Remarks by
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"Rising Losses in Home Equity Lending"

It's a pleasure to be here with you today, especially at a time when the issue on which this group focuses – housing policy – is such a critical subject of national concern. Indeed, when I look at the two supervisory areas to which the OCC has devoted the most attention over the past year, housing policy has played an outsized role. I'm referring, of course, to credit markets and credit quality, where the turmoil and losses we've witnessed began with subprime mortgages; spread to capital markets through mortgage-backed securitization; accelerated with the widespread decline in house prices; and eventually precipitated losses in a wide range of asset classes.

I want to focus my remarks today on one of those asset classes that has perhaps not received as much media attention as the others – at least not until recently – which is home equity lending. In their first quarter results, several banking organizations reported eye-catching losses and provisions generated by these loans, with predictions of much more to come in future quarters. Indeed, national banks, which hold about half of all home equity loans, sustained as much loss from this type of credit in the first quarter of this year than they did in <u>all</u> of 2007. In that context, let me provide the OCC's assessment of where we are with respect to this particular aspect of housing credit, including our expectations going forward.

Evolution and Growth of Home Equity Loan Market

Let me begin with some background. Home equity lending has grown dramatically in recent years, more than doubling since 2002 to about $1.1 trillion outstanding. To provide some perspective, that total is about 12 percent the size of the roughly $9.5 trillion dollars in first mortgages outstanding. This relatively smaller absolute size of home equity exposure gives us some comfort about the dimensions of potential losses. But unlike the many first mortgages sold to third parties, home equity loans almost always stay on the balance sheet of the lenders that originate them, which means they keep all the credit risk. And by definition, because they nearly always stand behind first mortgages, home equity loans tend to be riskier.

There are a number of perhaps obvious reasons why home equity lending grew so substantially in recent years. Rapid house price appreciation generated lots of home equity for millions of homeowners nationwide. Interest rates were low generally, and the secured nature of home equity loans made interest rates on this product considerably lower than interest rates on other types of consumer credit. And tax deductibility for the first $100,000 borrowed was another sweetener.

But another contributing factor was perhaps not so obvious: liberalized underwriting standards. These relaxed standards helped more people to qualify for loans, and more people to qualify for significantly larger loans. For example, many loans were made with limited verification of a borrower's assets, employment, or income. Higher debt-to-income ratios became the norm. And home equity loans were used in place of mortgage insurance to help borrowers qualify for first mortgages – so-called "piggyback" loans – to minimize down payments and help borrowers obtain larger mortgages. Of course, that resulted in ever higher cumulative loan-to-value ratios, meaning ever lower levels of equity in the homes.

In addition, during this period most home equity lines of credit evolved into "interest-only" products. Previously, such second mortgages had typically been amortizing loans that required payment of not only interest, but some principal as well. That changed. Most HELOCs today require interest payments alone for the first 10 to 15 years of the life of the credit line. The lower payments resulting from this change in structure made it possible for borrowers to carry higher balances. But it also meant that the first tangible sign of repayment problems could be delayed, often up to the point where the loan could be in real trouble, with the bank having few viable options.

Lenders also began to change collateral valuation procedures – that is, the process for valuing the home underlying the home equity loan – in the quest to maintain "speed to close" in approving loan applications in a fiercely competitive environment. Some automated valuation models and other tools were not properly validated, reviewed, or used in a rigorous way to produce consistently accurate valuations. The result in some cases was that larger home equity loans and lines of credit were approved than would otherwise have been the case.

Finally, a number of lenders began using brokers and third-party correspondents to ramp up their market share numbers quickly and with relatively lower costs – or at least that's what they thought at the time. As we have discussed in several pieces of guidance issued in the last several years, using third-party origination channels is not a problem by itself, so long as the relationships are managed appropriately. When they are not, however, the risk of loss can increase significantly. It's now apparent that a number of lenders did not manage the broker and correspondent relationships nearly as well as they should have, making loans from these third-party channels considerably riskier than loans originated through their own retail channels.

In short, there were a number of relaxed underwriting practices that significantly contributed to the rapid growth in home equity lending. But of course, almost by definition, each of these practices also increased the risk of home equity lending. And when used in combination, the layering of these practices significantly increased that risk.

