage-backed securities saying everybody's fouling that up. So, it would seem to be a tough time to be a mortgage banker.

But, unemployment's about four and a half percent, fixed-rate mortgages are about six percent, Secretary Paulson says we've created 7 million new jobs since August of '03, inflation around 3 percent or so, the Dow's at an all-time high, and we're going to do two and a half trillion in originations in 2006, which will be our fourth best year ever, so I've got a little bit of a "glass half full" view of this thing.

So let me go into some of the points that we wanted to discuss on the dispersion of credit risk, and this is again a great thing for the U.S. banking industry, but can be problematic when viewed from the, through the lens of some of the topics we're talking about today.

The dispersion of credit risk via securitizations, and as Lew just said, internationally and into CDOs as well, mean that U.S. financial institutions are able to control the risk much better than they were before by taking it off their balance sheet. Now this does have the effect of delaying the reaction to lending policies when they get out of whack, and certainly -- Lew's been through some of them, and others -- this risk layering is an issue we all need to be concerned about. I'm sort of a quaint, old-fashioned guy who believes in a down payment -- thatÆs sort of out of vogue these days -- but when you don't have a down payment, and you don't have pristine credit, and perhaps your assets after closing aren't as high, you've got a much riskier loan than if you did have some of those good factors.

So, the fact that the risk gets sold off the bank's balance sheet means that by the time the end investors in these loans take a loss, it's a delayed cycle to get back to the originations, and to tighten the policies. But we are seeing it happen, particularly first in the sub-prime area where we're seeing some failures and a lot of consolidation, and this wave of early payment defaults where the buyers are now aggressively requesting repurchases, that has, that's having an effect, and will continue to have an effect.

So the market does have mechanisms to correct these things, they're not as rapid -- I don't believe -- as they were when more of this risk sat on banks' balance sheets, but it's also, in some ways, better for the U.S. financial system, because these risks are off the balance sheets of the banks.

The second point I'd like to make is the tension between regulation and innovation. And to talk about the record levels of home ownership that we have achieved in this country. And several years ago the industry was challenged and said, study after study shows the biggest obstacle to home ownership is saving up money for a down payment. So, down payment requirements were reduced and reduced and in some cases, eliminated, and now there's criticism of the industry for making available products that eliminate that down payment hurdle. So, how much is enough, where is the limit, and what is the tradeoff in expanding access to credit and therefore home ownership? And I'll pose a philosophical question and not posit an answer, we could have another whole seminar on it: what foreclosure rate is too high to accept? If we have, because of expansion of products and access to credit, if the foreclosure rate were 1.5 percent -- that means 98.5 out of 100 people get this loan and succeed in home ownership, and while we've seen some negative statistics about home price growth, I think, I don't believe there's a person in the room who would say that long-term it hasn't been a good investment to own your home, and a wealth-building activity.

So, if 98.5 of that 100 people succeed, is that good or is that bad because 1.5 don't? And I just throw out one and a half as a -- I mean, that's no where near where the number is, I'd just posit that as a question worth thinking about.

I want to get a little bit specific now and talk about one area of the Guidance that I believe lenders are having trouble getting their arms around, and it concerns how you qualify people -- not so much for an option ARM, because I think the fully indexed rate at a fully amortizing payment if not universal, is certainly widespread -- but on a hybrid ARM, by which I mean a loan that has a fixed interest rate for some number of years, and then adjusts usually annually, or semi-annually thereafter, five-one is one of the most popular.

We make five-one loans, interest-only, and we've been in the habit of qualifying them at the interest-only payment at the initial rate. So, I did a little math, a recent rate we were offering was 6.125 percent, $250,000 loan, the payment that we would qualify that borrower on would be about $1,276.00. The Guidance says that I should take the index plus the margin -- which is the fully amortized rate, I used a six month li-bor which was at 5.39, I added two and three quarters margin, I get 8.14 fully indexed rate, so about 200 basis points higher than six and an eighth, right? Eight point one four. And I'm going to use some principle, I'm going to amortize the principle as well. Now my payment has jumped to $1,858.00 from $1,276.00, so not quite six hundred dollars. That means that my borrower, making some assumptions about taxes and insurance and recurring monthly debt, which you do when you qualify a, when you calculate a qualifying ratio -- my borrower now has to have a 46 percent higher payment, and the income required for that loan has just jumped from $72,000 annually to $90,000 annually.

So, the industry is having trouble getting its arms around that, I would support what Kathy says that I don't think a lot of lenders have gone straight to that qualifying regime, and I think frankly it's hard to be the first to make that leap and say, all right, I'm going to ratchet up my qualifying materially and feed market share to those who don't follow in my footsteps. So, that's one of the things I know the industry is struggling with, and of course, there's another way to do that, which is to say, well I will let a borrower devote a higher percentage of his monthly income to this payment, just raise my qualifying ratio, which is a, certainly is an alternative, but it would seem as though that would run counter to the intent of the guidance, so that's one active topic in the industry today.

Let me just touch on the fear of asymmetrical regulation, I know that the state regulators have started to, have recommended to the states that they adopt the guidance, and some of the states have and others are contemplating it -- we worry about enforcement resources in the states, that it's uneven and Federally-regulated lenders, we hope will not be put at a disadvantage by that potential, asymmetrical regulation.

And, given the time and hoping that we -- I don't know -- might have time for a question or two, I want to conclude right there, and thank you very much for the opportunity to present.

(Applause.)

Scott Albinson: I'm not sure if we're getting kicked out or not, but let's see if we can squeeze in a quick question or so, and then we're going to have to clear the room for lunch. There's Claude the taskmaster, Claude, do we have time for a question? Okay.

Charles Turnbaugh: My name is Charles Turnbaugh, I'm a regulator in, for Maryland, and I'd like to address the question of Mr. Ranieri -- I'm very concerned about the transparency issue, and basically what happens when whoever it is who's purchasing these traunches that don't know what to do with it, or don't know what's in them, gets burned? I mean, I remember, vaguely, the Penn Central situation that shut down the entire commercial paper market. What do you foresee as a less than good case scenario if the mortgage market goes into the toilet?

Lewis Ranieri: It won't be the mortgage market, that's what I said -- remember I started out by saying proportionality? The mortgage market is very large, and we're not talking about the whole market, we're talking the risk resides mainly in the last two years when the rise in home price appreciation became so great that it spurred this affordability attempt, you know, that's where most of this comes from.

So, I do foresee in some securities -- we talked about sub-prime, but even in some of the prime because -- one of the reasons I keep grousing so much about this transparency issue is that what has happened, as you tighten up one thing it sort of tries to go the other place so as we're seeing more and more of amounts of these affordability loans put into what would otherwise be a prime security, so there's a portion of it, and so as an example, that asset management company I was talking about, we spend all of our time not looking at the main corpus of a security, but that tiny little portion which could actually make a big difference, though, I mean, it changes the numbers pretty dramatically.

So, the issue overwhelmingly becomes in the support traunches. The support traunches in some of those securities could get harmed very badly. The senior traunches you're talking about are the loss of a rating or two. The real risk -- the one I don't know how, I remember when we had the '97 Merriweather Debacle as it's called, you know, we were all able to get in the office, and there was the meeting in the New York Fed, and you put 12 guys in a room, and we knew how to deal with it. You know, we understood how the ripples would work and the system was able to be protected. The system we have now is, as Bob was talking about, much more complicated with credit derivatives and swapettes and TDX's and just the bewildering way that people now lay off, theoretically, lay off swaps -- that it's hard to understand, it would be hard to sort of pull together who's where in a credit problem.

So, as an example of the sub-prime, I'll give you an example. In the neg am ARM market a research study that I just read had 1 in 5 loans in the '05 vintage were already upside down, with a ten -- this means they had negative equity. A ten percent decline in housing value would put 40 percent upside down. That would give you much higher default and delinquency numbers than we were talking about here -- that's not my, I don't think we're actually going
to see that -- but that would literally be the numbers. I don't know how to understand the ripple effect through the system today of what that would mean. Because all sorts of people are holding the risk, who would be hard to track down and normally wouldn't even, in some cases, know that they're holding the risk. Am I answering your question?

Scott Albinson: I think we're going to have to stop.
(Laughter.)
(Applause.)

Scott Albinson: Now, I think everyone will have to clear the room, we're going to try to set up for lunch, so make an orderly exit toward the doors. And take your stuff with you, or put it on the chairs, thanks.

(Lunch recess 12:23 p.m.)
(Reconvene 12:19 p.m.)

John Reich: If I could have your attention, please. If I could have your attention, please. Your desserts are in the middle of the table on a plate. Thank you.

We are, I am delighted today to have as our luncheon speakers two very distinguished members of Congress: Congressman Mike Oxley and Congressman Barney Frank.

Congressman Oxley is from Findley, Ohio, has represented the Fourth Congressional District of Ohio with distinction since 1981. As Chairman of the House Financial Services Committee, he's been a consensus-builder, skillfully guiding a Committee of over 70 members through a wide range of legislative issues. He's led the way on a number of important pieces of legislation, including deposit insurance reform, and the recently passed regulatory relief legislation, which is near and dear to my own heart. But he likely will be forever identified and attached to his work as co-author of the Sarbanes-Oxley Act, which established new investor protections and set higher standards for corporate governance.

As you know, Chairman Oxley is retiring from Congress at the end of this term, Chairman Oxley, we're deeply grateful for your 25 years of patriotic service to our country as a Congressman from Ohio, and particularly for your service to the financial services industry as a long-term member and Chairman of the House Financial Services Committee. You'll be missed on Capital Hill and I'm sure that you'll also be missed on the Republican Congressional Baseball Team, which you have participated and led for so many years.

Please join me in welcoming Congressman Mike Oxley.

(Applause.)

Congressman Oxley: John, thank you very much for that kind introduction, and this may very well be my last speech as Chairman, so thank you all for the kind invitation and I look out and see so many familiar faces, people I worked with for all of these years. I guess the baseball team will go on, John, nobody's indispensable, but we have played that game for so many years, over 50 years now, and it's been a great tradition on Capital Hill. A lot of people back home think it's softball, I tell them we play hardball in Washington, in more ways than one, and we'll look forward to the game coming up this summer. But it's been a wonderful experience and a lot of people thought my power base really was Chairman of the Financial Services Committee, my real power base was manager of the Republican Baseball Team, because I had the power to decide who played and who didn't and who got to hit and who didn't, so that's a wonderful responsibility to have.

But it's good to be here, and with my good friend, Barney Frank, and we certainly look forward to his leadership coming up next year, he's proven to be a stalwart in so many ways on our Committee, and one of the things we pride ourselves on when I took over the Committee six years ago, this new Committee where we blended the jurisdiction that I brought over from Commerce -- the old cash and trash subcommittee, Finance and Hazardous Materials to the traditional banking committee -- and put together, I think, a committee, a large committee, second largest Committee in the Congress. But I think the proof is in the pudding, and we came through time and time again with strong bipartisan legislation, as a matter of fact, I can't think of one bill that we passed in the Committee in my six years that was not a bipartisan -- rather strongly bipartisan -- piece of legislation that passed overwhelmingly. Whether it was what became known as Sarbanes-Oxley which was like a three to one margin, Reg Relief, privacy legislation, all of the major bills that we did work on -- and I think perhaps that's the proudest thing that I take with me as I leave office. You know, I always get asked this question, naturally since I've retired from the Congress, "What do you do next?" or "What are you going to do next?" and I get that question all of the time here in Washington, as well as back home. And I'm fond of quoting Mike Tyson who, after his last fight, when they asked Mike Tyson what he was going to do next he said, "Who knows, I might just fade in Bolivia."

(Laughter.)

Congressman Oxley: So, that was pretty good. As a matter of fact, Barney said a couple of nice things about me when I retired and one of the things that he said, it was probably a slip-up, because Barney Frank is probably considered the funniest guy in the

Congress and -- or at least he's right up there with other guys like Pat Roberts -- but Barney, I think it must have been a slip of the tongue, actually called me funny, so it was kind of nice to have that good laugh after that Tyson quote.

Well, anyway, it's been extraordinary, and it was a great learning process for me, this orphan who came over after serving 14 years on the Commerce Committee to come over to this new Committee, meet a lot of people that I didn't know all that well from both sides of the aisle and form these coalitions, and it's been quite an extraordinary circumstance, to be able to work with some colleagues across the aisle, as well as across the Capital -- Paul Sarbanes is a, I didn't even know Paul Sarbanes, and he certainly didn't know me -- but it's amazing how fate can put people together, and our names will ever be remembered on our tombstones -- some would like it sooner rather than later -- but we've had a wonderful experience. And working with Paul Sarbanes who I consider to be a real pro and a real patriot, was a great experience for me.

He and I shared the podium here at the Press Club a couple of years ago, and talked about our experiences and answered questions and it was just a wonderful experience -- I learned a lot about him. The person who introduced me of course raised the baseball story and the fact that I was the manager, and Paul commented the fact that when he was in the House, he played on the Democrat team, I had no idea. He said when he was a kid growing up on the Eastern Shore, that he was picked to play on the American Legion All-Star Team for the State of Maryland, which is pretty significant. And he was just, I don't know, probably 17 or 18 years old. He said he went to his first practice in Baltimore, and the manager said "Sarbanes, get out on second base." And Paul said, "Well, I've always played shortstop, I've never played any other position than shortstop." And the manager said, "Well, we've already got a shortstop, his name's Al Kaline, so get out there." And of course, I'm a loyal Tigers fan, and I don't say that just because we got into the World Series this year, either, but I've been a long-time -- as a matter of fact, long-suffering-Tiger-fan for a long time was one word, as was long-suffering-Red-Sox-fan for a long, long time as well.

Well, anyway, it's been a real honor and I look back with a lot of fond memories and I think we got a lot completed. One of the things we didn't get completed is a frustration for me, and that, of course, is GSE reform. A lot of people, back when Richard Baker was a guy in the wilderness talking about GSE reform even before I came over to the Committee, never expected in their wildest dreams that the House -- let alone any Committee -- would pass legislation dealing with GSE reform.

But just like anything in this town, it takes a scandal, it takes a misdeed, it takes some missteps to get the kind of necessary force behind legislation. We saw that with Enron and World Com and we saw that with Fannie and Freddie and to a lesser extent the home loan banks, but it triggered a response by the Congress, and the fact is, as smart as everybody is up on the Hill and as omnipresent and omniscient as we are -- the fact is we're a pretty reactive body. We react to things that happen out there. We were, we reacted because of Enron and World Com and our constituents pounding on the table and saying -- in the case of CEOs, let's give them a fair trial and then hang 'em -- that was kind of the attitude we had during that, and that's the kind of thing you need to push legislation.

So, but we took advantage of that situation and we crafted a good legislation that many people never thought we could do, and not only that but went far beyond what Richard Baker had envisioned and would have taken in a heartbeat and we moved past that -- whether it was receivership, portfolio language, it was extraordinary, including the home loan banks. And I have to say that one of my frustrations was that we didn't get that across the goal line. And it is something that is sitting out there for my successor and I know he's been spoken before about the need to do that and how they want to move early next year, and I know Barney will have more to say about that later.

I guess it's just a frustration with folks who, in many cases, can't get their arms and legs away from the status quo. And yet the status quo needed to be changed and what we did by combining some of those reforms and creating a world-class regulator was to also add an affordable housing provision, thanks to a lot of leadership in this room that not only dealt with the broad issue of housing and affordable housing, in particular, but then we targeted it for the first few years to the point in need, of course, which is the Gulf Coast.

And, for that reason alone, it's frustrating that we are delaying the ability to get as much as $500 million a year down to that area because of our failures.

Politics is the art of the possible. It's pretty easy to write editorials in the top of the castle, but it's quite different to try to put together a package that can get 218 votes in the House and 51 in the Senate. And that's why they call it politics is the art of the possible, because that's what you do.

There's too many times when you permit the perfect to be the enemy of the good, you end up with the bad or the status quo, and in this case, it's one in the same. So, my frustration is that while people that I'm going to name were in my category "heroes" there are others that I'm not going to name that could have been a lot more effective in dealing with this issue.

Obviously, Richard Baker for his vision, his expertise and his enthusiasm on this issue. For a long time he was a one-trick pony and I told him so, but he persevered and without his leadership we couldn't have gone forward.

Barney Frank, who is one of the smartest and most effective legislators that I've dealt with in all of my career, both in the Congress and the State legislature.

Secretary Paulson, for his leadership and the fact that he came in, he understood it, he got it, and he works assiduously to do that. His man, Bob Steele who is here was another one who came down from Wall Street, understood the issues, worked so hard with my staff and Barney's staff to craft a compromise, as necessary to pass legislation.

