Statement of Charles W. Calomiris

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and the

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Chairman Ney and Chairman Bachus, thank you for inviting me to speak today before this joint meeting of the Subcommittees on Housing and Community Opportunity, and Financial Institutions and Consumer Credit, on the important topic of subprime lending.

In my July 26, 2001 testimony, "What to Do, and What not to Do, About Predatory Lending," before the U.S. Senate Committee on Banking, Housing and Urban Affairs, I provided a brief historical overview of the progress brought by the development of the subprime lending market, made specific recommendations for regulatory reforms to deal with predatory lending, and expressed concern that regulatory overreach, particularly by state and local governments, could threaten the recent improvements in the efficiency and fairness of our national mortgage market. I will briefly summarize and update that earlier testimony, and offer some additional policy suggestions.

1. Subprime lending, and the development of a national market for financing prime and subprime mortgages, have been a great boon to consumers. The quantification of risk factors in mortgage and other consumer loan markets, and the securitization of these loans, have been especially beneficial developments, both from the standpoint of market efficiency and fairness. The development of quantitative scoring has been of fundamental importance to the pricing of risk and the democratization of finance. Instead of rationing credit to the favored few, suppliers of funds in the consumer lending market now can measure and manage risk better so that a much broader range of consumers can access credit when they need it. Securitization of consumer lending (which relies on the quantification of

risk) has broadened the sources of funding and increased competition in consumer lending, and has further facilitated the measurement and diversification of risk, all resulting in substantial cost savings for consumers.[1]

2. Many consumers have choices and opportunities in the market that they did not have even a decade ago. Houses can be used, and often are used, as a source of funding by people of all income levels, ages, occupations, and backgrounds to fund a variety of needs. Minority borrowers have been among those most benefiting from the democratization of consumer finance. According to Countrywide Financial Corporation, which describes itself as the largest mortgage lender in the United States to African Americans and Hispanics, it plans to lend $600 billion to minorities and low income families by the year 2010.
3. Although it is true that subprime lending has opened new opportunities for access to credit for low-income borrowers, subprime lending is not geared exclusively, or even primarily, toward low-income borrowers. In fact, Countrywide shows that the demographic characteristics of its prime and subprime borrowers are quite similar (that is, the age, income, and occupational distributions of the borrowers in the two categories are similar). Fifty-five percent of Countrywide's subprime lending involves loan balances in excess of $200,000.[2]
4. Why do middle- and upper-income people rely on the subprime market? Subprime loans can be the easiest form of credit for borrowers that are in urgent

[1] Charles W. Calomiris and Joseph R. Mason, *High Loan-To-Value Mortgage Lending: Problem or Cure?* AEI Press, 1999; Charles W. Calomiris and Joseph R. Mason, "Credit Card Securitization and Regulatory Arbitrage" (with Joseph Mason), *Journal of Financial Services Research*, forthcoming.

[2] "Debunking the Myths: Who Are Non-Prime Borrowers?" Presentation of Debbie Rosen, Executive Vice President, Countrywide Financial Corporation, to the Housing Policy Council of the Financial Services Roundtable.

need of funds for medical procedures, or to finance a child's wedding or education, or for those who wish to borrow against a form of collateral not favored in the prime market (e.g., a condominium). Subprime loans are particularly useful for the self-employed, who tend to have a harder time accessing prime lending markets because they lack employment records. The new financing opportunities brought by subprime lending have given consumers much more flexibility in their spending and financing choices, especially by enabling people to satisfy important medical, educational, or other needs quickly.

5. The rapid progress in the development of the new subprime market has also brought with it some growing pains. I refer to various practices (which were summarized in my July 26, 2001 Senate testimony) that are collectively known as "predatory lending," although there is disagreement about what should be included in the definition of predation.

6. There have been a variety of statutory, regulatory and voluntary private industry responses to abusive market practices over the past several years, some at the federal level, some at the state and local government level. Many of these responses have been sensible and measured (particularly the actions taken by the Federal Reserve and the OCC). Those measured responses recognize the need to address undesirable practices "surgically" – that is, by preventing or discouraging them without undermining the vitally important role played by subprime lending.[3]

[3] For a recent review of consumer protection controversies and regulation in the area of subprime lending, see *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, AAO Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate, January 2004.

7. Other responses (particularly, overzealous prohibitive laws passed in some states and localities) have been unbalanced attempts to use state or local government authority as a means of instituting "stealth usury laws" which are intended to have a chilling effect on high-cost subprime lending. By stealth usury laws, I refer to laws that impose "poison pills" on high-cost subprime lenders, either through prohibitively costly procedures or highly uncertain legal liabilities which make it undesirable for lenders to continue to participate in high-cost mortgage lending.
8. In my view, those stealth usury laws constitute an undesirable encroachment on the legitimate authority of federal bank regulators to regulate the terms of lending by federally chartered institutions. For that reason, and because stealth usury laws are contrary to the public interest, I believe that the OCC was correct in January of this year to assert preemption over these various state and local government laws, which it did to preserve its appropriate oversight role over federally chartered bank lending practices.
9. In justifying that decision, Comptroller Hawke pointed out the importance of allowing lenders to continue to operate in a national mortgage market.[4] It is important to recognize that there are large gains from having a national market. It is highly efficient to be able to pool loans from a variety of locations, and to finance them with funds from a competing group of investors in the national capital market. Federally chartered banks that operate throughout the country help the market to realize those efficiency gains, as do the ratings agencies and

[4] "When national banks are unable to operate under uniform, consistent and predictable standards, their business suffers and so does the safety and soundness of the national banking system. The application of multiple and often unpredictable state laws interferes with [national banks'] ability to plan and manage their business, as well as their ability to serve the people, the communities and the economy of the United States."

other intermediaries that monitor the performance of securities placed into securitization pools, which are financed by debt offerings in the national capital market.

