U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON, JR. BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON THE LEGISLATIVE AND REGULATORY OPTIONS FOR MINIMIZING AND MITIGATING MORTGAGE FORECLOSURES

Washington- Chairman Frank, Ranking Member Bachus, Members of the Committee, good morning. I very much appreciate the opportunity to appear before you today to present the Treasury Department's perspective on the recent events in the credit and mortgage markets and their impact upon consumers and the economy. I am also pleased to be here today with my Cabinet colleague, Secretary Jackson, and with my fellow President's Working Group Member, Chairman Bernanke.

Credit Markets and the Overall Economy

Recently, there has been an adjustment taking place in the overall credit market and the mortgage market in particular. The current market turbulence stems from financial practices, but unlike many previous episodes of market volatility, takes place against a backdrop of a healthy U.S. economy and strong global growth. In the United States, the unemployment rate is at 4.6 percent, close to its lowest reading in 6 years. Growth in real gross domestic product was 4.0 percent at an annual rate in the second quarter, supported by strong gains in business investment and exports. Core inflation is under control. Since August 2003, 8.2 million jobs have been created and over the past 12 months, 1.6 million jobs have been created. Real wages have increased 2.2 percent over the past 12 months. In the corporate sector, earnings continue to outperform expectations and default rates on corporate credits of all kinds are at historically low levels. The Federal government's fiscal deficit is declining and well below long-term averages as a share of the economy, reflecting strong revenue growth and the continued strength of the U.S. economy.

The global economy also remains strong, with annual growth at around 5 percent and with many emerging market economies growing even more rapidly than the global average. The advanced economies also continue to perform well, with unemployment down sharply in Europe, helping to make growth of the last several years the strongest since the early 1970s.

Credit markets play a vitally important role in the efficient operation of our economy by intermediating funds between investors and borrowers. Credit market participants are constantly evaluating their views on risk and their appetite for risk. Larger fundamental reappraisals in the pricing and appetite of risk have taken place numerous times over our nation's history, which is fundamentally the way that markets work. We are in the process of another such reappraisal period today.

As has been well documented, the current credit market reappraisal started in the subprime mortgage market. The performance of subprime mortgages deteriorated, as a result of higher than expected delinquencies and defaults. This introduced greater uncertainty regarding both the future prospects of subprime mortgage-backed securities and the methodologies the credit rating agencies used to rate these securities. These factors led investors fundamentally to reassess the risk of these securities and subsequently to reassess price. Compounding the challenge was the increased complexity and opacity of many of the mortgage backed securities investment strategies and instruments. The combination of uncertainty and complexity resulted in few investors willing to put capital at risk.

Given the interconnectedness of the various components of our capital markets, these concerns over subprime mortgages and related securities had an impact on investors' confidence and assumptions about the credit quality and value of other assets. Consistent with expectations, we have witnessed a reassessment of risk, and hence a subsequent revaluation across capital markets globally. Certain asset classes were able to reassess fairly quickly and investors have greater confidence in their fundamental assessments. In such markets, liquidity has returned and markets are operating in a more customary fashion. Good examples of these would include most world equity markets, sovereign debt markets, and even investment grade corporate debt. Alternatively, certain markets are still operating under stress with impaired liquidity. These would include the jumbo mortgage market, the leveraged loan market, and the asset backed commercial paper market.

Given the importance of credit markets to the functioning of our economy, when we experience a fundamental reappraisal like we have over the last several weeks, it is essential that policymakers evaluate the potential impact on the economy. Chairman Bernanke can provide additional details, but the Federal Reserve undertook several measures – providing additional reserves through open market operations, lowering the discount rate, and changing practices associated with discount rate borrowing – to increase liquidity and promote the orderly functioning of financial markets. Additionally, this week, the Federal Reserve lowered its target for the federal funds rate by 50 basis points and approved another 50-basis-point decrease in the discount rate. The Federal Reserve's actions have helped to stabilize financial markets.

At the Treasury Department, we have been closely analyzing the global capital markets on a daily basis. As Chair of the President's Working Group (PWG) on Financial Markets, I have been in regular contact with members of the of the PWG, which includes Federal Reserve Chairman Bernanke, Securities and Exchange Commission Chairman Cox, and Commodity Futures Trading Commission Acting Chairman Lukken. I also have been in frequent contact with other Federal regulators, including the heads of the OCC, OTS, FDIC, and the Federal Reserve Bank of New York. These contacts complement information gathered from market participants, finance ministers, and other participants in the global marketplace. I have been keeping the President apprised as well. Enhanced communication is vitally important for understanding how markets are operating, where disruptions are occurring, and evaluating what actions, if any, should be considered.