And I've learned one thing around this place in 25 years. You're not going to get anything done in a Congress the size of ours, with the diversity that our Congress has without the ability to compromise -- and compromise is not a dirty word, it is in some quarters -- but the fact is that you can accomplish so much by working with people who have slightly different agendas slightly different ideas, but at the end of the day that package that we ultimately pass reflects the contributions of all of these folks, and the positive contributions that they do. And so that's why I've been so proud of the work that we did, and the good news is, and I'm going to leave the rest to Barney, is we've got a good package to start the ball rolling with, we don't have to reinvent the wheel -- I keep saying we, because I'm going to be in the bleachers, instead of playing -- but clearly my interests in my heart will be with that and with their efforts to do that, so I hope that's the case.

Let me also say that when I came into the chairmanship, I would have to freely admit that the least important thing on my agenda -- personal agenda -- and probably the area that I had the least knowledge about was housing. I mean, I knew about the capital markets, I knew about insurance, I knew about banking enough to be dangerous, but I didn't know a whole lot about housing. And I'd have to say that in my six years as Chairman, I absorbed and learned a lot about housing -- it's importance to the economy, it's importance to people's daily lives and the way the see themselves and their self-image, the importance to kids, and the studies have shown they do better in school -- all of that I eventually assimilated over a number of years, through hearings, through meeting with folks in the private sector and the public sector. And it's encouraging to know that we're at about 70 percent of home ownership, that minority home ownership is increasing -- not as fast as we would like, but it's starting to make some changes upward, and that's a positive thing. So housing has really been -- and of course housing really carried out economy during some tough times when some of the other industries were having some difficulties, so I appreciate that. I also appreciate the fact that my wife's a realtor and she continued in a tradition of keeping me in a lifestyle of which I've become accustomed, and I thank her very much for that.

(Laughter.)

Congressman Oxley: But clearly, home ownership has been an enormous part of our agenda, and that's really something that I'm very proud of.

We had some 84 housing-related hearings in the last six years, either in the Housing subcommittee, or in the full Committee, which culminated in 32 different pieces of legislation signed into law by the President. The American Dream Down Payment Act, which is a, I think, a landmark piece of legislation that can only grow and prosper over the years when we re-authorize it -- there I go again, "we", when they re-authorize it. FHA reform and there's more to do in that, affordable housing as I mentioned in the GSE bill, particularly with that provision in it, the HUD Section 8 program that we worked very closely with then-minority ranking member Barney Frank and others, and I learned an awful lot about the Section 8 program. And it's not a huge program in my Congressional District, but it is in a lot of members' districts and there were a lot of changes that needed to be made and we put our efforts into trying to reform that overly burdensome rental assistance program.

There's been a lot of talk about the housing bubble and what's gone on in the bubble -- you know, that's how markets work and while the housing growth has subsided somewhat, I'd have to say certainly in the different markets it was unrealistically overheated, it really drove a lot of people out of the marketplace because of the rising costs. I saw it in my own household when my wife would tell me stories about buyers she would represent and they would make a bid on a house that was the asking price and in one case she had a couple who was in from out of town and they bid on it, and they bid the full asking price and they waived the home inspection and all of that kind of stuff, and they finished seventh in the race for this house. Obviously you can't sustain that, and so as a result you're going to see some modifications, and at the same time, some people now are going to find themselves to be able to buy some of those homes that they heretofore couldn't do -- younger people, starter homes and the like.

So, I think the market will take care of itself if we don't overreact to that particular situation. Part of it is a result of, again, the marketplace being, to quote a great American "overly exuberant" that was based, perhaps on interest-only loans, boutique mortgages and the like that pulled a lot of those people in.

So, I'm bullish on the housing market, and I suspect we're going to be successfully looking at a solid rebound in the housing market.

Flood insurance and homeowner's insurance, that was another issue that I thought we could have dealt with. We've had to raise the borrowing authority under FEMA for flood insurance -- this is staggering -- first we raised it to 3.5 billion. Then a few months later -- or was it weeks -- 18.5 billion, then 20.8 billion, and FEMA tells us that it's still not enough to cover all of the claims just from last year.

When all of this is said and done the NFIP will need $25 billion to pay all of those claims. Twenty five billion dollars. Now, that is something that we have an obligation -- this is not discretionary spending -- I say it to my conservative colleagues, this is a commitment by the Federal government to pay those premiums, and to pay those people who, in fact, paid the premiums, and reimburse them. And we have an obligation -- it seems to me and I know Barney shares this same feeling -- that we need to reform that program. We can't ask those folks who are dutifully paying their premiums that we're going to stiff them and allow other people who have taken advantage of the program to build and re-build and re-build in flood-prone areas, we just simply can't do that and we're not going to do it, and I think that that is critical. Unfortunately, not able to get that completed in the other body, another one that never got out of that other body.

Speaking of the other body, I had -- one of my protTgTe, one of my mentors in politics once said, when I was very frustrated with the other body, which is quite a bit -- he said, "Oxley, you've got to understand one thing. The Democrats are the opposition, the Senate is the enemy."

(Laughter.)

Congressman Oxley: And it is incredibly true.

But in closing, let me just give my best wishes to Barney and to Spencer Baccus, the newly-designated minority representative, the Ranking Member on the Committee. I'm sure they're going to continue our tradition of bipartisanship, solving problems, getting the job done in an efficient and effective manner, and that's really at the end of the day what we get elected to do, is solve problems and work on those, and not give speeches and pat ourselves on the back. And Barney and I may be a lot different, but we're pretty much the same in feeling that we have an obligation to our constituents and to the country to get the job done without a lot of extra falderal and the like, let's just get on with the job and get it done. That's been my attitude, that's been his attitude, that's why we've worked together so well the last four years for our country and for the financial markets, and in this case in housing, as well.

So, it has been a thrill, it has been an honor, it's been a fast 25 years, and it's certainly been the last six -- very quick. But I take with me a lot of pride, and a lot of thanks to a lot of people in this room for making it reality. Thank you all very much.

(Applause.)

John Reich: Thank you, Chairman Oxley. It's my honor and privilege now to introduce our next speaker, Congressman Barney Frank, Chairman-designate of the House Financial Services Committee.

Congressman Frank has represented Masschusetts' Fourth Congressional District also since 1981, and previously Mr. Frank served in the Massachusetts legislature and as the Chief Assistant to the Mayor of Boston.

He's also taught part-time at the University of Massachusetts at the John F. Kennedy School of Government at Harvard and at Boston University.

In 2004 and again in 2006, a survey of Capital Hill staffers published in the Washingtonian Magazine gave Mr. Frank the title of "The Brainiest" -- is that a word? -- Democratic member of the House of Representatives. In the same survey he was also listed as the funniest member, which Chairman Oxley just referenced. Anyone who knows him or has testified before him knows that those labels are well-deserved.

I'll take this opportunity to express my appreciation to Congressman Frank for your active leadership and support of the recently enacted Reg Relief Bill, please join me in giving a warm welcome to Chairman-designate Barney Frank.

(Applause.)

Congressman Frank: Thank you. Thank you, I should just be glad that while we both had University of Massachusetts faculty affiliation, Sheila and I never met at the Faculty Club because several decades and several hundred -- about a hundred miles -- separated our, where we were. But it is nice to be here.

And first of all, I'm delighted to have this last chance to make a joint appearance with Mike Oxley. Because I think it's important, what we try to do is to show what partisanship and bipartisanship mean. And bipartisanship is very important -- so is partisanship. There has never been a democracy in the history of the world that functioned without political parties. When large numbers of people want to govern themselves, they just naturally form parties.

Remember in America, the people who wrote the Constitution hated political parties, they wrote articles about what a bad thing they were, while they were forming them.

(Laughter.)

Congressman Frank: Because you just, otherwise you have a bunch of people milling around. Partisanship is essential. Partisanship becomes a problem when the differences that are legitimately expressed through parties become so embittering that they prevent cooperation where the differences don't exist. And I think that's what we've been able to do on our Committee.

Yes, there have been some partisan differences, I only had one foot in the door when Mike said, he said, none of the bills -- all the bills that went through went through on a bipartisan basis, and that is true. We had some we wanted that he wouldn't bring up, so that's the answer.

(Laughter.)

Congressman Frank: The partisan ones never reached it, but that's legitimate, that's what being in the majority means, there were elections, the majority wins, and they have the right to carry these things out. As I said, the important thing is not to let -- it is equally a mistake, it seems to me, to suppress legitimate differences -- and one of these things that I find very annoying is when the press talks about partisan bickering. I don't think Henry Clay and John C. Calhoun engaged in "partisan bickering" but I'm sure some yo-yo at the time said that they were.

(Laughter.)

Congressman Frank: I mean, that's legitimate discussions of differences of opinion is an important part of democracy. What we've been able to do is, in some areas, have some differences and in other areas where we didn't, we didn't let the one spill over into the other.

The differences were fewest in the financial services area. Where frankly you're talking about some intellectual issues, some issues about how the market functions. There were some differences in emphasis on some consumer things, but I think people are going to see far less difference with the Democrats taking over in the financial services/regulatory area than in virtually any other area of public policy, because we did work together on things like regulatory relief, and we have more to do.

And indeed, where there are consumer issues -- as there are -- my preference will be to try to find ways to incentivize the market to take care of them. Let me give you one example -- on the question of data privacy.

There are two things that I think should be in any bill. Now, we fell apart on that because there was just too much jurisdictional dispute, and I proposed a policy that we take, I think there were three major Committees: Energy & Commerce, Financial Services & Judiciary -- and Ways & Means a little bit because they have Social Security -- and we start working together beforehand. Because when each Committee does its own thing and then you get to the end, egos have engaged and it's harder to reconcile. And I am going to work for us to do that.

But there are two principles that I care strongly about -- first of all, the greater the likelihood that the material will be misused, that should determine how much expense and obloquy the entity has to experience to make it public. The beauty of that is that it gives the people an incentive to encrypt the date.

Now, I don't think we should order people to encrypt the data because that's a technological and other kind of issue, and there are some competitive issues there. But I do think, the principle that says, "The more likely you are to keep that data secret, the less you are going to have to go through the aggravation" that just gives the market a natural incentive to encrypt.

Secondly, as the banks have pointed out to me, there was this agreement out of the credit card contracts whereby the retailer does not have to own up to having been the place where the slip-up happened. And we will put in the bill that the entity where the slip-up happened is the entity that has to bear the responsibility.

So, you take those two together -- and our job should be not to protect people against data breaches -- but to the extent possible, minimize data breaches. And that's the approach that I will try to take in other areas as well.

The market is a wonderful thing, but it does leave some things undone -- there are some things it's not supposed to do. With regard to -- and the regulators know I feel this way -- although we don't know what's going to happen in the Wachovia case, but in general, given preemption of state laws, the biggest difference that makes to me is in consumer protection, and I do think it is important for us at the Federal level, to the extent that we have cancelled out what states have done, to show that we have adequate substitutes. And you've heard me say this before -- I would rather -- and I understand this, if I were Susan, I would rather think about the implications for the World of Bozzel, then worry about some guy who got in a fight with his bank over whether or not he cashed his check in time.

Consumer protection is generally not fun. It is a series of he said/she said disputes between cranky people and the institutions that they deal with. They're cranky by the time they get to us, no matter how cheerful they started out.
(Laughter.)

Congressman Frank: And the reason you have more consumer protection down at the state level is very simple -- there are more people running for office at the state level, and you do consumer protection because you have votes. And so we have got to make sure at the national level now that we recreate the state's consumer protection apparatus that has been diminished. And again, that's the approach that I think we have to take.

But now let me turn to housing -- we have more to do yet in the de-regulation -- I'm just saying one of things we did was to try to reduce the reporting requirement from the banks to the financial detectives, and far too much has to be reported now, in my judgment, of a routine nature and the metaphor I use is that we have told the law enforcement people to find a bunch of needles, and then we have set about building them a very big haystack, and we ought to thin that down so they can do a better job.

One of the things I want to stress to my liberal friends is, excessive regulation, or ineffective regulation is bad for regulation. Regulation is very important. The market does need some corrections. But, if you over-do it, then you weaken your case.

But now as to housing. That is the biggest difference between us -- there were areas where we worked together, and the GSE bill is a good example of that -- and I would say, you know, it's football season, I think we're about on the 10-yard line. And I think we're about to put this thing together. We have enjoyed working with Secretary Paulson, and I will now, having said that, apologize to him for the Wall Street Journal editorial that will come, denouncing him for that fact.

(Laughter.)

Congressman Frank: Oxley, Oxley used to get one of those a month. But we have come together on a, I think, a reasonable framework, and I believe we will be able to get a bill through, but there's some philosophical issues here, and I want to say that's what held up thing.

First of all, I welcome the chance, and part of the problem is the cynicism with which this gets written about. I have come to believe that the greatest and most disabling form of naivetT in Washington is excessive cynicism. There are people who are so afraid of being taken as nanve, that they automatically assume the worst about everybody. And in fact, much of what we do, indeed most of what we do, we do on the merits in the Congress, and elected officials. That's why we're there. Yeah, people need to raise funds, but we raise campaign funds -- remember, that's the means to the end -- the end is getting elected and staying in office.  If we just wanted to make money, almost none of us will be in the jobs.  Mike is going to make a lot more money in Bolivia then he made in the Congress.

(Laughter.)

Congressman Frank:  And maybe he, oh, he mentioned his wife's a realtor -- talk about sleeping with the enemy --

(Laughter.)

Congressman Frank:  But we're there to do what we think is the right thing.  Of course we take these other things into account, and that frankly disturbed me on the GSE thing, and I think one of the things we managed to tell people was no, including summers we weren't doing anything for Fannie Mae or Freddie Mac, at least most of us.  For me, the motivation was housing.  We were doing something for housing.  And I agreed with those who argued that because of the markets' perceptions, Fannie Mae and Freddie Mac got this great benefit and began being able to borrow money cheaply, but that the benefit was not being adequately returned to the public.

Now there were two things you could have done about that.  You could have reduced the benefit.  You could have cut back on their ability, in effect, to borrow as cheaply.  Or, you could leave that benefit in place and distribute it more fairly, that's what we chose to do with the Affordable Housing Fund.  And again, that is, not in either case -- in both cases, from the standpoint of Fannie and Freddie and the stockholders, they were going to lose something.  We had a philosophical debate about where it should go.

Now, the philosophical debate was, in part, I think based on a view, a legitimately held view by a number of very conservative people, and I think this has changed in some of the country -- and there was this view that, and I've heard Alan Greenspan express it -- the Federal housing policy in many ways is an inappropriate intervention into the allocative function of the capital market.  There is a view that says we would be better off if we left the capital market alone and did not introduce into it a preference for housing, which we do in various ways.

And I believe socially that was a mistake, I think there's now some economic view that it was a mistake, Mike talked about some of this, and I think -- particularly in terms of socially -- for instance, we talked about the homelessness problem.  Let's be very clear: You can do nothing to diminish homelessness if you don't create more affordable housing.  I mean, this is a case to be rid of -- home-less.  They don't have any homes.  It's not that they don't have medical care, it's not that they don't have enough mental health treatment, all those things they should get -- but being homeless means they don't have homes.  And if we don't do something -- and by the way, very few of them are going to be able to become homeowners -- you're not going to go from living on the street corner to buying a home, I don't care where it is.  There's going to have to be this intermediate set of steps.

You talk about family values -- homes are the center of families, Mike said, you know, I think one of the problems we have with the public schools is that we hold teachers accountable for the fact that kids come to them having lived lousy lives in lousy home settings, and there are limits to what you can do to overcome that a few hours  a week, when people have had those years, and much of the time is back there.  A decent home is not, of course, the answer.  Nothing is ever the answer, but they are helpful, and it also is a major economic factor for most people in this country -- the stock market having gone and up and down -- but for most people the only chance they are going to have to achieve really significant wealth is in a home, because it's a form of, kind of, forced savings.

Now, having said that, let me say I am glad that housing prices are dropping.  And I do want to address this thing about the bubble.  No, I think the bubble is an entirely inappropriate metaphor.  Let me just be very clear -- houses ain't tulips.  Houses today -- even with the drop in housing prices -- are more valuable than tulips were however many hundred years ago we had the tulip business.  People still need places to live, in fact, there is a large demand out there that as of yet is unmet, as Mike said.  In fact, I think that it's a good thing that the housing prices are dropping.  A few speculators get stung -- that's icing on the cake.

(Laughter.)

Congressman Frank:  The cake, the cake is, the cake is that people can afford to buy houses now.  And a 10 percent drop in housing prices is a good thing, housing was overvalued.  But let me make this distinction, and why I think it's not a bubble, and I'm just thinking about this as Mike was talking -- it was maybe housing suffered from irrational exuberance.  But bubbles, in history, have not been cases of irrational exuberance -- they have been cases of exuberant irrationality, and there really is a distinction.

Irrational exuberance means you get all carried away with something that is basically a good thing.  But the exuberant irrationality is when you start thinking that tulips or some of those dumb ideas on the internet when they were selling things that nobody in their right mind ever wanted to buy -- those were excessive.