10. We have already seen tangible evidence that state and local government actions can cripple high-cost subprime lending, and that these laws can undermine the ability of mortgages originated in the jurisdiction covered by those state and local statutes to participate in the national market. My 2001 Senate testimony reviewed evidence from an empirical study by Michael Staten, which identified a severe reduction in high-cost subprime lending in North Carolina in reaction to its stealth usury law. We have also seen evidence of the positive effects of OCC preemption in preventing the fragmentation of the national mortgage market. In response to New Mexico's Home Loan Protection Act, Fitch announced that it would not be rating RMBS transactions containing high-cost home loans originated in New Mexico. Then, in response to the OCC's preemption policy, Fitch announced that it will rate, without additional credit enhancement, RMBS transactions in any state so long as they are originated by OCC-regulated national banks and their operating subsidiaries.[5]
11. Some have suggested that the Congress should go further than the OCC has, and should provide legislation establishing a national standard for practices in subprime lending. There are always costs and benefits to taking discretion away from the states with respect to their regulation of *state-chartered* entities. On the one hand, one could argue that the national mortgage market is sufficiently

[5] "Fitch Ratings Addresses New Mexico Predatory Lending Legislation," Business Wire, January 15, 2004; "Fitch Ratings Addresses Preemption Statement from the OCC," Business Wire, January 15, 2004.

protected from inefficient regulation by regulatory competition between the states and the federal government, where each is free to set rules for its own chartered entities. That system has served us well for nearly one and a half centuries. On the other hand, one could argue for a national standard for all intermediaries as a means of providing a uniform standard for all lenders. I do not have a strong opinion on this issue, but I would argue that whatever Congress decides, it should protect federally chartered entities from state regulation. In particular, I do not agree with those who propose that Congress only establish a "floor" for the national standard, rather than full preemption. In my view, that would effectively establish state authority over nationally chartered institutions, undermine the authority of the OCC and OTS to regulate nationally chartered institutions, and threaten the ability of those institutions, and their borrowers, to participate in a national mortgage market.

12. What should a national standard for subprime lending try to achieve, and how should those goals be achieved? The key goal should be to ensure that consumers make informed choices. I believe that a combination of improved (and streamlined) disclosure, consumer education, and strengthened enforcement, are what is needed.

13. A rush to prohibit, rather than to regulate, prepayment penalties, balloons, or other often legitimate and desirable features of subprime loans, runs the risk of depriving consumers of contractual features that often save them money when used properly. I would also caution against placing too much credence in some of the statistical studies being circulated, or in summaries of those studies by

advocates. Statistical analysis is a useful tool, but it is also subject to alternative interpretations based on wishful thinking or outright abuse by advocates on both sides of any issue. There is precious little research on subprime lending that has been scrutinized by peer review and published in refereed economics journals.

14. I would suggest that Congress focus on preserving and ensuring informed consent by consumers through five measures.

15. First, mortgage disclosure is too voluminous, which makes consumers rush through the paperwork rather than focus on the most important facts about their mortgage. Congress should establish a commission of experts to recommend ways of streamlining the reporting requirements on consumer lending. And it should add a simple new reporting requirement that would be enormously helpful. I propose that all consumers should be able to see, on a single page, the terms of their mortgage in comparison to the terms received on average for that product by consumers with the same FICO credit score and the same loan-to-value ratio. That simple measure will empower consumers who are not financially literate or experienced, especially those that would qualify for prime loans but who are being targeted by subprime lenders, to see that they are being cheated. Those borrowers would be able to clearly see a big difference between the interest rate, points, and penalties on their loans and the average characteristics of comparable loans to comparable borrowers.

16. Second, the federal government should budget funds for testers who would respond to advertisements for subprime loans and help identify and prosecute lenders who are not abiding by the law.

17. Third, the government should continue to support, and perhaps increase funding for, 800 numbers and other consumer information services that help to inform consumers about their rights and about standard practices in the mortgage area. It would be especially helpful if the government would circulate information to consumers about the terms that are generally available in the marketplace to borrowers seeking similar products, with similar FICO scores and loan-to-value ratios.
18. Fourth, my first and third proposals would require the establishment of a national database on mortgage loan terms for all mortgage lenders. There is a cost to establishing such a database, and there are legitimate privacy concerns of borrowers and lenders that must be respected. But I am confident that there is a way to collect a few simple pieces of information in a low-cost way, without posing a threat to the privacy of lenders or borrowers, and that there are substantial benefits to consumers from creating this database.
19. Fifth, regulators or legislators should seek to avoid the chilling effects of "stealth usury" laws. Any rules about subprime lending should be easy to comply with and should offer clear guidelines for what procedures would ensure safe harbor from prosecution. Lenders should be able to be confident that if they follow clear guidelines for best practices, then they will not be subject to liability for unpredictable enforcement of the rules.

Chairman Ney and Chairman Bachus, I hope that you and your colleagues, along with the OCC and the Fed, will help to maintain the efficient operation of the national

mortgage market, and continue to support balanced efforts to protect individuals from predatory lending without undermining the progress that the quantification of mortgage risk and the nationalization of the mortgage market have allowed. That progress has given people the freedom to make choices that have benefited millions of individuals. I hope that you and your fellow subcommittee members will agree that the overzealous and misguided agenda of those who wish to use stealth usury laws to effectively outlaw high-cost subprime lending, and undermine the authority of federal regulators to control the lending practices of federally chartered institutions, must not be permitted to succeed.