During this period, the OCC became increasingly concerned about these trends. As I mentioned, national banks hold about half of all outstanding home equity loans, with most of these loans concentrated in our very largest banks. In 2005, we joined the other agencies in adopting guidance on home equity lending. Using this guidance, the OCC began monitoring this business much more closely, and we leaned on national banks to improve underwriting practices, boost reserves, and take other steps to mitigate losses.

This was a world of rising house prices, however, and this was a product that had a history of exceptionally low credit losses, even during the last mild recession. Year over year, since at least the 1960s, the median house price in the United States had never declined. Even though the many changes in underwriting practices had since transformed the nature of the home equity product into one that had considerably more embedded risk, and even though the new product had never undergone a real stress test of a significant market downturn, bankers remained sanguine about its risk profile. In this pre-market disruption world, it's fair to say that banks were slow to change their practices despite enhanced regulatory attention. And at the same time they priced the product with the very thin margins associated with secured credit.

But was this credit really secured, at least in the traditional sense? As loans increasingly tapped out borrowers' equity in their homes, there was increasingly little margin for error. If house prices flattened and then declined, creating the much discussed phenomenon of "negative equity," subordinated or second mortgages like HELOCs would be at the point of the spear. They would quickly migrate from loans secured by the value of the home to loans that were essentially unsecured. That, in turn, would make them look a lot more like credit card loans – but ones that were priced at much lower rates of interest.

But in these circumstances, would these underwater home equity loans really behave like unsecured credit? There has been a widespread belief that the link to a borrower's home would make that person more likely to stay current on a home equity loan, even one that is underwater, than on a truly unsecured credit card loan. That belief would plainly be tested in a world where house prices declined and borrowers developed significant levels of negative equity.

Substantially Increased Losses

Thus the stage was set when the market began turning in 2007. As we all know, house prices did indeed decline, and in some markets quite substantially. That significant trend, combined with the relaxed underwriting practices I've just described, has begun to produce unprecedented rates of loss. Let me provide some numbers to illustrate this fact.

Traditionally, losses on home equity loans have run at the rate of 20 basis points, or .2 percent. Needless to say, that's quite low, but through September 30 of last year, that’s just what we saw. Losses at national banks barely budged from that mark, although they did drift a little higher in the second and third quarters. In the fourth quarter of 2007, however, the loss rate spiked to nearly one percent. And by the end of the first quarter of this year, the loss rate climbed still further to 1.73 percent. Compared to the historical rate of 20 basis points, that’s almost a nine-fold increase, and far, far higher than banks had projected. Moreover, loss rates on loans originated by brokers and correspondents have in many cases been significantly higher still.

Looked at in dollar terms, losses on all home equity loans, including HELOCs and junior home equity liens, rose from $273 million in the first quarter of 2007 to almost $2.4 billion in the first three months of 2008 – again almost a nine-fold increase. And the largest home equity lenders are now saying that they expect losses to continue to escalate in 2008 and beyond.

This elevated loss rate and pronounced upward trend line are certainly causes for concern and scrutiny. But they also need to be put into perspective. As I previously mentioned, home equity lending loss rates were exceptionally low compared to other types of loans, and their many-fold increase in the last year – while eye-popping – still brings these rates to levels that are lower than on other types of retail credit such as credit card loans. It’s true that home equity credit was priced with lower margins than these other types of credit, and it’s true that the product has become a significant on-balance sheet asset for a number of our largest banks. Nevertheless, the higher level of losses and projected losses – even under stress scenarios – are what we at the OCC would describe generally as an earnings issue, not a capital issue. That is, while these elevated losses, depending on their magnitude, could have a significant effect on earnings over time, with few exceptions they are not in and of themselves likely to be large enough to impair capital.

Loan Loss Reserves

That brings me to the subject of loan loss reserves. I can’t stress enough how crucial reserves will be in helping the industry manage its way through this situation. At some banks, the portion of reserves attributable to home equity loans just barely covers 2007 chargeoffs. With losses accelerating, those reserves simply are not going to be adequate, and that’s why our examiners are encouraging more robust portfolio analysis and loss reserve levels.