It's also not the same as the Savings & Loan crisis.  As I remember, the Savings & Loan crisis, we had a lot of empty land out there that had been greatly overvalued and I also believe that one of the major causes for that was some irrationality on the Congressional part that is in the 1981 Tax Act -- endowing man with buildings with enormous value, artificially inflated -- and then taking it away in '86.  I don't think there's ever been a case of going from one extreme to another in public policy like what we did with some of those buildings.

But housing is somewhat overpriced, in fact, I remember when I was younger the rule of thumb was that you were supposed to pay, maybe 25 percent of your income for housing. Somehow over the last 15 years, it got to the point where housing was supposed to contribute 25 percent of your income.

(Laughter.)

Congressman Frank: I mean, people are indignant that, what sort of suddenly happened, people became indignant that they weren't making money off of living in their house, "I went home today and I made $80," you are supposed to pay something, let's get back to a more normal situation so that we can extend housing.

And I, again, that doesn't mean we want to encourage this and we've got to be careful about the way in which it happens, but fundamentally I don't think there was a crisis and I do think the end result in a 10 percent drop in many parts of the country will be a more rational and healthier housing market.

So the other question is -- what does the government do about it? Well, I do think we should keep a couple of principles in mind. First of all, on the Section 8 Program, and this is going to be the biggest difference -- we will get the Federal Government back into a program of preserving and building affordable housing. And Section 8 is a good program, and certainly it is better than none. But the current Section 8 program is -- as you know -- an annual program. You get a voucher for one year, and the landlord gets one year's promise from the Federal government to rent to a tenant. You literally cannot take that to the bank. The bank regulators are here. If I tried to borrow money and my collateral was that I hoped to get Section 8 certificates for the next 20 years, I think you would be unhappy. And in that criticism of commercial real estate, I would agree with you -- not in the other.

In the, the problem we have with the Section 8 Program is that it puts money into the rental market, but in a way that does not contribute to any construction, in other words, in fundamental economic terms, if all you have is the Section 8 Program and no production program, you are adding to the demand for housing in a way that cannot help the supply, results higher prices. Now, it has equity, and that's better than nothing, but I think it has to be accompanied by a sensible housing production program, partly the Affordable Housing Fund that we have put into Fannie Mae & Freddie Mac, which is as you know -- many of you -- based on what Henry Gonzales did with the Federal Home Loan Banks, and that has been a very successful program, people talked about how terrible it was going to be, it is a very successful program, very little scandal -- I've heard of none -- and so we do believe there is a need to add to affordable housing.

When you add to affordable housing, by the way, and that's the argument -- if you look at Section 8 alone, you're driving up housing prices. That's why when we do an affordable housing production program, we are not just helping the low income people who qualify for the affordable housing, we are reducing the strain on housing across the board -- it's a spectrum -- and we will be building more housing that more people can live in.

A couple of other points I want to make in this -- home ownership, a very important thing, but let's be very clear. There are large numbers of people in this country who will spend all of their lives as renters. And I am troubled by a tendency to denigrate renting. This notion that only homeowners are responsible, et cetera -- there are a lot of responsible people who rent. There are other people who rent by choice, I rent now because when something breaks, I want to call somebody and not have to worry about it. I have other things on my mind, I'm also, I mean, I'm, I, you know, we all have a certain mix of talents and not talents -- I'm pretty good with words, but I'm not so good with things.

(Laughter.)

Congressman Frank: I have had a lifelong struggle with things, and the less I am the one responsible for dealing with them, the better off everybody is.

(Laughter.)

Congressman Frank: Renting is an important thing and the poorest people and a lot of people are going to rent -- many people are going to rent all of their lives. Let's not denigrate renting, and let's remember that construction of rental housing is an important piece of this.

Secondly, then, as to home ownership, one other important point I want to make, and that is I do want to extend home ownership, and we should be clear with regard to predatory lending, and we're going to try to deal with that and it'll be one of our higher legislative priorities. We didn't -- but we have to be careful how we do it – we didn't used to have predatory lending. We had a very effective way of preventing predatory lending. It was called red-lining. And the people who now get predatory loans, couldn't get a loan, and we don't want to recreate the one bad situation -- you cannot overdo it. Remember, even with the things we're talking about now, at this point, the great majority of people who get the loans repay them. Let's not penalize the majority of responsible borrowers because there has been some abuses.

And particularly there's one thing we have to do about this, and I'll give you an example of one of the things I hope to do legislatively. The FHA came forth -- I don't know if the Commissioner is here, I saw his nameplate -- and they had a very constructive notion of expanding the FHA downward, so that people who are not now eligible for FHA mortgage insurance because of their economic situation, would become eligible for it.

But, they said, the problem is that when you go down to that stratum, you're going to have more losses. So, the people in the lower income categories, and in the less wealthy categories -- relative for qualifying for mortgages -- they will have to pay more for their mortgage insurance.

They will pay more up front, a point or two, and then they will pay a higher mortgage premium. And that's to offset the losses that will happen because we are lending to people in that stratum.

The problem is that that takes the great majority of very responsible low-income people, who are going to make their payments, and makes them pay for the minority that aren't going to be able to make the payments. So, you're doing the low-income people a favor in the large, but if it's gotta be internally self-financed, it really is kind of cruel. And what you're saying is, the low-income people who are going to make the payments have to pay for the low-income people who aren't.

Now, I wanted to deal with that, and we did deal with it some, and I appreciated Commissioner Montgomery negotiating with us, and we tried to get somewhere with the help, by the way -- let me just, I wanna, you know, talking about cynicism and everything -- Mike quite correctly pointed out that while we have a difference on production, we did get a lot done in housing, and let me mention one of the people who deserves some credit for this is Bob Nay. People are mixes in things, and Bob Nay and Maxine Wardiff were the odd couple of housing, and between them managed to get a number of things done.

But, what we were told was, "Okay, let's extend the FHA downward to help the low income people," I'm for that, but not by having the 90 plus percent of low-income people who are going to make the payments have to pay extra for the eight or ten percent who won't.

We have another issue which is -- and this is one that I know gives people some concern both with Fannie and Freddie and with the FHA -- we have an upper limit on the amount of house that we can pay for either through the FHA mortgage premium or that Fannie and Freddie can buy. And the purpose of it is to keep Fannie and Freddie and the FHA out of the luxury housing market, and it works very well. They cannot buy or insure luxury housing in Nebraska. And they cannot buy or insure luxury housing in Los Angeles, Boston or San Francisco. They cannot buy or build any housing in Boston, Los Angeles or San Francisco.

(Laughter.)

Congressman Frank: And, in fact if you look at housing policy, whether it's Section 8 or anything else -- no price in America varies as much as housing prices, by geography. Because it's not mobile. Prices of mobile commodities -- a car costs more in Illinois than it costs in Mississippi, nobody sells a car in Illinois -- housing you can't do that.

What I am proposing with many of my colleagues is that instead of a flat dollar amount, that we meet the principle of not having the FHA or Fannie and Freddie subsidize luxury housing, but that they be allowed to do the median-priced house, and so you use a median price.

Now, leave aside the Fannie and Freddie issue, which we will get to later, but in the FHA here's the advantage to that. The Congressional Budget Office gives us a positive dollar score if the FHA is allowed to go to a median house price rather than a flat dollar limit in the high-cost areas. What I'm going to come up with -- I believe I have support in the Committee on my side -- is a bill that gets the FHA into that upper reach, takes the money the Federal government will be credited with by CBO and use that to subsidize the higher loan loss rate for people at the lower end. That seems to me the kind of way that we can do this in a reasonable way.

And I would hope -- and somebody pointed out -- to the extend that we do that, by the way, you can also help with predatory lending, give people an alternative, let people who might be in the predatory category get into the FHA situation, and it's improved. But that's one of the principles that I want to talk about when we go to predatory, as well. Yes, the great majority of people in this category are going to make their payments, and we have got to make up for losses, but we should not make up for the losses by putting the burden on the back of the people who are in the lowest category.

So, one other thing that we plan to do -- by the way -- the one production program for families that has continued to work is the Low Income Housing Tax Credit, which is very highly regarded. Once again, you get into a regional problem -- the level of subsidy you need to make housing affordable for people in the lower income brackets in many parts of the country is so great that the Low Income Housing Tax Credit by itself doesn't work, and so people, developers work, they take the Low Income Housing Tax Credit and they make it work with other Federal and state programs -- State Housing Finance Agency programs, the HOME Program, Community Development and grants, et cetera.

I am told by people in the business that it is inordinately complicated to make those work, that you run into all kinds of different sort of rules about thing.

Johnny Wrangleman and I have staff working -- we started the day after the election -- to make the Low Income Housing Tax Credit fully and easily inter-operative with every other housing program. And that, we are told, will save a lot of transaction costs and a lot of time, and won't cost the Federal government a nickel, so that's another area that we are moving.

But finally, we will be pushing for a housing production program. I'm a great believer in the market, but there are market failures, people get Nobel Prizes in Economics for market failures, and the housing market is one of those. There just are glitches, and I think it is not healthy in this country for people of very low income to be living in desperate straights, and we ought to help them build housing.

It's also not acceptable -- let me just, for a minute, talk about the HMDA data -- by the way I'm glad, I remember when the HMDA data, when the notion of getting the data was very controversial, when Joe Kennedy had to fight for it, but we do know that the data shows it irrefutably: If you are black or Hispanic, you have less chance to get a mortgage, and more chance to pay more for one. I know it's not entirely racism, on the other hand, we haven't totally abolished hundreds of years of racism in a few decades. Whatever the cause, it's unacceptable in America, and I really do hope that we will be able to work thoroughly together -- the industry, the consumer groups, the representatives, the minorities, the regulators -- we have to diminish this disparity, it simply is not acceptable in America for people who are black and Hispanic to have less chance of buying a home, or to have to pay more for having to buy the home, virtually everything else being equal. And that we will work on and I hope we will get rid of it.

We will also, as I said, do a housing production program, because there is a need. One last point I would ask us all to join in. The biggest obstacle to building affordable housing, especially once we get some of these things put in place, is sadly democracy.

Now, I've said this before. We politicians make a lot of mistakes, the regulators aren't always perfect, other people do things wrong, but let's be honest and recognize that sometimes the voters are no bargain, either.

(Laughter.)

Congressman Frank: The major obstacle we run now in trying to build affordable housing is not, I guess it's not irrational exuberance, it's irrational nihilism, irrational negativism -- oh my God, poor people are going to live next to me, that'll be the end of my life. One of the things I plan to do is to try and gather statistics on how inaccurate is the perception that when subsidized housing that's done right -- yeah, nobody wanted to live next to Columbia Point or Pruitt-Igo or Cabrini Green, nobody wanted to live in there, much less next to it -- but that wasn't the poor people's fault, we built lousy stuff. We built these great slabs, et cetera. You can build affordable housing that's economically integrated, that's architecturally appropriate, you can do all of these things -- if you have enough money. The less money you have, then the worse that building is going to be in terms of social services and all of that.

But I hope we will have a uniform effort to come together and try and overcome this resistance to building housing anywhere. And one of the things I want to do, as I said, is to -- one of the set of hearings I'm going to have, we have had hearings about, we often have hearings, as Mike said correctly, scandal is what does it, and sometimes we have hearings in which we, a scandal has happened and we are very indignant about the fact that other people didn't do anything about that scandal, not mentioning that we could have done something, too, but that's okay.

(Laughter.)

Congressman Frank: We often talk about the failure to anticipate scandal. I want to do another set of hearings, as well, those are important -- but that is the anticipation of the scandals that didn't happen.

(Laughter.)

Congressman Frank: You know the line about the indicator that predicted 8 out of the last 4 recessions. We have this mindset that sees disaster, in fact, as several of you know I had a riddle at one time -- what does the expensing of stock options have in common with same-sex marriage in Massachusetts? And the answer is: In both cases people predicted terrible, terrible consequences, and they were implemented and nobody even remembers what the problem was supposed to be. I want to gather up some of these objections to, "Oh my God, if you build housing near me it's going to be terrible!" and show how little that had. But we really all need to work together.

That, by the way -- and I will end it with this, I've gone on too long -- but that's one reason why another major thing of ours will be preservation of existing affordable housing, housing that was built under various programs, 221(d)(3) and 236 and some state agencies. The reason is this: Buying out the right of a landlord -- the landlord's got the right under many of these programs for it no longer to be affordable after the mortgage is paid off -- buying out from the landlord the right to convert that unit into a market-rate unit, is almost certainly cheaper than building the unit de novo, but one thing I know is the case, that housing is already there, and you obviate that whole zoning fight. Protecting existing affordable housing ought to be something we all come to -- I'm talking about hundreds of thousands of units in the country -- and protecting that means that we get those units with less social disruption and no political effort. So, that is going to be our agenda.

I just want to close by acknowledging what a pleasure it's been to work with Mike Oxley personally, and the personal and the political come together. And Mike and I have had some disagreements, obviously, on issues -- we're in different parties -- but I think what I most treasure about our relationship is that we did set this example that you take the things where you disagree, and you argue about them civilly and then you turn your attention to the things that you agree with and you do not allow the fact of disagreement in any way, shape or form diminish your ability to work together. That was, I think, the recipe for a fairly successful Committee over four years, and I intend to carry it on. Thank you.

(Applause.)

John Reich: Thank you very much Chairman Oxley, and thank you very much Chairman Frank. As a Federal bank regulator, I look forward to the opportunity to be on the receiving end of your verbal capabilities and our future testimony before the House Financial Services Committee.

What? Ten minute break? At this time we are going to take a 10 minute break, I would -- we have two panels this afternoon, followed by a reception and as I mentioned this morning, Chairman Ben Biernacki will be joining us at the reception. Thank you, ten minutes, 2:20.

(Recess 2:15 p.m.)
(Reconvene 2:27 p.m.)

Scott Polakoff: So, I have good news and bad news. The good news is that I was actually supposed to get up here and get this panel started right after lunch, with the caveat that there was going to be no afternoon break so I could watch you all squirm a little bit, but there was a break, so that's the good news.

The bad news is we're behind on our schedule, and we need to make some slight modifications, so we're going to ask each of the remaining two groups to cut their presentations short by 15 minutes, which will allow us to still attempt to end the day at 4:45 for our reception.

So with that, I'm going to briefly introduce Montrice Yakimov and all of the bios are in the book, so this is just going to be a quick overview.

Montrice is the Assistant Managing Director with OTS and has responsibility for compliance and consumer protection. She has previously held positions as Manager, Community Affairs for the Federal Reserve Board, Senior Vice-President and Director of Regulatory Affairs at the Conference of State Banks Supervisors and as Deputy Director for the State of Delaware Banking Department. Please let me turn it over to Montrice.

(Applause.)

Montrice Yakimov: Thanks, Scott. Hi, everybody. Our theme, Critical Consumer Protection Issues in Housing Finance was designed to be broad. Our goal at OTS for this panel was to have a conversation among industry leaders and experts from different vantage points, as you will hear, focused on mortgage-related consumer protection challenges.

We wanted to talk about what's working for consumers in today's housing market. It's been said, and was recently announced by the Economic Policy Institute that nearly 69 percent of all Americans own their own homes, that's a good thing.

We also wanted to talk about challenges that consumers are facing, like rising delinquencies among sub-prime borrowers. Like the fact that -- as consumers choose non-amortizing mortgage products, they're facing lower levels of home equity and payment shock. Many consumers are struggling with affordable housing options. We're also seeing rising levels of foreclosure in various parts of the country. There's no shortage of challenges facing consumers today. So, I wanted to engage in a dialogue about issues like these.

For our topic, our panel will really focus on three core things: One, we're going to explore some of the various roles the Government plays in protecting consumers in mortgage transactions, and in providing access to affordable housing.

For example, we'll discuss the FHA program, and plans to continue to strengthen it. We'll also discuss the Guidance the Federal Banking Agencies recently issued this fall with respect to non-traditional mortgage products. And we'll talk about whether more needs to be done.

We'll also explore whether new industry standards in consumer protection laws are needed in order to provide enhanced consumer protection to better ensure that consumers are receiving sustainable mortgage loans.

Second, we'll discuss the role of disclosures and financial education as vehicles to protect consumers, and to help them navigate the increasing number of different and complex mortgage products. We'll talk about, for example, the CHARM Brochure, Consumer Handbook of Adjustable Rate Mortgages that's soon to be issued, published jointly by the OTS and the Federal Reserve Board, and its role in trying to help consumers walk through the 80-10-10's and the 5-1 and 1-1 ARMs and interest-only and Option ARM and on it goes.

Number three, we'll discuss the role community banks play in financing housing and delivering affordable housing solutions. So, to help tackle these issues, I have a very distinguished panel here today.

The Honorable Brian D. Montgomery, Commissioner with the Federal Housing Administration. John Taylor, President and CEO of the National Community Reinvestment Coalition, or NCRC. Alan Fishbein, Director of Housing and Credit Policy for the Consumer Federation of America. And Michael -- Jane Gell, Managing Counsel, Federal Reserve Board, my former employer. And Michael Steward Menzies, Senior President and CEO of Eastern Bank and Trust Company, on behalf of the Independent Community Bankers of America.