As I have said before, the recent reappraisal of risk could result in some modest penalty to economic growth. However, as I noted at the outset, the economy was in strong condition going into the recent period of volatility, and while certain sectors like housing are undergoing a transition, overall economic fundamentals remain solid. It will take time for the current reappraisal to work itself out, but in my view the underlying strength of the economy should allow for continued growth.

Challenges in the Mortgage Market and the Administration's Plan

While the current reappraisal of risk in the credit markets will work itself out over time, the transition taking place in the mortgage market is causing difficulties for many borrowers and we are quite focused on this issue. This will be especially so for borrowers who took out subprime adjustable rate mortgages in recent years.

We should not lose sight of the fact that the subprime mortgage market improved access to credit and homeownership for millions of Americans. Starting in the early 1990s, consumers with less-than-perfect credit histories were able to gain easier access to mortgage credit at interest rates above prime borrower rates. Individuals and families could use this new source of credit to tap previously illiquid home equity wealth through refinancing or to purchase homes. Subprime mortgage origination volume increased from less than 5 percent, or $35 billion, of total mortgage origination volume in 1994 to nearly 20 percent or $625 billion, in 2005. During this time period homeownership rates also increased, growing from 64 percent in 1994 to 69 percent today, some of which was due to expanded opportunities in the subprime mortgage market.

The growth in the subprime mortgage market (and the mortgage market generally) was facilitated to a large degree by securitization, a process by which individual loans are transformed into securities. In a typical private label mortgage securitization, the mortgage originator transfers loans to a securitization sponsor, who pools together mortgages into mortgage-backed securities, and sells pieces, or tranches, of these securities to investors. In this way, the securitization process allows for the creation of securities that better match investor preferences for particular types of risk, which broadens the availability of capital. The benefits of such development are (1) increased capital for mortgages resulting in more products and lower costs, and (2) greater dispersion of investor risk. While these are net benefits, securitization also has introduced some challenges which are described later and are the focus of additional work for the PWG.

Further expanding the potential investor base was the development of another structured product, the collateralized debt obligation (CDO), which purchases asset-backed instruments, such as mortgage-backed securities. Mortgage-backed CDOs, nearly 40 percent of the entire $500 billion CDO market in 2006, have been one of the major purchasers of mortgage-backed securities, in particular the lower-rated tranches. For both individual mortgage-backed securities and CDOs, the credit rating agencies work closely with the sponsor to rate the credit risk of various pieces of the transaction.

A key challenge in the current subprime mortgage market (and to a lesser extent in the prime market) is the significant amount of hybrid adjustable rate mortgages that will be resetting in the next few years. Hybrid adjustable rate mortgages have a fixed rate of interest, often free of amortization payments, for an initial period, resetting at an adjustable rate for the remaining term of the loan. The most popular hybrid adjustable rate mortgage was the 2/28 – a fixed rate for two years, then an adjustable rate for the remaining 28 years of the mortgage. The fixed rate of interest in the first two-year period was typically lower than the initial adjustable rate in the reset period, and it often had an even lower teaser rate at the outset.

Hybrid adjustable rate mortgages can be a useful product, and, in the past, rising house prices often enabled borrowers with hybrid adjustable rate mortgages to refinance on more attractive terms prior to the first reset. However, the recent trend of a decline in house price appreciation (or depreciation in home values) has made refinancing more difficult. Other problems in the subprime market (and in some cases in the prime market) include lax underwriting standards, especially in 2005 and 2006, which have led to a significant amount of early defaults. Finally, while this is not a new issue, mortgage fraud continues to be a problem and may have increased with growth in the subprime market over the past few years. Some of the most egregious individual stories in the subprime mortgage market involve some type of fraudulent activity that is already illegal. A combination of these factors has led to a significant spike in mortgage delinquencies and foreclosure starts. Much of the increase is concentrated in subprime adjustable rate products, and it is also concentrated in areas of the country that are experiencing some degree of economic difficulty or a decline in housing prices.