While objective evidence exists to support higher reserves, we also need to recognize that we're in uncharted territory. New product structures, relaxed underwriting, declining home prices, potential changes in consumer behavior – all of these factors make it difficult to predict future performance of home equity loans. Circumstances have changed fundamentally, to the point where benign, low-stress historical trends have little relevance in estimating credit losses. With this new reality, qualitative factors such as environmental analysis and changing consumer behavior clearly should become more significant factors in the reserve calculation. Likewise, lenders should take into account the very real possibilities that unemployment or interest rates will increase from their quite low current levels.

Lenders also need to carefully monitor and manage unfunded credit lines. For national banks, the total amount of unfunded home equity commitments is actually larger than the total amount of home equity lines drawn down. As a result, changes in line use or patterns may be a warning signal. Again, banks need to recognize that we’re in new territory, and make some qualitative judgments about how to manage exposure and reserve for these credit lines, which could very quickly stop performing.

In short, with so much evidence of the potential for higher home equity losses, we believe that higher reserve levels are prudent.

Expectations for the Future

Let me balance this gloomy assessment with this observation: we see evidence of higher quality in recent home equity loan originations. Partly in response to market conditions, and partly in response to the examination process, major home equity lenders are making some prudent adjustments in their underwriting. Large national banks have become less willing to take enhanced risk to achieve growth, and they are either abandoning or placing stronger controls on third-party origination channels. There is much more emphasis on customers with known track records, and banks appear to be moving away from explicit, broad-based, stated income programs.

That's all to the good. But even as banks begin to work their way through the current problems, we need to ask some hard questions about home equity product structure and underwriting criteria. In particular, we need to revisit the problems that landed lenders where we are today – particularly some of the "shortcuts" established in reaction to aggressive competition.

One such problematic practice is the rampant use of home equity lines to finance down payments. In the past, rapid house price appreciation almost guaranteed that, if the borrower had no equity at closing, all the lender needed to do was wait a bit and there would soon be equity in the house to protect its loan. As we've seen, however, rapid house price declines can indeed occur, wiping out equity and security. Lenders need to structure loans and lines with enough equity cushion – “skin in the game” – to minimize the likelihood of that outcome.

There are a number of other questions that need to be addressed as well, including the appropriate use of collateral valuation tools like AVMs. These tools can be both cost effective and useful, but only if closely managed, periodically validated, and supported with sound business rules. Put another way, cost alone simply cannot be the guiding principle for their use. Our examiners have been working closely with national banks on this issue, and we expect to continue that discussion over the coming year.

Income documentation is another key area. As mentioned, the transparent practice of overtly accepting “stated income” has largely been discarded. But some lenders have made only modest adjustments by using so-called "reactive stated income" programs. Here, the lender does require the borrower to provide detailed information and authorize the lender to verify income, as if the lender were really going to do just that. But then, supposedly unbeknownst to the borrower, the lender deliberately chooses not to incur the additional time and cost of actually following through and verifying the income. This practice is only marginally better than expressly relying on stated income, since it is questionable whether the borrower’s belief that income will actually be verified will really induce a higher level of honesty in providing information. We need to think carefully about whether anything short of actual verification of income is acceptable from a safety and soundness perspective for most borrowers.

We also need to rethink the extended interest-only structure that home equity credit lines have in the early years of the loan term. Again, payment patterns are only a proxy for a borrower’s capacity to handle a given debt level if the payments are meaningful. Interest-only payments reflect a borrower's capacity to pay interest on a debt, but not the debt itself. Further, this lack of structured payment discipline encourages borrowers to assume greater levels of debt, often to the limit of their ability to make minimum monthly payments. In contrast, higher payments that reduce principal address both these concerns. Indeed, when I took office in 2005, we were in the final stages of implementing the credit card account management guidance, which mandated that minimum payments include some principal reduction each month. Despite dire warnings from the major card companies that consumers wouldn't be able to handle the higher minimum payments, there was little disruption as the guidance was implemented. And I think most would now agree that the guidance made the system better – not just for the industry, but for consumers as well.

Conclusion

In closing, let me be clear that we are not expecting all the changes I've discussed to occur overnight. National banks' first priority should be to address the significant issues I've described with the home equity loans and lines they've already extended. But as we move forward, they will need to revisit and strengthen their underwriting practices so they can avoid a return to the very real problems they face today.

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