As we've done consistently today, in order to maximize our time together, we're going to skip the bios, please refer to them in your folders for a more fulsome description of their very distinguished backgrounds. But I do want to invoke the moderator's privilege of making one note about one person's bio on this panel. And that is, I notice that Commissioner Montgomery recently celebrated the birth of his first child, Emily. And although we applaud you, that's an exciting time in your life, but we don't envy the lack of sleep that you're getting right now. And we're going to start off with Commissioner Montgomery. Brian, let's begin with you.

Commissioner Montgomery: Thank you so much, Montrice, and yes, thankfully Emily does look like my wife.

(Laughter.)

Commissioner Montgomery: Before I begin, I'd like to commend the OTS and the other Federal banking regulators as well as saying thank you to John for hosting this conference, I think he's around here somewhere.

In addition to recognizing your good work, I want to make clear how much I appreciate that you've asked me to be a part of this conference. As FHA Commissioner, I have spent a great deal of time over the last year expressing my concern about the harmful trends affecting thousands of homebuyers nationwide.

Every time I speak, I highlight the risky nature of the recent shift in home financing. A shift away from the tried and true government lending products, to the more innovative, but less secure, non-prime product offerings.

According to industry data over the last six years, sub-prime purchase activity has increased 800 percent, while FHA business dropped at that exact same amount.

While the extension of credit to more Americans has increased home ownership rates, even for those hardest to serve, increased access to credit has come at a tremendous cost. A cost that often outweighs the benefits of home ownership. The proliferation of, and reliance upon the exotic new products has put many families in a financially precarious position, and is having a negative effect on local economies nationwide.

Well, we're all here because we're concerned, and we are looking for solutions. We're looking for a way to save families who are in trouble today, and to protect families who have not yet entered the housing market from future harm. Now, one of the simplest solutions is something I've been advocating for the last year, which Congressman Frank also mentioned a little while ago, and that's to give homebuyers a better alternative, a safer, more affordable house financing option. I'm talking about reinvigorating the FHA product.

You see, FHA is good for American homebuyers. We enable borrowers with riskier credit profiles to access prime rate financing. FHA products are safe, and they are consumer-friendly. And we stay in all markets, all of the time. And FHA's Default Prevention Program helps families stay in their homes.

Now, let me be clear, I'm not opposed to other proposals -- such as enhancing industry oversight. Certainly we've all talked about Federal law that would create a comprehensive set of requirements to protect consumers. Moreover, the Federal Banking Regulator's Guidance is an excellent first step.

However, while regulatory and legislative fixes are worthy, and they should be pursued, a much easier and equally effective fix is to restore the vital role of the Federal government into the housing finance system.

Let's review the reason for the recent trend to fully appreciate this simple solution. Over the last five years,
rapid house appreciation shut many lower income consumers out of the home buying market. These families needed alternative forms of financing to achieve affordable monthly payments on high-cost homes. Lenders accommodated them, offering more and more homebuyers non-traditional mortgages. But many consumers didn't understand the inherent risk of these products.

Further, without traditional credit enhancements -- such as FHA Mortgage Insurance to mitigate the risk -- lenders instead compensated by risk-base pricing the interest rates charged on these non-traditional loans. Given this set of market dynamics, there is a gaping hole that we collectively failed to recognize and address.

Where was the government credit enhancement that traditionally filled this gap? Well, sadly, we were missing in action. Again, let's examine the facts.

The United States has the most sophisticated housing finance system in the world, in large part due to active government involvement. The U.S. housing sector has achieved an extraordinary level of financial growth and stability because we foster a healthy balance between the profit motivation of private companies, and the public purpose of government institutions. That balance between the public and the private sectors is an accomplishment that other countries strive to replicate.

In the U.S. housing finance system, the Federal government supports, and complements, the private sector, rather than subsidizing or supplanting any aspect of the private market. As the primary Federal insurance company, we protect lenders against loss. Giving riskier borrowers access to market rate financing. Similarly, the Veterans' Administration and World Development provide appropriate Government guarantees to reach traditionally underserved borrowers.

Backing all of this business is Ginnie Mae, which provides liquidity to the market, and brings foreign capital into the country. All of these wholly-owned Government corporations play a vital role in helping the private sector reach families who would otherwise go unserved, or would pay substantially more than necessary to take part in the American dream.

The dynamic, the proactive presence of the Federal government in the housing and finance system is exactly what has been missing over the last five years. To address the current housing crisis, what we need to do is to re-dedicate ourselves to restoring that balance, and restoring the role of Government agencies.

Now, I'll admit that I'm somewhat biased, after all, I am the FHA Commissioner. Regardless, I think we can all recognize that without FHA, those who traditionally were best served with Government credit enhancements, were put into loan products that did not meet their needs. Further, many of these borrowers didn't understand what they were doing.

FHA is intended to serve the very kinds of families that we are all concerned about -- first-time homebuyers, families with less than perfect credit or little savings to put into a down payment and low and moderate income homebuyers. FHA was designed as a means to provide these riskier types of borrowers access to prime rate financing.

According to HMDA data in 2001, 38 percent of African-Americans, and 39 percent of Latino purchasers relied on FHA financing. In 2005, those figures are 7.7 and 4.6 percent, respectively. Meanwhile, as Alan knows, because I'm quoting Consumer Federation of America's figures, in 2005, 53 percent of African-Americans and 37.8 percent of Hispanic borrowers used sub-prime financing.

So where was FHA when these families needed us? Well, as a result of outdated processes and overly restrictive legislation, my agency has not been able to reach many of these families. The law governing FHA's programs and operations has hampered our ability to offer an attractive financing option. The primary problems are that FHA's loan limits are too low, the cash investment requirements are out of sync, and programmatic requirements are too restrictive.

Yet FHA is the most consumer-friendly mortgage product I know. We will not permit payment sticker shocks, or pre-payment penalties, or negative am loans. We never have, and we never will. Our primary mission is to get people into homes with safe and affordable financing. Our underwriting permits riskier families access to credit, but without paying exorbitant risk-based interest rates.

Further, for those who don't meet the underwriting standards, FHA will not permit a lender to qualify a borrower at a teaser rate. Moreover, our loss mitigation program is the best in the business. We set stringent requirements for FHA-approved lenders to follow, so that they ensure families facing financial hardships can stay in their homes. It is extremely important to us that families who enter home ownership, retain home ownership.

Finally, FHA stays in all markets all the time. Unlike private mortgage insurers who pull out of stagnating and declining markets when the risk of loss is too great, FHA assumes the catastrophic risk associated with localized recessions. In other words, we actually stabilize local real estate markets by maintaining our presence. Helping homeowners stay in their homes, and new homebuyers enter markets.

To restore FHA's ability to serve these types of borrowers who today are relying on sub-prime loans, we developed a comprehensive legislative proposal. The Expanding American Home Ownership Act of 2006. We received incredible support from the entire housing industry -- or almost the entire housing industry -- as well as bipartisan support in the House, with a vote of 415-7. I like to tell people every Democrat that voted, voted for the bill.

Of course, the 110th Congress will have a different composition from the 109th. But I believe that we can get the legislation passed this year, and we can put FHA back on the map again.

The bill proposes to remove the primary barriers to FHA lending, an objective that has been extremely well-received by all of the major private sector trade organizations who recognize that the Government has a vital role to play in our housing finance system. These organizations, including the Mortgage Banker's Association, the National Association of Realtors and the National Association of Homebuilders, and the largest real estate group representing African-Americans, Latinos and Asian-Americans and the U.S. Conference of Mayors, and the National Association of Counties, all backed this legislation. They understand our housing system benefits from a strong government sector.

We've also embarked on a more aggressive and comprehensive consumer awareness strategy, including improvements to our web-based services, which by the way we have a new website that we are standing up, www.fha.org, as well as our new call center, 1-800-CALL-FHA. Our marketing and outreach efforts continue to expand, and for the first time we now have a dedicated outreach team to make sure the right information is reaching the right audience. Through radio and print advertisements in both English and Spanish, FHA is reaching out to potential first-time homebuyers with low to moderate incomes in 44 markets nationwide, with high focus on minority populations where the home ownership gap is most pronounced.

The bottom line is if we want to protect consumers, we need to revitalize FHA. Restoring FHA may be easier than efforts to establish a uniform set of Federal or state regulations. We can give homebuyers who desperately need a government-backed product a choice once again, and we can help homeowners who are already in trouble re-finance into an FHA product. When it comes to consumer protections, there is no better option than FHA.

Montrice, thank you for inviting me here today, I look forward to our continued work together.

(Applause.)
Montrice Yakimov: And next we'll hear from John.

John Taylor: Thank you, Montrice. And thank you Director Reich and the OTS, I think this is a very important forum, National Housing Forum, and I applaud you for taking this initiative and the for the other regulatory agencies that have been willing to participate. And also for allowing community representatives to be a part of this.

From a community perspective, in terms of talking about trends of what we see, we see the same trends, essentially, that we've been arguing about for the last 10 years, which are now -- we think -- organizing themselves into a kind of perfect economic storm. Led in great part by what we call the fairly unaccountable and highly unregulated mortgage broker industry that has grown to capturing almost 75 to 80 percent of the mortgage originations. Compounded by these non-traditional or exotic mortgages -- the interest-only and payment-option ARMs, where in the year 2000 about 1 percent of the industry, or the lending fell into the category of interest-only or payment-option ARMs. Now almost 33 percent of all of the mortgages in 2005 fall into that category, and disproportionately in the communities that we look to protect and serve, disproportionately those figures fall in communities of color, and in low and moderate income neighborhoods.

Some of the characteristics of these non-traditional mortgages are that almost -- or more -- than one-third of the interest-only borrowers earn below $70,000 annually. About one in six earn less than $48,000 annually. More than half of the payment-option ARM borrowers and 28 percent of the interest-only mortgage borrowers had credit scores below 700. Most of their credit scores were actually quite lower.

African-Americans were more likely than non-African-Americans to receive interest-only loans and payment-option mortgages, and Latinos were nearly twice as likely as non-Latinos to receive payment-option mortgages.

And it's estimated that 70 percent of the payment-option borrowers chose the minimum payment every month, that's 70 percent chose the minimum payment every month.

A Federal Reserve study found that 35 percent of the ARM borrowers did not know that maximum increase that their interest rate would rise to. Forty-four percent of them were unsure of the maximum rate that they could be charged, and 18 percent did not know the frequency with which that rate would change.

From a community perspective, we think that there's been a, somewhat of a head in the sand approach to the regulatory oversight, and that it has led to questionable underwriting standards, where layered risk factors belie the true risk of these mortgages. Reduced loan documentation with stated incomes, simultaneous second liens, these what we call hook 'em and gut 'em loans -- interest-only and payment-option ARMs -- for people who clearly should not be taking out these loans, and then the complexity of these mortgages which, for many consumers, are simply not really understood as they're getting into these kinds of products. Really, borrowers that particularly, traditionally underserved borrowers end up qualifying for loans that they really shouldn't be signing up for.

Moving fast forward to 2007, which is not that -- we don't have to move that fast to get there -- this is the year when many of the re-set or re-adjustment rates of these option-ARMs are predicted to occur, and some predictions show that in 2007, between $1 and

$2 trillion dollars worth of re-adjustment rates will occur. Some industry experts predict that over 10 percent of these mortgages will go into default -- that's $100 to $200 billion that may be under water -- and disproportionately this will be true in many communities of color, and in working poor communities, low and moderate income neighborhoods.

Couple this potentially catastrophic occurrence with the falling housing prices, which you've heard throughout the day, the discussion about that, rising interest rates which have really not risen what many predict will be to the levels that many have predicted, falling real wages, inflated appraisals -- and this is an area that the industry, the regulatory agencies, while there's been some conversation about it -- this is one of those head-in-the-sand kind of issues that is finally now coming back to haunt us. Where studies and surveys have shown that as much as 60 percent or even more or higher of appraisals that are given under duress or given to really match what the lender is looking for or given because there's influence from the lender -- 60 percent of those appraisals are really above what the genuine, independent appraiser who didn't fear for losing business from the bank would have given. That's been really overlooked in our industry for a very long time. I'm glad to see that in some of the regulatory agencies there's more conversation about that, but these now are going to come home to roost as the housing prices fall and people are, for various reasons, are looking to move, to sell, they're finding they simply don't have the equity that they had in their homes.

Couple that with large credit card debts that have grown since people have taken out their mortgages, and then the increases in foreclosures. You know, foreclosures -- it isn't just what occurs to the family in the home that's being foreclosed upon -- but foreclosures really impact other housing values in neighborhoods. Harvard's Joint Center for Housing Studies has looked at the impact of a single foreclosure in a micro-neighborhood and are able to show how property values go down as that occurs, and then when you have multiple foreclosures, or even property just abandoned, where people just simply can't afford to make the mortgage payments as they're reset or the economic conditions change and their aren't any options for them, we begin to see entire neighborhoods that are affected.

Realty Track -- it's tough to really get a handle on foreclosures -- my crystal ball is not any clearer than anyone else's and unfortunately there's just, not every place is computerized or has the kind of data sets that we would all feel comfortable with, but looking at Realty Track estimated in 2004 that there were about 850,000 homes that were at or near foreclosure, and they have looked at 2005 and they've found that in each and every quarter in 2005 those numbers went up, and I think we're seeing similar experience in 2006.

I think all of this leads to what is potentially a perfect economic storm, and the ones who are going to suffer are the last ones in -- they'll be the first ones out -- and I think this is going to have the kind of impact on neighborhoods that will take us many, many years to try to fix.

I do want to make a couple of suggestions so as to not be totally, totally negative about this, but I wanted to suggest a couple of things that might be helpful, I think, to avoid some of this in the future, and future similar problems.

One is, there really needs to be much more transparency in, for the borrower. Borrowers going into these deals simply really need to know what they're getting into and when we've done surveys and we've talked to different borrowers, it's very clear to us that they really don't understand a lot of times when they're doing an interest-only or an option-ARM or a payment-option ARM what it really means when they're only doing the minimum payment -- what it means in terms of equity growth, what it means when in two years down there road there's a re-set and their monthly amount goes up.

We think that there needs to be -- and I was happy to see here Barney allude to this, some work done around the HMDA Act and some improvements there that we think will be useful. Recording, for example, whether the loan was fixed or adjustable, the amount of points and fees, whether there was a full payment required every month, and ideally credit scoring information. We need to avoid -- this has been a term that a lot of people have used in a lot of ways today -- but what I would call the irrational exuberance associated with these financial education programs.

There's a lot of stock -- both in the regulatory agencies and from the industry -- put into, "Well, we'll just, you know, we'll create financial education programs and this will solve a lot of the problem because people will know what they're doing." We have more financial education, financial literacy programs in this country than we ever, ever did before and the problem with predatory lending and the problem with people being in trouble and potentially under water has never been greater, at least in my lifetime.

So it hasn't been the financial education problems, and what I always think about is -- when I travel to Europe and when I have conversations with NGOs, Non-Government Organizations, as well as governments over there about protecting consumers -- they don't have this proliferation of financial education, they don't put the onus upon the borrower to be wary, they simply protect the consumer. There's laws, there's regulations that are enforced, and the kind of lending activities that people get away with in this country today are simply not allowed over there.

And so you don't have in the industrialized nations where they have consumer protections, you don't have the problems of predatory lending, that's just the bottom line. And so that leads very much to the need of a strong national standard, and we're obviously very pleased to see who is the Chairman of the House Financial Services Committee, soon, who that will be -- we're very much pleased to hear the words he had to say and before. I think we need to have a standard that really protects people, and we need to clean up this industry. And included in that standard, a national predatory lending standard, must be a suitability standard that really once and for all protects the consumer and doesn't allow products to be re-shaped and re-defined and morphed into yet another kind of usurious activity.

I still think this housing industry and the financial services industry can remain robust, competitive and be able to both pay their shareholders, but also provide quality product that doesn't take advantage of consumers.

Finally, let me close by saying a couple of other things that I think. I want to support most of the changes to the FHA system, I think it's important to have a very robust system. We do have some problems with the risk-based pricing system as proposed. We want to expand CRA to credit unions, these guys -- the big credit unions, I'm not talking about community development credit unions but the big credit unions -- will soon equal about one-seventh of the banks and thrifts in terms of assets. They've been getting away with murder. They, first they have a much better benefit than banks and thrifts in this country in that they don't pay taxes, and secondly, they do not have an obligation under the Community Re-investment Act, and the result shows. Banks and thrifts outperform almost in every state the large credit unions in serving people of color. And it's always a surprise whenever I say this to anybody, anybody. But it's not a surprise to Barney Frank who has CRA for credit unions, non-Federally chartered credit unions where I'm from -- you might have picked up on the accent -- and he really has a Brooklyn accent, that's where he's really from.

(Laughter.)