To address the current situation, President Bush recently announced an aggressive plan to help as many homeowners as possible stay in their homes and to improve our mortgage finance system for the future – the HomeOwner Protection Effort (HOPE). As part of HOPE, the Treasury Department has, in coordination with the Department of Housing and Urban Development (HUD), started working on a new foreclosure prevention initiative to help struggling borrowers. The goal is to expand mortgage financing options and to identify and reach struggling homeowners before they face hardships, helping them understand their financing options, and helping them to find a mortgage product that keeps them in their home. Community organizations, mortgage servicers, and mortgage finance entities all play key roles in helping borrowers avoid foreclosure. Community organizations, such as mortgage counselors, work with struggling borrowers to help them identify all the options available to them. Mortgage servicers are often the first contact with borrowers and they have tools available to help borrowers who are in trouble. And mortgage finance entities, whether it is the Federal Housing Administration (FHA), government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac, or insured depository institutions, all develop mortgage products that borrowers can use to refinance existing obligations. I and other Treasury officials have held important and useful meetings with these organizations to understand the challenges borrowers face and to explore ways to help them. We will continue to do so in an effort to minimize foreclosures.

We are working very hard to try to help as many Americans as possible keep their homes. We have learned several things already, two of which I would like to take an opportunity to share today.

First, it is clear to everyone that the earlier we identify struggling borrowers, the more likely they will be able to modify their mortgage or refinance into a more affordable mortgage. If we wait until borrowers miss several payments, their credit profiles will be tarnished and they will have far fewer refinancing options.

Second, many borrowers mistakenly believe that their lender wants to repossess their house in foreclosure. Foreclosure is tough on families, bad for communities, and very costly for lenders. The vast majority of lenders would rather find a way to help the homeowner stay in their home than foreclose. Yet according to most of the servicers and counselors we have spoken to, 50 percent of those who lose their home to foreclosure never contacted their mortgage servicer or a mortgage counselor for help. Often times borrowers are fearful of foreclosure and not aware that their lender may be able to work out a solution – such as a lowered interest rate or a payment plan. Clearly, we need a concerted effort to reach those who might have trouble meeting their payments and urge them to look for help before they get behind on their payments. There is a public service announcement running now, encouraging homeowners to call for help. I went to Chicago last week and held an event to publicize the availability of homeownership counseling. I plan to do more to urge people to be proactive, and I urge all of you to hold events in your districts, highlighting the availability and importance of mortgage counseling.

In addition, as part of HOPE, the Treasury Department has been working closely with Congress to change temporarily a provision of the federal tax code that currently considers cancelled mortgage debt on a primary residence as taxable income. Today, if borrowers are able to secure a loan modification or refinancing that involves a write down of existing principal, they could be subject to federal income tax liability on the value of the write-down. Moving forward, by providing much-needed tax relief to homeowners that are faced with this situation, we will remove an obstacle to keeping more borrowers in their homes. As President Bush has said, “when your home is losing value and your family is under financial stress, the last thing you need to do is to be hit with higher taxes.”

Finally, the President has asked me to lead efforts of the President's Working Group on Financial Markets in examining some of the broader market issues associated with the challenges in the mortgage market, which include: the role of credit rating agencies; and how securitization has changed the mortgage industry and related business practices.

Secretary Jackson can provide additional details on HUD's efforts related to HOPE including FHA modernization legislation, the new FHA-Secure initiative, and reforms to the Real Estate Settlement Procedures Act (RESPA).

Considering Other Issues to Address Mortgage Market Issues

The Role of Government Sponsored Enterprises (GSEs)

The President directed Secretary Jackson and me to work with all mortgage market participants to see what can be done to help struggling homeowners stay in their homes. Given that the GSEs play a significant role in the mortgage market, we believe they can be helpful in assisting many homeowners in this period. In fact, Fannie Mae and Freddie Mac were created in part to assist in these types of situations.[1]

Fannie Mae and Freddie Mac were established in part to help provide a degree of liquidity to the secondary market for home mortgages to increase the capital available for home mortgage financing. To perform that mission, Congress granted the GSEs benefits and imposed constraints. The benefits include exemptions from state and local taxes, conditional lines of credit with the Treasury Department, and the ability of banks to make unlimited investments in GSE debt securities. But the most important benefit is the market's perception that they are somehow backed by the Federal government, even though this is not the case. This benefit, unfortunately referred to as the "implicit" government guarantee, is the one that provides the GSEs with a funding advantage over other mortgage market participants.