John Taylor: It also won't be a surprise for Senator Dodd, who also is the only other state in the country that has CRA for credit unions. It's long time we leveled the playing field by having these institutions have the same obligation as CRA-regulated banks and thrifts.

I want to promote the passage of the Housing Trust Fund efforts, I want to promote the need for more support for rescue funds for foreclosure prevention funds, such as the one that NCRC operates, and I want to thank you for your patience and for not throwing anything at me as I disparaged the industry. Thank you very much.

(Applause.)

Montrice Yakimov: Jane?

Jane Gell: Thank you, Montrice. I also want to thank the OTS for inviting me to the National Housing Forum. This is a great opportunity to provide an update on consumer protection in the mortgage market from the regulator's perspective, but it's also an opportunity to hear from you, and hear from my fellow panelists, about issues that we'll need to address going forward.

I'm going to focus on the pubic hearings that the Board held this summer on the mortgage market, touch very lightly on the Non-traditional Mortgage Guidance, because I think Scott's panel did an excellent job this morning on that, and tell you a little bit about the new and improved Consumer Handbook on Adjustable Rate Mortgages, the CHARM booklet that Montrice referred to in her opening remarks.

And finally, I'd just like to give you a sense of where we'll be going next, what our next steps will be in our ongoing review of Regulation Z, Truth in Lending, and that impact on mortgage lending.

The Board conducts outreach and research to help us better understand consumer behavior, and also to help us determine the best approaches for helping consumers make informed decisions about credit products. Toward this end, we sponsor consumer surveys, we hold public hearings, as we did this summer, we discuss issues with our Consumer Advisory Council, we conduct consumer focus groups and other forms of consumer testing and of course, we solicit public comment on proposed changes to our regulations. To address the complex issues involved in non-traditional mortgage products, we will use all of these approaches.

I'm going to begin with the public hearings. As John knows, we found them to be a valuable source of information about the mortgage market. Under the Home Ownership and Equity Protection Act, HOEPA, the Board is required to hold periodic hearings on the home equity mortgage market and consumer protections in that market.

So, this summer we held four hearings across the country: In Chicago, Philadelphia, Atlanta and San Francisco. We wanted to examine developments in the home equity lending market since our last hearings in 2000. We had 67 panelists providing remarks at these four hearings, and they covered the whole spectrum of mortgage lending.

We had mortgage lenders, brokers, we had realtors, credit rating agencies, consumer advocates, community development groups, housing counselors, academics, researchers and state and Federal government officials.

Members of the public also had an opportunity to participate, we had an open mike session at the end of each hearing, and a transcript of the hearings and the public letters submitted as supplement to the hearings are available on the Board's website.

The hearings explored consumer behavior in shopping for mortgage loans, and included discussions about the challenges involved in designing more effective disclosures. And I think this goes to the point raised earlier about transparency, about effective disclosures. We looked at products with growing popularity like reverse mortgages, trying to get a little ahead of the curve on that, and we also focused very heavily on non-traditional mortgage products -- that was one of the very important issues that we wanted to explore through these public hearings.

Industry representatives told us that they believed that when these loans are prudently underwritten, consumers are able to benefit from the flexibility that the products offer. On the other hand, we heard from consumer advocates and state officials who testified that aggressive marketing and the complexity of these products put borrowers at additional risk in obtaining mortgages that they didn't understand and that they might not be able to afford.

Consumer advocates were particularly concerned about mortgage brokers and some lenders and their very aggressive push marketing, pushing these mortgages out to low-income consumers, and also to borrowers living on fixed incomes, without adequate regard for whether the products were appropriate for these particular borrowers.

They were also concerned about marketing the focus very heavily on the low initial payments based on discounted rates that quickly expired. And while they supported additional information, many of them believed that disclosures alone would not be adequate to provide the information consumers need to make good choices in this market.

Staff is now analyzing the transcript from the hearings, and as well as related public comment letters, and we will use this information in developing our plans to view the mortgage rules under Regulation Z.

I'm going to turn just very, very quickly to non-traditional mortgages, as I said, there was an excellent discussion about them this morning. But this is another piece of our approach for dealing with this particular part of the market. These are the products you heard about this morning -- the exotic mortgages, the alternative mortgages, the non-traditional mortgages -- and as you know, the Board, along with the other agencies issued guidance on this in September.

I wanted to just tell you very briefly what the Guidance does and doesn't do -- it does not apply to fully amortizing residential mortgage loan products, and it does cover loans that allow borrowers to defer payment of principle and sometimes interest. And there has been a bit of confusion about what the Guidance covers, and what it doesn't.

The Guidance urges lenders to underwrite non-traditional mortgage products, based on the fully indexed rate, taking into account negative amortization, and as you heard this morning I think this is a very important point, the Guidance talks about risk layering. Combining these loans with other features that may compound risk, for example, simultaneous second lien mortgages. Or, relying on reduced or no documentation -- low doc and no doc -- loans.

The final Guidance discusses the importance of carefully managing the potential heightened risk related to these particular loans, and as you heard this morning, the Guidance also had some illustrations that were designed to -- particularly for community banks -- to provide some guidance and what information might be disclosed to consumers early in the mortgage application process.

We took public comment on these illustrations, the comment period closed on the fourth, last Monday. And so we'll be reviewing the comments from that particular proposal and moving forward on the illustrations.

On the consumer education front, in October the Board, the other banking and thrift agencies and the NCUA announced the publication of a new resource that can help consumers better understand these complex products.

This is a brochure called Interest-Only Mortgage Payments and Payment Option ARMs -- Are They For You? It has a glossary of lending terms, a mortgage shopping worksheet and a list of additional sources of information for consumers about these products.

I think one thing that we're doing that will be extremely helpful to consumers, and you should see this before the end of the year, this is what Montrice mentioned just a few minutes ago, the Board and the OTS are working together to update the Consumer Handbook on Adjustable Rate Mortgages, the CHARM brochure. This is the brochure that I think can be a very effective way to educate consumers about the benefits and the risk involved in these products. Because this is the brochure that the Board's Regulation Z requires creditors to give to consumers when they apply for an adjustable rate mortgage, or an ARM. Because the brochure is provided at this very early stage in the process, it's very useful in encouraging consumers to ask brokers and lenders the right questions to decide whether or not this loan is for them. It explains features, or will explain features such as payment shock, negative amortization -- it will contain additional information tailored to interest-only and option-ARMs, it will address hybrid arms -- three-ones, five-ones, seven-ones -- and it will describe 2-28s and 3-27s. I've clearly looked at a number of versions of this brochure and I think it explains in very simple, very clear terms to consumers again, these very, very complex products in a way that I think consumers will be able to understand. It talks about payment shock, it talks about a deeply discounted "teaser" rate, and the consequences when that rate expires.

And finally, turning to our review under Regulation Z, this will be our next step. We focused initially on credit cards, and we have already begun with the home equity hearings, the process of moving toward the mortgage rules under Regulation Z. We're going to use design consultants, as we have with credit cards, to help us design more effective disclosures. We're going to bear in mind that these products are going to change over time, but because rule makings and consumer take time -- and they do, they take considerable time to do them right -- we've taken these more immediate steps to make sure that consumers have information about these non-traditional mortgage products.

To wrap up, our goal is to promote and sustain home ownership through effective regulation, responsible lending, and informed consumer choice. Thank you.

(Applause.)

Montrice Yakimov: Thank you, Jane.

Alan Fishbein: I think I'm going to avail myself of the podium so I can at least see people on this side of the room. Montrice, thank you for putting this fine panel together, and it's a pleasure to be here. And I, too, applaud Director Reich for putting together a very interesting and provocative, and timely, housing forum.

As we've heard mentioned by a number of speakers today, one of the constants over the past decade is Americans' desire to own their own home. We have home ownership rates that are near record levels and as Congressman Frank was saying at lunch, about red-lining being the old form of predatory lending, I started my professional career when red-lining was the major problem for access to credit for many undeserved borrowers, and considerably progress has been made over the years that I think we all can feel good about although certainly gaps remain, they still need to be addressed.

But, the desire for home ownership is understandable, because aside from providing shelter, it's traditionally been a path to gain security, financial stability and to build wealth. That's certainly why an organization like CFA is interested in this topic.

Home ownership represents the single-largest investment for most households, two-fifths of all financial wealth is in people's homes, it's 80 percent for low-income families, but as we all know -- or I hope we all know -- to achieve the full effect of home ownership and the wealth creation, the financing to buy a home must be sustainable. It's not enough to put people in a home if we're going to show them the door soon thereafter. And that's one of the challenges we face today.

So there's this paradox -- why is it that the largest financial asset for many consumers is subject to, perhaps, the least consumer protection? Elizabeth Warren, who is a Harvard Law professor and somebody you may know as author of "The Two Income Trap" uses the analogy between mortgages and other potential risky products, and she wonders why greater protection, by and large, is afforded to consumers taking out a toaster and bringing it home -- which is potentially hazardous -- then taking out a hazardous loan on their home.

And so we've seen predatory and abusive mortgage practices, and more recently the mass marketing of risky loan products eroding the traditional benefits of home ownership. And for the past decade, many of us on the consumer side have been battling the explosion of predatory practices, which have been mostly confined to the sub-prime, refinance market. And that's the practices that are aimed at stripping equity from people's homes, often through outrageous and hidden fees, loan flipping and junk products that are added to the mortgage.

There's evidence that 20 percent of sub-prime loans wind up in foreclosure after five years. And we know that this form of high-price lending is heavily concentrated in African-American, Latino communities, and to African-American and Latino homeowners. And so, the concentrated foreclosures that result from where these people live undermines neighborhood stability, and can undermine the local tax bases of the areas in which they live.

Now, the more recent concerns has been the mass marketing of non-traditional products and I emphasize "mass marketing". Federal regulators have taken note that these "exotic products" as they're called can be a little too exotic for many borrowers who have taken them out, and they've issues the Inter-Agency Guidance on Non-Traditional Mortgage Products, and we certainly applaud that effort.

Interest-only and option-ARMs combined with the layered risk features that have been discussed at this conference have exposed borrowers to significant payment shocks, especially if interest rates rise.

Now once they were a niche product to the affluent, and they had benefits to those, but the super-heated housing market and other changes in mortgage lending have increased the market share of these products, and actually have contributed in some ways to the drastically inflated housing prices that has been talked about.

It's our research at CFA has indicated, peddled much more frequently to borrowers with below-median credit scores and lower incomes than traditionally has been the case. And borrowers -- make no mistake about it -- are concerned about this, a recent AP/AOL real estate survey found 65 percent of borrowers are anxious about making their mortgage payments. And fully one-third of adjustable rate mortgage borrowers are concerned that they cannot handle higher payments if rates increase. And certainly, as it's been indicated, there are indications of higher problem loans stemming from the recent lending boom, and dire predictions of one out of eight of adjustable rate mortgages ending in default.

There's no doubt that adjustable rate mortgages originated last year, in '05, were three times more likely to default than in '04 and '03. But the particular concern for many of us in the consumer community are about hybrid ARMs with deep teaser rates, which predominate the sub-prime market. The 2-28 loans and 3-27s -- which represent over 80 percent of the sub-prime market and are sold to credit-impaired borrowers, they're labeled by many of my colleagues as "exploding ARMs". And as we know, sub-prime lending which was once a tiny little niche of mortgage originations is now over 25 percent of the market, so it's a considerable problem if those loans do not perform.

A typical product, the 2-28, as they start off with in a current market of initial payment of about 7.5 percent, and after the end of a two-year fixed-rate period, fully adjusted rate -- even without interest rates going up -- are likely to jump to about 11.5 percent. Producing a payment shock of 40 to 50 percent for the typical borrower.

Now, most sub-prime loans are not affordable under that scenario, and the borrower would be forced to refinance, or fall into default. Some can't do that because of pre-payment penalties, which will sock them with additional costs if they choose to refinance before the end of the initial period. And when you add in the reduced documentation, or stated income loans, they increase the likelihood that borrowers may run into difficulty in handling repayments.

We know the delinquency rate for these loans is over 12 percent, without interest rates even starkly increasing, and in 18 States, it's over 15 percent. Now, there is some confusion about whether the Inter-Agency Guidance covers these 2-28 products, these hybrid ARMs. We certainly hope that the Inter-Agency Guidance will be clarified so they clearly are covered, and we're encouraged by the remarks of Sheila Baer and some other regulators who are looking at it in the same way.

Now, existing consumer protections in this kind of market are just clearly inadequate. Disclosures are less useful -- the kind that we have in place now -- given product proliferation. In any event, they should be revised to provide advanced and binding disclosures on specific products a consumer chooses.

Self-regulation, which has also been tried, is -- often falls down because the lowest common denominator in the market typically prevails. HOEPA covers too few loans, only 36,000 loans were covered under HOEPA at last reporting.

And State laws, even if they're stronger than the Federal protections, aren't always able to encompass some of the teaser rate loans that are being offered in the sub-prime market, and lenders have become adept at circumventing the protections that are provided under these State triggers.

So, it's little wonder, and this is the point I really want to end with, that consumer advocates are increasingly looking to make wholesale and comprehensive approaches to protecting consumers seeking mortgage credit.

One approach would be to establish a clear-cut fiduciary responsibility for mortgage brokers, which as it's been said, are responsible for originating as much as 80 percent of all mortgage loans. Many consumers already believe there's this obligation -- and in fact it's not in most places -- and as a result borrowers are taking on loans often relying on mortgage brokers that just aren't the kinds of loans that they can afford to repay.

Another alternative approach that I think will get a lot of attention in the year ahead, would be to build on the Inter-Agency Guidance and establish a flexible standard of good faith and fair dealing that places the responsibility on loan originators to match borrowers to loans that are suitable for them. Some say -- and I'm not using the term suitability, certainly parallels can be drawn to the broker-dealer market in the investment of stocks and bonds. Haven't figured out whether using the term suitability is a useful term to be using to facilitate a discussion on this or not. But, regardless of what is described, a standard that loan originations would have to adhere to based on a borrower's ability to repay, the borrower's circumstances, the borrower's objective in obtaining the loan, I think would go a long way to addressing problems that we're seeing in the marketplace at the present time.

And let me say that I think we're in a historic moment where the industry and consumer advocates, and regulators and public policy makers can have a good discussion on establishing this type of standard. Recognizing that the markets change, and that it's unlikely to go back to the way it was before, and not even saying that we want it to go back to the way it was before.

We've shown that these kinds of collaborations can exist, they've been very successful, for example, in the aftermath of Katrina and the hurricane damage that was done down there, and we look forward to working with interested parties on this topic and see if we can replicate that kind of partnership going forward.  Thank you.

(Applause.)

Michael Menzies:  I will also expose the left-hand side of the room to my mug -- I'm Mike Menzies and Director Reich, thank you and the OTS for inviting a community banker -- you've been a great supporter of community banking for many years, and I'm personally grateful.

The only thing standing between you and mortgage fraud and the bar are my brief comments, and they're going to be brief.

First I want to say that it's an honor to address an audience that includes Commissioner Turnbaugh, who is the Commissioner of the State of Maryland, and as a State-regulated bank, he's the most important person in this room to me.

(Laughter.)

Michael Menzies:  I don't really know what wisdom I can impart to this distinguished group of intellectuals, but let me just share for a moment how this one individual, a victim of only my experiences, tries to deal with housing as a community banker.  And we are a community bank -- $125 million in assets, 72 stockholders, 14 years old, and we support a world banking environment the Eastern Shore of Maryland, between Wilmington, Delaware and Norfolk, Virginia, 400,000 people in total.  And within a three hour drive of Eastern Maryland, assuming the bridge is functioning, we have over 38 million people.

Statistically, between 2009 and 2016 about 30 percent of those 39 million people are going to retire and go somewhere, and we fear that they're all looking at the Eastern Shore of Maryland, which is a possibility.  That pretty much describes our market.

Eastern Bank & Trust operates divisions Oxford Bank & Trust, Denton Bank & Trust and Greensborough Bank & Trust, and they're named after the communities in which they reside, because those are our core values, that's how we live and we survive.

We do have a secondary market operation, and I had the opportunity to chair the ICBA Mortgage Corporation which did about $350 million worth of volume last year -- not a great big chunk of the $2.5 trillion that was generated by the industry.  But let me tell you, those loans for all intents and purposes are 30-year, fixed-rate, 20 percent down payment, plain old, ordinary vanilla loans.  That's the nature of community bank lending.

A non-traditional loan in community banking isn't Alt-A or interest-only, or -- I've learned some new terms here -- premium option-ARMs, or that sort of thing.  A non-traditional loan is a relationship-based loan that's made by a loan officer who lives in the community in which they've made that loan, who goes to church with the person who's borrowing the money, and who takes ownership and responsibility of that loan. They're personally responsible if something goes wrong with it.

We make non-traditional loans on a regular basis, we made one just this week, $215,000, owner of the dealership guaranteed 20 percent of the loan -- even though it was 100 percent loan -- so that his bookkeeper could find an affordable place to live in Talbot County. And we'll have that on our books for a couple of years, and then we'll take it to the secondary market. For us, that's a non-traditional loan. It's the nature of community banking.

Our loan committee meets every week. Our loan committee sees every delinquent loan. And they criticize me for every delinquent loan. Our loan committee makes every decision in excess of $100,000. It is a relationship-based banking environment and I believe that goes on in community banks -- in 6,000 community banks throughout this country -- on a regular basis.

Challenges that we face really are not related to access to finance, in all candor. We have no problem getting access to money and connecting people and money. That has not been a problem in our environment. Our problem is affordable, or work-force housing. Our problem is the cost of housing. And that's a solution that I believe needs to be derived at the local/municipal level. Because municipalities often don't believe that they should take personal ownership to the responsibility of affordable and work-force housing, it doesn't get on the radar screen. They're fighting growth, they're fighting the debate of growth, they're fighting the infrastructure demands, and they don't say, "We need affordable housing, and we need to find a way to get it into our community."

And it is not affordable. Impact fees, hookup fees, developer fees, permit fees, landscaping requirements, sidewalk requirements, infrastructure costs, labor costs, lumbar costs and the costs go on. You can't find a property in Talbot County, Maryland that's affordable, because there's nothing under a quarter of a million in our market. So we're lending into adjoining counties -- Dorchester and Caroline County, in the $175,000 to $250,000 range, that's the meaning of work-force housing in these markets. And I suspect that's happening throughout America. The costs are too great, we've got to find a way to get those costs down, and I think we need to get municipalities involved to get those costs down.

It was an honor to be with all of you, and there's only a few minutes left between mortgage fraud and the bar at this point, thank you.

(Applause.)

Montrice Yakimov: While we're waiting for someone to approach the mike with a question, I'll toss one out to the panel. One theme that I heard throughout your remarks was this question about -- particularly with respect to non-traditional mortgages or alternative mortgages -- what's suitable? What's appropriate? We talked about these loans being made to sub-prime borrowers, and I wonder -- it seems to me there's a balance between this dynamic, open market that -- maybe unlike Europe -- we have this buffet of mortgage choices in a real robust market. And I wonder -- how do we strike a balance between what is, I think, sound underwriting in terms of determining what's a suitable loan for a borrower, and what's appropriate. How do we determine that people are not getting in over our heads? Where does financial education come to bear in that equation? Let me toss that out to anyone who's intrepid enough to take it.

Alan Fishbein: Well, Montrice, I'll start off. I think you had it right, which is sound underwriting and suitable loans are rooted in the borrower's ability to repay the mortgage. Taking into account all of the various expenses the borrower has to pay, their likely income, any features that might be added to the loan, such as negative amortization, and importantly -- particularly for low income people -- the residual income that borrowers have after all the debt is paid. That used to be -- as I recall years ago -- just a cornerstone of mortgage lending. I think the industry has gotten a little away from that, and as a result the borrowers who are looking to the industry as kind of the gatekeepers of credit are finding to their dismay that in fact, just because a lender gives you a loan, doesn't necessarily mean they expect your or anticipate you'll have the ability to repay it. That's a tremendous change from the tradition, and I think we have to get back to that again.

John Taylor: Let me add to that, if I may, it's -- I think one of the changes that's really different for the industry, 15 years ago when sub-prime constituted -- maybe it was 18 years ago -- about 1 percent of the market, and then it's steadily grown, and I think it has opened up opportunities for people who otherwise might have been locked out of the market, but this evolution into these products that have the net benefit of having no benefit, or actually a negative amortization, or a negative value to the borrowers is really a fairly recent new phenomena. Not that those kind of things didn't happen on occasion, but it's becoming now a mainstream part of our business and, I guess the part that bothers me most about this is, I mean, we do have regulatory agencies that actually do protect consumers when they turn to make investments in different products.

If you go into the stock market, and you make investments in the stock market and that broker or anybody in that process from the point from where your money travels into that system and travels out -- if there's anything that's not in your interest, if there's anything usurious, not only are you in trouble for perpetrating that. Actually, the SEC will come after your boss, and even if your boss didn't know, for failure to supervise there's penalties, I mean, there's just penalties along the line that make it real difficult for the consumer not to be protected and not to be looked after through that whole process.

You flip that to the mortgage market, and we had this evolution of a product which is -- I mean, they're sitting there, how do I trick them or cajole them into taking out single-premium credit life? Or taking on a pre-payment penalty that's five years down the road, because I make more if I get them to do that. Not in the interest of the borrower, but in the interest of me, the broker. How do I get them -- hey I can get you in a bigger house, forget the house you want, I can get you a loan that actually will be lower than what you came in for, this 30-year mortgage, it will actually be lower, I can do you a real deal here -- and the real deal is their screwing that consumer.

And this, in the securities business where other people make their investments for some people, this just doesn't occur and we need to have that same standard and get away from the -- I'm all for financial education, I'm all for it in elementary and high schools, teaching people all about credit and mortgage and all of those things, I think that's where it belongs and that's where we ought to do it -- but if you think it's going to be resolved by teaching people when they're out there trusting these well-dressed brokers and other people who look like them, who act like this borrower, who look like they have the borrower's interest mind and talk very good and then stick a bunch of papers and ideas in front of them that are very difficult to balance, even for educated consumers. How many of us lawyers go to these closings, see that stack of stuff, and really all take a leap of faith when we close on those mortgages? What does it mean when you're less educated, and less capable and have less historical experience in the business of owning a home? It's a bigger leap of faith.

And we, as leaders in this industry both from the industry itself, from the regulatory community, from the community sector -- we ought to make sure that we have rules and regulations and guidelines and things that really protect the consumer, that even if they are not as well educated and not as well financially literate, that they cannot be tricked into getting a loan that isn't suitable for them given their conditions. And that just seems like a no-brainer to me.

Brian Montgomery: What I would add to that, I agree with Alan and John, one of the things my staff often hears me talk about is -- what if we had had a robust a vibrant FHA the last five years? Sure, I'm a Johnny-One-Note, I'm the FHA Commissioner, but when I look at our traditional borrower and the sub-prime market increased 800 percent, while ours decreased 800 percent, it doesn't take too long to figure out largely what happened here.

And I think that if families had been presented with an option, I think if lenders and others -- and by the way, I'm the first one to say I don't blame them for not wanting to do business with FHA, our systems were so antiquated and our requirements were so stuck in the last century that we were the slowest game in town. You know about our appraisal requirements, our IT systems -- I just want to get us into the late 1990's, much less this century.

So, I can't make enough of the fact that our process side was slow, but you obviously know what we were trying to do on the product side, but I think in families, in particular in California, this is one way we were able to get Maxine Waters, I want to thank her for her leadership, too as well on our housing legislation -- is when I showed her FHA volume in her Congressional District in the year 2000, we did about 1800 loans in her Congressional District -- last year that number dropped to 34. And she could figure out real quick, as we all did that, "What a minute, we need to -- " it didn't make any sense to her, it didn't make any sense to us, at the Nation's flagship home-buying program where low to moderate income homebuyers couldn't be accessed to the Nation's most populous state. I'm a Texan, but I'm the first one to advocate that California and Connecticut, and Massachusetts and Northern Virginia ought to be able to access this program as well.

So again, John and Al, I agree with what you all said, but I think to the degree -- and it's not a panacea, I can't speak to the past relative to the here and now and to the present -- agree that we have a more robust, more vibrant more moderate FHA, I think is beneficial for low and moderate income buyers.

Montrice Yakimov: Thank you, Brian. There's no question in my mind that this is going to be a busy year for all of us with respect to consumer protection issues. Looking to some of the remarks that Congressman Frank mentioned -- affordable housing, predatory lending, disclosure simplification -- it's going to be a busy year, and I'm sure we're all going to be engaged. Will you please join me in thanking the panel for a fine job.

(Applause.)

Scott Polakoff: So we started with the economy -- I think Mike's comments about the bar got everybody focused -- we started with the economy, we moved on to credit risk, we focused on the consumer aspect, and now we're going to end with the very important aspect of mortgage fraud.

And with that, I'm going to introduce Bob Russell, and again Bob's full biography is in the handout. Bob is counsel to OTS Director John Reich. He served in a similar position for John when John was the Vice-Chairman of the FDIC board.

Prior to joining the FDIC in 1989, Bob served as the senior trial attorney in the litigation section at the Federal Home Loan Bank Board. He was also Assistant Director in the Enforcement Division of the CFTC and a trial attorney and Program Director at the FTC. I'll turn the podium over to Bob.

Robert Russell: Thank you very much, Scott. I'm pleased to act as the moderator for this last panel of the day and I want to thank all of you, the steadfast and the faithful who have stayed with us all day. We've had a busy day and a long day, we have one more hurdle and that's a phenomenon in an aspect of mortgage risk that is frequently overlooked and that's called mortgage fraud.

We have a challenging and an exciting topic, and we have a very exceptional panel, so let's get started.

Lenders and consumers have benefited significantly from lower interest rates and a mortgage boom over the last several years. Faced with increased volume of loans and mortgages, mortgage lenders have developed ways to cut costs, and create efficiencies in the mortgage underwriting process.

Recent moderations in the housing markets have added pressure to exploit these efficiencies in an effort to capture demand while retaining profits. Today, mortgage loan decisions are made remotely, usually by underwriters with no firsthand knowledge of the property, the borrowers or the sellers to the transaction. In many instances, all of the relationships among parties to a mortgage transaction can be measured in a matter of hours, if not minutes.

There's no doubt that innovations in mortgage lending have produced efficiencies that are often good for borrowers and lenders alike, however, while they have made borrowing easier and more user friendly, the have also made it more abuser friendly. And mortgage fraud is causing significant losses to financial institutions and consumers alike.

According to the FBI, Federally regulated institutions alone reported over $1 billion in losses due to mortgage fraud in 2005. And FINCEN estimates that approximately 22,000 mortgage-related suspicious activity reports will be filed in 2006. That compares with fewer than 10,000 filed in 2003. In other words, reports of suspected mortgage fraud are expected to more than double in just three years. And during the first quarter of 2006, reports filed of suspected mortgage fraud reflected an increase of 35 percent over the filings of the first quarter of 2005.

In a review of new stories related to mortgage fraud reveals the daily accounts of scams, investigations, prosecutions and convictions.

This afternoon we're going to explore the phenomenon of mortgage fraud, what are the main causes and types of mortgage fraud, who is harmed by mortgage fraud, how big is the problem, what are the trends, are there regulatory or legislative gaps, and finally, what can be done to identify and combat mortgage fraud.

We're very fortunate to have a distinguished panel of mortgage experts today who will help us this afternoon try to find answers to these questions. Let me take a few moments to introduce our panelists.

From my left to right, first we have Rachel Dollar, she's an attorney and recognized expert in the mortgage lending industry. She is the editor of the popular News Service Industry website, Mortgage Fraud Blog, which is committed to raising awareness of the growing problems associated with mortgage fraud. In 2005 she was recognized by the Inman News as one of the 100 most influential people in real estate.

Next we have Bill Brewster who is Fannie Mae's Director of Anti-Fraud activities. His unit in Dallas is responsible for conducting Fannie Mae's mortgage fraud investigations, analyzing and reporting mortgage fraud incidents, and partnering with the industry and law enforcement on anti-fraud initiatives. These efforts include education, information sharing, expert witness testimony. Prior to taking his position in Dallas in 2005, Bill was the manager of Fannie Mae's National Underwriting Center.

Scott Husted, next to Bill, is appearing here today on behalf of America's community banks. He is first Vice-President and Chief Underwriter of Endimac Bank, headquartered in Pasadena, California and is a member of ACB. In his role as Chief Underwriter, he manages high-risk underwriting strategy and investigations, he represents the company in both civil and criminal fraud litigation. Scott has served as a member of the Mortgage Banker's Association Quality Assurance Committee, as well as the MBS's Fraud and Ethics subcommittee.

Matthew Price, David Richard Freeman, Gerald Scott Kugnow, Michael Sean Shannahan, Gary Lee Sullivan, Michael John Eckert, Michael White, Kevin White, David White, James Red. Can I get a show of hands from our panelists as to how many of you know these people?

Rachel, could you tell us who they are?

Rachel Dollar: Aliases or stolen identities used by Matthew Cox.

Robert Russell: And who is Matthew Cox and what does he have to do with mortgage fraud?

Rachel Dollar: Matthew Cox is probably one of more notorious of our mortgage fraudsters over the last several years, I should say alleged mortgage fraudsters at this point in time.

Back in 2003 he wrote a book, and it was called "The Associates," and in that book he described the perfect mortgage fraud scheme. And basically this scheme was to go out and to rent a property from the owner. To forge the owner's name on a conveyance deed, and to record that, as well as forging names on any mortgage reconveyances to clear title, and then to go out and to obtain multiple mortgages against that same property, closing the same day in his name, and funnel out the proceeds. He then ran this book by various different friends of his in the mortgage industry, and asked them if there were any holes in this scheme so that it would be a believable book. And after he patched up all those holes, he went out and he did it.

In Tampa, Florida, he closed over a million dollars in loans and walked away with the proceeds, disappearing in 2003. He then showed up in Atlanta, Georgia in 2004, and again rented homes, placed multiple loans, took the proceeds, and then left. And again showed up in South Carolina, did the same thing, disappearing once again. He and his girlfriend, Rebecca Hock were actually on the run for several years, or a couple of years, I guess. She was arrested this month in Texas, and they just arrested Matthew Cox here last month in Nebraska, he was turned in by his babysitter.

Robert Russell: Thank you, Rachel. You know, that will be the last cheap theatrical trick I'll use to get our attention.

(Laughter.)

Robert Russell: It may be appropriate to begin by just defining what mortgage fraud is and providing some examples of mortgage fraud. Perhaps I can begin with you, Rachel.

Rachel Dollar: Mortgage fraud we define as a material misrepresentation made to a lender that causes the lender to extend credit beyond that which would have been extended had the true facts been known. So it includes, really, two forms of fraud -- what we term fraud for property or fraud for housing where a borrower, often in conjunction with a broker, a real estate broker or a mortgage originator, commits misrepresentations within the loan process in order to obtain better loan terms or a larger property or just a home at all. And then there is fraud for profit which is fraud where the participants go in, never intending to make the mortgage payments, but where they intend to pull money out of the transaction and allow the loan to default and to make profit out of the fraudulent transaction.

Robert Russell: Let me stop for a moment, if I could. Most of you probably noticed that I didn't introduce one of the panelists, John Arterberry, I apologize for that, John.

John has served in the Criminal Division of the Department of Justice since 1981, and currently holds the position of Executive Deputy Chief in the Criminal Division's Fraud Section. He chairs two of the department's enforcement coordinating bodies -- the Inter-Agency Bank Fraud Enforcement Working Group, and the Securities and Commodities Fraud Working Group. I have known John for over 20 years and worked with him, and I'm not going to live this down any time soon.

(Laughter.)

Robert Russell: Well, thank you, Rachel. Can, maybe, John can you describe circumstances under which criminal gangs might be involved in mortgage fraud?

John Arterberry: Well, Bob we're seeing just as I think any, any area, any sector of our economy where there is the possibility of getting easy money -- that's where gangs are going to go. They use, they can use mortgage fraud to fund a lot of their other activities. They see it as a profitable endeavor, and unfortunately some of our intelligence is that they see it also as very good on their range of risk-benefit -- they think it's either low risk, at least in terms of the time they'll serve, compared to other criminal gang activity.

So, is it on the rise? The indicators are yes, we are taking a very close look at it, the FBI has, it's certainly on their radar screen as keeping a close eye on it.

Robert Russell: And Scott, could I ask you if you could provide an example of mortgage fraud from your perspective as an originator?

Scott Husted: Well, of course like Rachel had indicated mortgage fraud is broken up, essentially, into two different segments, one is fraud for profit where the borrower, I'm sorry, fraud for housing where the borrower intends to ultimately pay but their looking to some advantage to getting the mortgage at origination that either be occupancy mis-rep, or income mis-rep, but again, ultimately they intend to pay the mortgage.

And the other is fraud for profit and that could be a variety of things, it could be a flip scheme where they essentially get the loan, someone is unjustly enriched, and then they take the money and the loan never performs a, through an early payment default, the loan would result in an early payment default or a scheme -- and it's kind of a combination of what John just mentioned, and also what Rachel mentioned earlier -- and that is where they actually have an enterprise, and their enterprise itself has a risk-management component to it, and they weigh out the risk/reward benefit of mortgage fraud, just not on a transactional basis, but really a business into itself. And then they will do hundreds of these -- this business of theirs -- will do hundreds of these loans, laying to waste ultimately the straw buyer they might have hired along with the homes within the neighborhood, and so on and so forth. So, there's really quite a difference that I've seen over the last few years where they will start off -- before it was transactional -- and now it really is a business, we see it come down from not only street gangs, but also organized crime has gotten into this in different cities, and they develop a business around this activity.