The constraints imposed on the GSEs include that they: are limited to operating in the secondary mortgage market; can only purchase or guarantee loans below the conforming loan limit set by Congress (currently $417,000 or lower); and must have credit enhancements if the loan-to-value ratio exceeds 80 percent. In addition, they are also subject to safety and soundness oversight, and they must meet affordable housing goals.

Fannie Mae and Freddie Mac operate in the secondary mortgage market by providing credit guarantees on mortgage-backed securities (MBS) or by directly investing in mortgages and mortgage-related securities through their retained mortgage portfolios. In the credit guarantee business, Fannie Mae and Freddie Mac generally enter into to swap agreements with mortgage lenders under which individual mortgages are transformed into MBS guaranteed by the GSEs. Fannie Mae and Freddie Mac also have the ability to purchase mortgages and package them into MBS. In the mortgage investment business, Fannie Mae and Freddie Mac issue debt securities to fund an investment portfolio of mortgage-related securities. In comparison to the credit guarantee business where credit risk is the main exposure, the mortgage investment business involves both credit and interest rate risk. The mortgage investment businesses of Fannie Mae and Freddie Mac presents the greatest potential risks, while at the same time having a much less clear connection to their housing mission than the credit guarantee business.

The GSEs are an unusual construct – they are government-sponsored with a public service mission, but they are also publicly held companies that have to answer to boards of directors and shareholders. If we

[1] The Federal Home Loan Banks (FHLBanks) have also played an important role by providing a source of liquidity to FHLBank members (primarily insured depository institutions). As of August 31, 2007, advances (collateralized loans to members) outstanding for the FHLBanks on a combined basis were $769 billion, up by $110 billion from July 31, 2007

knew then what we know now, we likely would not have designed entities like the GSEs that have private ownership but are required to undertake a public mission. These competing interests are too difficult to manage, and the potential long-term market distortions and public policy concerns are too significant. The tension born by this construct is highlighted in the current situation in the subprime mortgage market. On the one hand, assisting subprime borrowers is at the heart of their affordable housing mission. On the other hand, these mortgages do pose greater risks, which if not managed correctly could lead to less return for shareholders.

We all understand that the GSEs have had some accounting and risk management problems in recent years. To some extent these problems are a result of their unusual construct – the private sector goal of increasing earnings led to the rapid growth in the GSEs' retained mortgage portfolios, and contributed to a lack of focus on internal controls and risk management. I see no benefit in restating these issues which have been well publicized and documented. It is worth noting, however, that the new managements at both institutions have improved their operations. Despite these improvements, however, there are still legitimate concerns about the systemic risk posed by the GSEs' retained portfolios due to their large size and the lack of ordinary and effective market discipline.

Turning to current market conditions, the conforming loan market, which is the segment of the mortgage market in which the GESs primarily operate, has continued to function well during periods of market stress. This should not be a surprise. Investors do not take on the credit risk of the underlying mortgages when they purchase GSE-guaranteed mortgage backed securities. In contrast, in the non-GSE mortgage market, the securitizing, packaging, and trading of credit risk have created an increased amount of complexity. As we have seen, market participants are growing more cautious and deliberative in evaluating credit risk in non-GSE securitized instruments.

We are starting to see encouraging signs that other markets, such as the jumbo mortgage market (loans greater than $417,000), are loosening up but these markets are not functioning as normal. While some financial institutions are more willing to take these loans onto their balance sheets than they were weeks ago, others are in a sense compelled to do so because the demand for jumbo and other non-conforming mortgage backed securities (and other asset backed securities) has broken down and liquidity concerns remain. Over time, we expect market conditions to improve. In other areas, such as subprime, this process will take even longer. Market liquidity will adjust as investors reassess risks and return, relative to the underlying fundamentals. But all of this will take time as markets digest new information.

As we work to alleviate stress in these markets, we naturally must ask what the GSEs can do toward that end. And to the extent we see room for them to do more, any consideration of a change in policy must find a balance between competing and distinct concerns, including: the temporary needs of today's market; the legitimate public policy question of how much of the mortgage market should be directly or indirectly influenced by GSEs, which the market perceives as being backed by the federal government; and the issues of size, systemic risk and longer-term market distortions that will occur by inserting perceived government intervention.