Robert Russell: Thank you, Scott. Now, I want to get an idea of how big this problem is, and maybe I'll call on John to provide some information from the Department of Justice, from the FBI and perhaps from FINCEN as well. How big is this, John, and what are the trends?

John Arterberry: Well, it's -- in your introduction, Bob, you were giving us some idea from recent FBI and FINCEN reports. I think the difficulty we have is that the reporting data that we receive, primarily from suspicious activity reports -- extremely valuable -- we are using it better every month, and that's not an overstatement. I think with the investigative agencies, including FBI, but also Secret Service, Postal and IRS -- the tools that are brought to bear on this information and the way it's correlated to other criminal intelligence, I think, together give us, I think, a much better picture than we had problems like this even 10 years ago.

Having said that, I think again our challenge is take what is a snapshot of a limited part of this financial services sector where mortgages originate and try to extrapolate.

As you pointed out, we've seen an increase over the past four years in which SAR-reported, that is SAR-related mortgage fraud, has almost -- it's almost tripled -- and it's in those numbers. At the same time, the losses have just about tripled. Those are strong indicators to us.

Now, what does that mean over the entire industry? We think that it means trouble, we can't put a number on it, but it certainly has our attention and I think it warrants taking the limited resources we have and focusing those resources right now on this problem, that's what we're doing.

Robert Russell: Now, John, the Suspicious Activity Reports are currently only required by Federally-regulated institutions and their affiliates. Can you describe or can you estimate the amount of mortgage fraud because of, to FINCEN because it is not a required report?

John Arterberry: Well, I think our other panelists may be able to help me on this, but my understanding is that we're probably looking at maybe a third of the picture when we try to base this on suspicious activity reports. Our understanding is maybe as much as 60 to 70 percent of the origination of mortgages is occurring outside this reporting sector. So, we certainly think that it's safe to take the data we're getting from SARS and spread that out over the entire industry. On the other hand, that is a huge gap, and we have to do just that -- extrapolate rather than basing it on good, solid information.

Robert Russell: Scott, can you provide an estimate of the amount of losses you think might be occurring out there, I know it would be scientific but just your best estimate. If the FBI is reporting a billion dollars in losses in 2005 -- what do you think the total might be for the entire industry?

Scott Husted: Extrapolating FINCEN's report, or out of their report for all financial crimes, and boiling it down to mortgage fraud, the estimate ranges between $1 billion to $2 billion, and as John indicated, FINCEN's data is based off of originators which only originate about one-third of mortgages in the country. So, it's not hard to do, you can take one to two billion dollars, and you essentially triple it, and you're going to be talking about $3 billion to $6 billion in losses, and those are reported losses which doesn't -- not always -- mean it's the fraud for housing, but it certainly does mean the fraud for profit. So this problem really is somewhere between $3 billion to $6 billion -- a cost, I might add, that is born by the honest borrower through the process of getting legitimate loans and paying a yield on that. So each and every one of us in the room that have a mortgage from an institution pay that money.

Segue waying into a couple of other points that we'll make a little later, it's important to remember that this cost is borne by individuals, low to moderate borrowers -- and for that matter -- all borrowers who borrow from institutions, they pay for this. Whether it's $3 billion or $6 billion, it's a lot of money.

Robert Russell: Thank you Scott. Let me follow up on that by asking Rachel if she could expand on why do we care about mortgage fraud? Who gets hurt? What are the, who are the people out there that are getting hurt? Rachel, could you describe that, please?

Rachel Dollar: Well, as Scott indicated, consumers get hurt just by the increase in interest rates and having it spread over their own loan rates, and lenders of course are damaged by that in $3 billion to $6 billion in losses every year.

But even beyond that, we do at times have consumers who are victimized in these schemes. In a large number of frauds for profit, we don't see true victims as a lot of the borrowers and other participants in these schemes are in it for profit and they're paid for their participation.

We do, however, see it in various different types of schemes, for instance, chunking schemes that are very common right now that are investor-based schemes where the fraudsters are going out into the community and trying to get people to become investors in real estate and really selling them properties that are not worth what they're paying for them. So sometimes they're buying homes for two and three and four times their value and then they are being left with these loans when they thought they were getting into an investment deal.

It also comes down farther into neighborhoods. When we have mortgage fraud, it generally occurs within discrete neighborhoods and so you have a number of different homes within a certain area that have been involved in these flipping and fraud schemes -- they generally don't pay the mortgages on them and they go into default and the foreclosures in the area drag down property values. At the same time that those increased, inflated values are driving up property taxes. And so you have a real dichotomy there between what's affordable for the people who already live there and how it's affecting them, and what happens to the values of their property and who ends up moving into those neighborhoods. It also can affect municipalities extremely, there's estimates out there that one foreclosure can cost a municipality up to $30,000 -- whether it's lost property tax revenues to increased foreclosure costs, costs of law enforcement in these areas -- there are some real ramifications that go through all stratas of society and economic position with these fraud schemes.

Robert Russell: Bill Brewster, could you comment, you've worked for a company that creates a secondary market for mortgages, a securitizer -- why does a securitizer care about mortgage fraud?

Bill Brewster: Well, really for the same reasons that have been mentioned, we're concerned about the impact on the neighborhoods, the impact on consumers, also the impact on lenders and securities holders and investors. Loans that are securities that are subject to fraud are not only -- we've talked a lot today about transparency -- think about an extension of what Lou Ranieri mentioned this morning, information that's in a security that you have to disclose in a prospectus, if there's fraud in those loans then all of that information is bogus, or it's all compromised, at a minimum.

And the difference between a for-profit scheme and then a fraud-for-housing scheme is sometimes the immensity of a for-profit scheme could be hundreds of loans spread over many securities and that's a major impact on, it could be on the whole business.

Robert Russell: Thank you, Bill. I'd like to talk a bit about the causes of mortgage fraud and maybe start with Scott. Scott, can you get us going in this area -- what are the major reasons why we're seeing such an uptake in mortgage fraud?

Scott Husted: Well, there's a variety of reasons, I think one of them, kind of going back to the risk management, these schemers, if you will, they will put together this program where if they walk into one of our institutions and they rob the bank and have a gun and steal $100, they're looking at approximately six to eight years in prison. Where if they create a mortgage fraud scheme and they steal $100,000 more from us, they are really looking about 18 months. And also because of the mortgage industry, the size of the industry, it's much more likely that they will get away with a smaller, let's say a $50,000 theft or otherwise, just because the system is really burdened at this point. So, that's one reason why you're seeing more, we believe you're seeing more mortgage fraud because it's created such a vacuum in the manner in which we chase these guys.

John can speak to the SAR filings and the enormous task it is to week through all of the chafe in those numbers. It also burdens the institutions as far as process goes, it again disrupts the yield for the security holders, and it certainly is a cost ultimately borne by the consumer. So, there's a variety of issues that occur in each segment of the mortgage business related to mortgage fraud and that is essentially it.

Robert Russell: Good, thank you. Thank you, Scott. Scott, could I follow up with you on that and ask you if you can discuss the role that appraisals play in mortgage fraud. I think in preparing for this panel, it seemed all of the panelists agree that the foundation of mortgage fraud is, at least for-profit, is the valuation process and so, perhaps you could start off our discussion of that, Scott.

Scott Husted: Well, essentially there's two things that -- certainly in our institution the most important document in the loan file is first and foremost the appraisal. If you don't get the appraisal right, then it would really disrupt the ability for you to analyze the performance aspect of that loan and in the aggregate, the bond itself.

And then second to that, transactional mis-rep -- we really are very interested in when a loan is perceived to be a purchase money loan, or when a loan is perceived to be an owner-occupied loan and it really isn't, so there's a transactional aspect, and in fact, that's really one key way that we find fraud in mortgage files is we look to see the anomaly and look for the transaction mis-rep.

If you can get the transaction right, meaning you know that it's a buyer -- a legitimate buyer -- and that they're -- or a person refinancing a home -- and you get the value right, you're far and away ahead of the game.

Second to that, of course, you want to look for employment mis-rep and asset mis-rep -- those types of things -- but if you get the transaction and the appraisal right, you're light years ahead. We feel that there needs to be some reforming in the appraisal arena. They're a great partner of ours, it's a critical, because it is such a critical piece, we would really like to see modified standards and for that matter, the Appraisal Institute has also voiced their opinion that they'd like to see some modified standards in the manner in which not only their, some of their appraisers produce their product, but certainly the way the industry addresses their product as it associates itself with a mortgage loan.

Robert Russell: Bill, could you explain how appraisers are licensed and supervised and can you address the importance of independence in appraising?

Bill Brewster: Sure, absolutely. As was mentioned, appraisals keep document -- it's been brought up today a few times about loan-to-value ratios, housing prices up or down -- the pressure on the appraisers, ironically, sometimes there's more pressure on an appraiser in a down market. But it's easier to support an inflated appraisal in a down market, because the prices are coming down so you use prior sales.

One of the pressures that appraisers have is they're trying to meet the loan officer's request for a value, and they don't necessarily feel independent enough. However, if you think back to regulation in the late eighties, early nineties the whole idea of regulation was to have the States regulate the appraisers, and the States feel insufficiently independent, or the appraisers feel insufficiently independent to render a good lending, a value for lending purposes. And what we've seen over the years, our companies work closely with the States, sent a lot of appraisals to the States where we've had questions about, and we haven't got a consistent response. A lot of the problem is the States don't have resources in a lot of cases to dig through these.

Just recently we met with the Association of Appraisal Regulatory Officials which is a group of State regulators trying to get together and come up with better ways to be consistent on this.

So, there's progress being made, but as Scott mentioned, reform may be necessary to really get the teeth into the regulation of that whole industry.

Robert Russell: Thank you, Bill. Now, Rachel, do you believe that appraisers are subject to certain pressures and it may threaten their independence, could you comment on that?

Rachel Dollar: That's the main complaint we hear out of appraisers these days is that they are pressured and that they can't stay in business and they can't compete in this market until they're willing to increase values or inflate appraisals because so many other appraisers are doing it. I speak to appraisers a lot, and really the point that I always try and make is that the appraisers are usually not, are not really financial participants in the mortgage fraud. Very, very seldom do we see appraisers walking away with a percentage of the "take" in these schemes. I remember one appraiser in Texas who was getting $7,000 or $8,000 per appraisal, but usually the appraisers are doing it for their regular fee. And so we see appraisers committing appraisal fraud for $350 or $450. And when you look at some of the underlying indictments and some of the court records on what, exactly, it is the appraisers are doing, they are basically just giving into pressure to inflate appraisals or change values and they're doing it for their best customers.

Robert Russell: Thank you, Rachel. Scott?

Scott Husted: I'd just like to add that we're pushing forth an initiative through our friends at the MBA, Josh Denny, a proposal which is going to ask that the Appraisal Institute require insurance for appraisers. Today, there's no requirement that they have any insurance whatsoever.

And in addition to that, we're going to look forward to proposing a national registry for appraisers, and that's where appraisals are registered as they go through, and appraise a particular property -- you may not be able to get all of the data on the appraisal or make public the appraisal itself, but at least if you had an indication that there were multiple appraisals done on a particular property, it would be an indication of fraud.

And that goes along the lines, also, with our initiative for data sharing. Currently, there's a huge deficit in the process of data sharing, and reporting. And it's a huge void. And the industry has to get its act together, the regulators have to get their act together to go through and promote the ability for institutions to data share, either on a peer-to-peer basis or somehow create some sort of access to a limited amount of the SAR information. Currently our institution -- as all institutions -- report up to the SAR into a national database that FINCEN owns.

FINCEN, essentially, has three hundred people that try to work on these thousands of SARs that come in. It's to the benefit of the Federal investigators, it's to the benefit of local D.A.s and certain State regulators. However, as a company, as an institution that puts forth this data up into this national database, we have no access to that information. We have no access to the information that OFHEO requires Bill, to my left here, to report.

However, there's this huge list of fraudsters that we're trying to combat at the front side when they come to our shop, but I don't know. I don't know the names of those fraudsters. I know the ones that I've reported, but we really feel there needs to be some reform in this area where we, on the front side -- we're willing to take ownership of this issue -- we can't rely on John to chase every criminal out there. But we certainly need, for the benefit of our institution, for the benefit of the good borrowers who are paying the price, we need access to that data so we can do our job. This is not about us pushing up to the Government, this is us wanting to pull down so that we can get out there and do what we need to do to better this process of data sharing. And we're going to put forth that initiative -- again the MBA group is helping us put that together -- Richard Wohl, who's the president of our company is going to campaign that personally in the coming two years.

Robert Russell: Thank you, Scott. Rachel, I've heard that there may be some problems with sharing of information and maybe instances where the person who submits the information may be creating some liability for his organization. Can you talk about that issue and the need for a safe harbor?

Rachel Dollar: There are potential defamation, of course, issues whenever you share specific borrower information and suspected fraudulent activity on behalf of either a borrower or other people within the transaction, and potentially other issues as well when you bar somebody from obtaining credit based just upon suspicion.

In order to be able to share the information without those kinds of concerns, the industry needs to have a safe harbor in place, that is legislated, and one of the issues that has been discussed around that is a condition that loans not be decisioned just based on the fact that somebody's name appears upon that list, in order to stem some of the potential problems with just passing on names and having people decide loans based solely upon the identity of an individual or their participation in a transaction.

Robert Russell: Scott, could you comment on the licensing of loan officers at brokerage firms and whether that's a problem?

Scott Husted: Certainly. Today it's very difficult to track loan officers because we really acquire their name from the bottom of the standard application, which is the 10-03. We don't have any sort of tracking information, we don't have any indication of whether or not that particular loan officer in their book of business that they originated ended up being a person that originates loans that have a tendency to go delinquent, fraudulent or otherwise.

It's imperative we start getting our hands around this. The securities dealers have it, the appraisers themselves do actually a good job, but the loan officers -- that's an area that is essentially unregulated. Certainly on the Federal level it's unregulated, there are a couple of groups that are moving forward to attempt to get their hands around that aspect, so as soon as we can get a tracking device, if you will -- and that's going to not only establish the loan officers that are associated with the good loans, but bad loans as well.

So, if you think about it in the context of the good loans, and talk about it in a process perspective -- a lot of what I do at my shop is process-oriented around trying to validate the information within a loan file. But if I happen to know that a) I don't have a loan that otherwise was rejected down the street at one of the other institutions the last couple of days, b) it's with a loan officer who has a wonderful track record, well I can actually speed up the loan or lessen the process because I have something to benchmark the risk attributes to, right? So that's what we would really like to see, is a tracking area of loan off-, a tracking facility on loan officers so we can execute better on behalf -- again, going back to the consumer -- so I can execute better for that good consumer, and of the loans which warrant a further, a deeper dive, we can do that deeper dive on just those loans. Right now I have to say we have to do a deeper dive on too many loans because of a lack of this information.

Robert Russell: Now, we've talked a bit about what mortgage fraud is, how big the problem is how, whether it's growing, why do we care about it, and what are the basic causes of mortgage fraud. I'd like to spend a little bit of time now talking about detection and prevention, I think we touched upon it a bit, but again maybe starting with you, Scott.

There are numerous players involved in the process of obtaining a mortgage. There are banks, appraisers, mortgage companies and brokers, real estate brokers, title and mortgage insurers, secondary market firms and Wall Street. It would seem to make it very difficult to keep all of the pieces organized and understood so that you can identify situations where mortgage fraud might be trying to crawl its way into your portfolio.

Scott Husted: Oh, it's not too bad, actually. No, actually it is. It's an orchestra. And the orchestra is built around accountability, and the accountability is built around a practice that each individual does their own job. There's segregation of duties, so if the closing agent does their job, the appraiser does their job, the loan officer does their job, so on and so forth, you end up with a loan oftentimes, or that will generally perform and not have any fraud within it.

I'm oftentimes asked of people -- laypersons -- and I tell them what I do for a living and they say, "You're kidding me, people actually construct a mortgage and they're able to get it through the system fraudulently? But don't you get an appraisal, don't you check their income, so on and so forth," and it does -- the system works great for $2.4 trillion worth of business a year.

However, it's when you have a corruption of those two, two of the processes, which is the closing agent starts works with the appraiser, or the borrower or the builder, and so on and so forth, and then you would, what happens is it starts deteriorating. And then the credibility decreases and as that decreases, then they can come in our shop.

Remember, the system is built not -- inherently the system is built to help homebuyers, or home refinancers, to help people, legitimate people get mortgages -- but it's again, it's built off of the segregation of duties and it's when there's an corruption within that that it causes some concern. It's not uncommon on a fraud scheme we will go out, and whether it be one loan or a hundred loans we'll go into the neighborhoods, and we will find that there really is a consortium -- there's a group of people that built a business to rip us off. And so we're keen to that. Again, tracking is key to that, making sure that each one of the segments works independently of the other.

Robert Russell: Bill, could you comment on a concept that you referred to when we were talking earlier, reverse engineering fraud schemes, and how that is critical to prevention?

Bill Brewster: Yes, as Scott mentioned the system, as all of us know, I think, is built on trust. If you're a processor, you trust the loan officer, the borrower trusts the loan officer, people trust the appraiser, and so it makes it even easier and more insidious when someone gets in there and compromises that trust, abuses that trust and then rips off a whole bunch of money.

The biggest thing that a company can do, in addition to the pre-funding and quality control and things that Scott mentioned, is to make sure they educate as many of their employees as possible, and also their business partners as to what, how some of these schemes actually happen.

It's amazing -- I love talking with groups like this -- because we spend a lot of time looking at bad loans, really ugly loans that are full of fraud. And when we go out and talk to people about it, they say "Really? That happens? Wow, I can't believe that so-and-so actually lies about this, or they actually make up an entire building of a property value that has nothing, it's all boarded up and yet an appraiser can say that this has 10 units and each one is worth $200,000." But to reverse engineer them means to go back and figure out how did the fraud happen, and make sure that people in the process are educated and that we share this information.

Where Scott mentioned that we're working, trying to make progress on sharing names. It's a very important thing for Fannie Mae for Endimac and for a lot of other people to share information as best as we can.

But as we work through these issues of defamation and the legal constraints that we might have, we also have to think, "What can we do?" And one thing we can do is we can discuss how fraud schemes are built, what kind of individual, what kind of role comes in there and make sure we educate and share that with as many people as possible.

Robert Russell: I've read about animated, automated computer-based predictive tools that can identify and save you guys from fraud. How well do they work?

Bill Brewster: I'll just start out by saying there's no perfect automated system. I mean we, they, a lot of times the better they catch the fraud, the more fraud they catch which means the more supposed fraud which means the more false positives, so it's a challenge to work through that.

But a well-placed, well-deployed system that you know the detail of what they're finding can go a long ways toward determining which loans you have to take a deeper dive on.

Scott Husted: Fraud detection is really about anomaly. You're looking for an anomaly and there's a way to look at it from a system perspective, which is often times what the current automated programs do. Are they good? Sure. They're a lot better than they were three years ago, but I will tell you the best fraud-detection tool that we have are our underwriters.

We have modified the priorities of our underwriters. It used to be that their number one job was to make sure that the debt-to-income ratios work, that the loan-to-value is proper, so on and so forth.

Today, the priority, number one, is fraud detection. Because nothing else really matters, nothing else is credible if the loan has fraud within it. So you have to look at the loan and you have to identify the fraud.

We used to train underwriters to detect fraud by looking at the verification of deposit, and if it didn't have folds in it, yet it was otherwise represented that it was sent by mail, it probably is fraud. Well, those days are long gone. Different colored inks -- those days are long gone -- today, the benefits that our industry has in the way of automation is the benefits the crooks have, as well. They'll sit there and they'll produce paycheck stubs, they'll produce wonderful verifications of deposit, so on and so forth. So it's not the hard document that it's unto itself you're able to detect fraud on, it's really the anomaly in the transaction.

And our underwriters are trained, in fact, they get training every other month on fraud detection, and their number one job is to identify any fraud within the file. They're looking for anomalies -- does it make sense that this person who lives there doing this job is buying that home? And going back and re-engineering fraud cases, and every fraud case that we get, we re-engineer it, and we painfully go through the process of finding out -- what was the deficiency in our process? How good were these people? And they are very good, I will tell you they are very, very good at getting money out of institutions. Somewhere between $2 billion to $6 billion they get out of us, right?

So, it's a big business and they're very good at it. Number one fraud detection tool -- underwriting. And it really comes down to oftentimes -- as simple as it may sound -- common sense.

Robert Russell: Rachel, I've read reports in the media that some of large lenders have pursued recovery against individuals who have engaged in mortgage fraud.

Can you comment on when it might be appropriate for a mortgage lender to pursue civil recovery against mortgage fraud.

Rachel Dollar: Certainly. I see lenders pursuing civil recovery really for two different reasons. One is just the ability to obtain subpoena power and to obtain evidence that they can turn over to authorities. To obtain additional evidence for their criminal referral in order to increase the chances that the authorities will pick up a certain scheme or go forward with a certain prosecution.

The other, of course, is just based solely on recovery or on deterrence. And one of the things that we really focus on in looking at civil recovery is the recovery possibilities. We're looking at first, whether or not there are any assets out there, whether there were defalcations by anybody who, or any companies that potentially have assets that can be recovered.

A lot of the schemes and the participants in the scheme send assets off shore, which makes things more difficult, so you're looking at all of those things initially before you can formulate a fraud recovery plan and make that decision to go forward, it can be very expensive. But in terms of the potential recovery, and just in terms of the message that is sent to some of these people with these organized fraud schemes, it is very important on some levels that civil recovery go forward and that those actions are prosecuted aggressively.

Robert Russell: Thank you, Rachel. John Arterberry, I failed to introduce you and then I've hardly asked you any questions, that hardly seems quite fair.

The Florida Bankers Association has developed a shared database called FraudNet that captures patterns of repeat offenders. John, can you describe that program and can you give us your evaluation of it?

John Arterberry: Sure. Scott talked about wanting to have systems that give him information that would cause his underwriters, his staff to focus on the loans that need to get attention, I think it's the same thing as going to the airport, when we go through security, those security specialists want to focus on the threats -- they don't want to focus on the 99 percent of the people who are simple interference in the picture.

We think that is a valid and extremely significant way to attack the fraud problem. I know that -- and Rachel's talked about the concerns that State privacy laws and other restrictions have on data sharing -- we in law enforcement think those are probably overplayed. We realize they're there, but FraudNet, I think, is an example of a system that was developed by the Florida Banker's Association, I think it's now spread out across the country in a number of states, it's kind of an open system that states can adopt.

It's, I think it's a promising start. I think those, obviously, in law enforcement recognize that although the SAR database is restricted properly because we have in that raw data that have not been gathered through investigation, but let's face it -- it's a very low threshold to file a Suspicious Activity Report, it's simply suspicious activity. And we don't expect, nor do we want filers, the institutions filing these, to conduct investigations. What we want is a timely -- and that means quick filing -- with just the basic information, we'll take it from there.

But it could -- this SAR database -- and I know we've talked about this informally, SAR database could be a starting point for financial institutions, perhaps not gaining access to it, but simply being able to ping questions against that database. Now, we'd have to work through this, but I think this, FraudNet and other types of databases that give lenders a head's up when they're entering into a danger area.

And I think as the panel as suggested this afternoon, mortgage transactions are very complicated because there's so many players and there's so many forces that are really operating in conflict. And that's what we see in our prosecutions. We talked about the appraiser, the appraiser maybe getting just a relatively insignificant fee, but that's that appraiser's income. And yet, no matter how badly the appraiser wants to do the job right, there are forces in that transaction that are coming to bear on that appraiser just to give them the number that everybody wants so that the deal works.

And that, I think, when we recognize it through the system there are these other forces that are often fee-driven that work against this notion that Scott is trying to drive home, which is let's look for the problems, let's try to keep the process honest.

The crooks know where the vulnerabilities are, and they're going to play those opportunities, and that's I think what keeps, unfortunately, keeps us in business.

Robert Russell: Thank you, that was a good discussion, I'd like -- Bill?

Bill Brewster: Just one quick thing. I know I had to work through trying to share more data, there is, the Mortgage Asset Research Institute, or MARI, is a database that's out there right now that lenders are -- we encourage lenders to use -- we submit to it, the mortgage insurance companies do. So there are vehicles there that we just want -- we need to keep refining them to make them more effective.

Robert Russell: Scott, I understand that you have information on the MBA's Project on Fraud and Ethics and on quality assurance, could you describe that?

Scott Husted: That's correct, I alluded to it a little bit earlier, and that is that we're going to put forth, number one is going to be the data sharing. I can't stress that enough, and it can't be a voluntary process, we need the help from regulators, we need the help from not only the OTS but the other regulators, we need help on the Hill to get mortgage bankers along with thrifts to contribute into a database, first and foremost. It cannot be voluntary.

Second of all, the peer-to-peer sharing which FraudNet does, MARI does -- if you think of it as a, like a pre-emptive strike so, peer-to-peer -- it's not uncommon, someone will come to our shop, and John has seen the report, we stop a lot of fraud at the front door. And it's the best-kept secret. My competitors don't know that I stop that fraud, they don't know their names. But it's very likely that those loans went right down the street, and I'll just use the closest entity down the street, not picking on them, Country Wide. So they probably tromp down to their shop -- by the way, now they have the benefit of my underwriting catching the anomaly, the problem within the loan, it gives them a couple of days to clean that up -- and they take, now a cleaned up file down to the shop down the street, and they get the loan done.

My contention is, this happens over and over again, thousands of times, billions of dollars a year are originated through this process. But, wouldn't it be nice if I was able to put forth a name, an address, some indicator peer-to-peer so that Country Wide would know when that loan came in that shop that an institution -- and maybe they could even know as much as Endimac -- had a problem with this loan, right? That's all we need. We don't want to say they're crooks, we don't want to say that these people are bad guys and we're running down the street chasing them, we want to say "There was a problem with this loan at Endimac."

We are light years ahead of having -- if we had that -- we would be light years ahead of where we are today. Today, I don't know which loans are in my shop. I have right now about $18 billion of loans in our shop right now. I don't know which ones were denied by the shop down the street. I can't wait for the SAR filing to go through and otherwise -- even if I did have access -- you have a 30-day period, so on and so forth.

I've already originated that loan, and all I'm going to find out is -- I just got hosed, right? You can't do that. This is not about, this is not about prosecution, this is about prevention.

And, sure, there's problems on prevention, and there's exposure on prevention. But if you don't do anything, you're going to get ripped off upwards of $6 billion, right? And guess what? That's exposure, right? I'd rather have a few lawsuits or a few issues I have to settle out on one side and have a few more billion dollars in the hopper, then just saying, "Well, we really can't do it." And John mentioned this, he thinks it's overplayed -- I think it's overplayed. I think it's overplayed. Many of us have looked at the crooks in the eye, and they love the fact that we don't want to share data.

At some point we have to step up and we have to -- as regulators, as financial institutions, bear the burden on the front side, and play the prevention role and not the prosecution role. He can do the heavy lifting when we can't get it done, but we've got to take care of it on the front side.

Robert Russell: Assuming you can't get it done --

Scott Husted: I'm a little passionate about this.

Robert Russell: Yeah, let's -- we've got five minutes, about, to cover two more subjects, so let's move quickly.

John, I want you to talk a little bit about referrals and prosecutions and what the Justice Department and the other criminal law enforcement agencies have been up to.

John Arterberry: Well, I think as the other members of the panel made clear, as much as they want to focus on trying to prevent mortgage fraud, it's occurring and we are, I think, unlike -- if we think it's not even two decades since the Thrift Crisis, that perhaps caught us slightly off guard, us, the Government -- I think this time everyone, regulators, law enforcement and the lending community, all want to get ahead of the wave, and that's certainly what we're trying to do in law enforcement.

The FBI is our principle force, they're our primary Federal investigative agency -- let's face it, they're part of the Department of Justice -- we remind them of that quite often. But they do work closely with us, but the reality today is counter-terrorism has taken a huge chunk of the investigative resources that we once enjoyed and has placed those beyond our reach, so we're having to do much more with a lot less. And that means that we have to do it a lot smarter.

The Suspicious Activity Report System helps us do that. It helps us identify where the hot spots are, where the trends are going, where we need to put those limited resources.

We also work with the Secret Service, which is a much smaller investigative agency, but they're also especially affected. And together what we've done is we've tried to reinforce -- we have small task forces across the country, they're not necessarily called mortgage fraud or bank fraud task forces, they may be called white collar crime, economic crime task forces, sometimes identity theft task forces -- whatever the name, they focus on a variety of crimes, but often mortgage fraud is a substantial part of their work, and that's a very effective way for us to take these limited resources and focus them on these problems.

One other thing we do, Bob, and you're very familiar with it. We have to do this -- I talk about the roles that SARS play in it, we also have to do it in a coordinated way with the regulatory community, and one of the ways we do that is through the Bank Fraud Working Group. Every month we bring together representatives from all of the bank regulatory agencies from your headquarters offices here, and we have also representatives from all of the key law enforcement players. And we go over, every month part of what we do is to look at what emerging trends are out there, how are we doing -- mortgage fraud is almost always on the agenda. But this keeps us, I think, tuned into where the lending institutions think the problems are, what the regulators here, what's percolating from the field, I think it ensures that we in law enforcement and the regulators are working in concert to address the problems rather than waiting for things to happen.

So, I think what I can say is we are focused on it, we've done two nationwide sweeps -- those fraud cases, mortgage fraud cases, together all over the country at one time -- so we can focus public attention, media attention on the response so that the crooks out there know that mortgage fraud is getting attention. And I think you'll see more of those sweeps in the future.

Robert Russell: Thank you, John. Last subject I'd like Rachel to address, Rachel are there legislative, statutory and regulatory gaps that need attention?

Rachel Dollar: Yes, and mainly on a State level, I would say. Currently there is no Federal law that specifically outlaws the crime of "mortgage fraud". But, Federal authorities do have several different statutes that apply to the elements that occur within a mortgage fraud, and allow prosecution to occur, such as wire fraud, mail fraud, bank fraud, and those are typically the Federal statutes under which mortgage frauds are prosecuted.

On the State level, however, a lot of prosecutors are left without a criminal statute that really comfortably fits the conduct that occurs during a mortgage fraud, and they're left prosecuting under statutes such as forgery statutes, and grand theft-type statutes.

So, in May of 2005, Georgia was the first state to enact an actual law that criminalized mortgage fraud. And they -- it's called the Georgia Residential Mortgage Fraud Act -- and it actually criminalizes, creates a specific crime for misrepresentations made to a lender during the loan origination process. After that time there have been several arrests, I think there was over 20 arrests after, during the first three months that the law was on the books.

Since that time similar laws have been proposed in Oklahoma, Colorado, New Jersey and Utah, and we're seeing more and more States talk about enacting laws that allow prosecution just directly of mortgage fraud as a separate and distinct crime.

Robert Russell: Thank you. We have about four minutes left, we can take some questions from the audience. If anyone has the energy to stand and get to a microphone.

(Laughter.)

Robert Russell: Well, I'm done asking questions, if no one else is going to ask them we're going to call this to a conclusion.

I want to thank, if we could get a round of applause for our panelists.

(Applause.)

John Reich: Good panel, good discussion, well done, thank you very much.

Today we heard panel discussions on the National outlook for housing, challenges of lending in today's housing market and consumer protection issues in housing, concluding with this discussion on mortgage fraud.

We also had the benefit of observations from Treasury Secretary Paulson and from Chairman Mike Oxley and Chairman-elect Barney Frank. All of this discussion and issues and perspective on housing are significant to all of us in this room.

I think this has been a good forum, I hope that you agree, we heard expression of views on the housing market and a diversity of views and current financing options. I think it's difficult to generalize that a consensus exists on where the market is going, but I think it's safe to say that the discussions that we heard today were interesting, informative, concerning and in some cases, alarming.

I think there's general agreement that the housing market is vulnerable to further deterioration, there are some views expressed that we are approaching stability in the market. We heard a fair amount of concern expressed about the current and future performance of sub-prime mortgage portfolios. We've heard about, we've heard from the regulatory agencies, expressing concern about the quality of institutional stress testing, customer disclosures, promotional materials, the dangers of risk-layering, and the problems that are attributable to unregulated or unsupervised mortgage originators.

And finally, the large and growing problem of mortgage fraud, mentioned in the neighborhood of $3 billion to $6 billion, the types of fraud, some appraisal issues, and a call for appraisal reform.

Let me just say that OTS, that regulates the thrift industry and supervises various prominent companies that own thrifts, plans to be a continuing participant in the national conversation and debate about housing, housing issues and housing policy. Going forward, you have my commitment that we're going to be active in this area in supervising institutions that make home loans and ensuring strong consumer protections are maintained by the institutions that we regulate, and continuing a national dialogue on the future of housing.

I want to mention that later this week, and for about a year, we will have available on our website this, the entire National Forum will be on the website at www.ots.treas.gov. I want to thank all of our speakers today and panelists, I want to thank each of you for being here and for staying, we're going to start the reception now, it's out the door, turn right, turn right again. I've been informed recently that Fed Chairman Ben Biernacki expects to be here at 5:00, that's about 30 minutes from now, hope you'll have an opportunity to stay to meet him, to greet him when he's here. I've promised him that I'm not going to call on him to make remarks. For one thing, the Open Market Committee meets tomorrow and secondly, I have been at receptions where people try to make serious comments when people are clinking glasses, and it just doesn't work
.

So, at any rate, thank you for coming, I -- have a safe trip home and I wish you happy holidays, and hope to see you at the reception. Thank you very much.

(Applause.)