And, just as important, how will we change market participants' expectations and behavior if they assume, rightly or wrongly, that there is a risk that their own market functions would be displaced by the GSEs at any point in time? The existence of government influence certainly helps when confidence in credit quality is causing marketplace stress. However, this "benefit" is not without cost in the form of a reduction in market discipline and competition, innovation, and efficiency.

Some have suggested that the GSEs should be permitted to inject some liquidity into the jumbo mortgage market. There is little question that allowing the GSEs to securitize jumbo mortgages would give a short term lift which would be helpful to a segment of the housing market that has shown some recent improvement but is not functioning as normal. GSE entry into this sector would improve liquidity. The jumbo mortgage market traditionally has been a very profitable part of the mortgage market, with low default rates. For that reason it seems logical that this market will right itself in the weeks and months ahead. Therefore, consideration of this issue should be limited to a provision that is temporary and is part of legislation strengthening the regulatory structure. If it goes beyond that, it raises difficult public policy issues and could be seen as detracting from the GSEs' affordable housing mission and displacing private sector participation, which the Administration does not support.

The borrowers who are facing the greatest stress today are those who have less-than-perfect credit, and also those who have little equity in their homes, due to a decline in house price appreciation or a depreciation in home values. These difficulties are not limited solely to subprime mortgages, but are also surfacing among some prime jumbo mortgage holders. Anything the GSEs do to provide liquidity in this area, then, would mean taking on more risk. Therefore, such steps, and any additional authority permitting such steps, must be contemplated only in conjunction with legislation that addresses the inadequate regulatory structure of the GSEs.

The current GSE regulator has less authority than a federal bank regulator. Many argue that a good solution would be for the GSEs to be regulated in a manner consistent with regulation of large national banks. However, in our view, the GSE regulator should have more tools available than does a bank regulator to take into account the unique characteristics and tensions of the GSEs.

This Committee and the House of Representatives worked very hard to pass a meaningful GSE regulatory reform bill. In our view, the House bill is not perfect, but it goes a long way in addressing the issues that must be considered. The Senate now must act. The case cannot be stronger for the Senate to take up GSE reform legislation.

It would be unreasonable and irresponsible to expand the GSEs' businesses without addressing the fundamental problems of their regulatory structure. I would welcome this debate and repeat our request for the Congress to send the President a strong GSE reform bill. I frankly am disappointed that we have not had further engagement on these important issues.

Helping Struggling Homeowners

We also have been discussing with the GSEs how they might play a meaningful role to help struggling borrowers keep their homes. Of course, there are a number of constraints on the GSEs ability to help, especially where struggling homeowners have little equity in their homes. Many mortgages were originated with high loan-to-value ratios, and the declines in house price appreciation (or depreciation in home values) have put additional pressure on the current loan-to-value ratios of all types of mortgages. The GSE charters require that they have adequate credit enhancement on any loans they securitize or purchase that have a high loan-to-value ratio (greater than 80 percent LTVs). Changing this would require legislation. Again, I would welcome the debate in Congress about whether the GSEs should have the ability to go deeper into the credit spectrum to help current homeowners and to support further their affordable housing mission. This debate should be part of the broader regulatory reform discussion because allowing the GSEs to take on more risk elevates the importance of having adequate regulatory oversight.

Another, perhaps larger, constraint on their ability to assist borrowers is their own internal underwriting standards. Many of these borrowers represent significant credit risk, and present greater risk management issues for the GSEs in comparison to the traditional prime market. To undertake more business to assist these borrowers, the GSEs would have to reevaluate their own underwriting standards and develop new products that can help reach troubled homebuyers. By guaranteeing these types of products they would increase the flow of liquidity available to refinance some subprime borrowers into mortgages they can afford. We are encouraging the GSEs to do more. However, we recognize that the GSE management teams must also answer to their boards of directors and their shareholders in making these business decisions. We would expect the GSEs to evaluate fully the risks associated with any new initiatives in that context along with their public purpose mission.

In financing mortgages for either of these two types of struggling homeowners – those with credit problems or those with little equity in their homes – the GSEs would be taking on greater risk. Legislation that encourages them to assume more risk must also create an appropriate regulator to provide the proper regulatory oversight. We should not create tomorrow's problem as we construct today's solution.

Portfolio Caps

Recently, there have been calls on the Administration and the Office of Federal Housing Enterprise Oversight (OFHEO), the GSEs' independent regulator, from some policymakers and market participants to undertake certain actions to expand the market segments in which the GSEs may operate. Most prominently, the Administration has been asked to lift the temporary caps on the GSEs' retained portfolios.

It is important to note that the portfolio caps were imposed by the GSEs' independent regulator because of the well-publicized and documented concerns that I referred to earlier. It is also important to note that this regulatory decision does not affect their securitization activities at all.

I view the GSEs' requests for an increase in their investment portfolio as legitimate from a business perspective, but less so from a public policy perspective. From a business perspective, when mortgage spreads widen, growth in the GSEs' retained mortgage portfolio provides enhanced profit opportunities given the GSEs' debt funding advantage. Thus, the business motivation for this request is clear and sound.

Whether this request will have a positive impact on the mortgage market is much less clear. There is already ample liquidity in the prime conforming marketplace, the marketplace in which the GSEs concentrate their investment portfolio business. The securitization efforts of Fannie Mae and Freddie Mac have been a huge contributor to this liquidity. The more efficient use of their capital to ease current market strains is in the guarantee business, where each dollar of capital goes further in adding liquidity.

Given that the prime conforming market is functioning well, I would largely characterize the portfolio cap debate as misplaced. It is easy for some to point to lifting the portfolio caps as a "solution" to a complicated problem that, regrettably, needs more time to work out. This portfolio cap issue is something that the regulator should look at and continue to evaluate. Just yesterday, OFHEO announced steps to adjust Fannie Mae's investment portfolio cap and to provide more flexibility to both enterprises with regard to the management of their investment portfolios. I hope that both GSEs will use this new flexibility to provide liquidity to parts of the market experiencing the most strain.

This matter is not something that requires Congressional action. This is a regulatory decision, and it is being addressed where it should be, at OFHEO. Generally speaking, the caps may be lifted, at OFHEO's discretion, when each GSE becomes up-to-date and current in their filings with the SEC. My understanding is that because of the good work of the new management teams, both enterprises likely will complete their restatements some time in 2008. Because this regulatory matter does not impose negative consequences on the overall economy, I see no reason for legislative intervention.

At the Treasury Department, we are very open to ways to enable the GSEs to do more to relieve the strains in the mortgage markets. Our discussions have been thoughtful and constructive. They understand that this is a critical moment for them to demonstrate their ability to make a meaningful difference in the affordable housing market.

Mortgage Origination Issues

As noted earlier, securitization has fundamentally altered the process of obtaining a mortgage. Securitization has led to innovation in product design and increased capital availability. Of course, the decentralized nature of the mortgage market also presents certain challenges as many different participants – mortgage brokers, mortgage banks, insured depository institutions, investment banks, and ratings agencies – play a role in the mortgage process.

As we evaluate ways to improve the mortgage process in the future, we must look broadly across all participants in the process. While there are many issues that can be considered, I would arrange them in three broad segments: (1) disclosure provided to the borrower; (2) market practices; and (3) capital markets aspects. A thorough evaluation will require looking at each of the segments.

Importance of Disclosure

Adequate disclosures are a key component in fully empowering consumers to shop for the best mortgage product and promoting competition among mortgage originators. Our current system provides a voluminous amount of disclosure, but still consumers are confused about key aspects of their mortgage loans.

We need to work toward simplified disclosures that provide consumers information about key features of their mortgage. The key is not more disclosure, the key is better disclosure and this might be a case where less is more. Taking it as a given that many people will not read all (or even most) of the disclosure documents, we should try to evaluate what type of information is most critical for a lending decision to be consummated. Some of the proposals to create a one-page mortgage disclosure have been designed with this goal in mind.

As we consider new legislative proposals for enhanced or simplified disclosures, we should be fully aware of the efforts that are currently underway to improve disclosures. The Federal Reserve is engaged in a comprehensive review of the disclosure regime underlying the Truth in Lending Act, with the goal of developing disclosures that more effectively help consumers understand their loan terms. Chairman Bernanke and I have discussed this issue and I have confidence that he and the Federal Reserve will work diligently to achieve this goal. I am sure that Chairman Bernanke can provide additional details on the scope of the Federal Reserve's efforts.

Similarly, as described in Secretary Jackson's testimony HUD is engaged in an effort to propose RESPA reforms that would promote comparative shopping by consumers for the best loan terms, provide clearer disclosures, limit settlement cost increases, and require fee disclosures.

Simplified and meaningful disclosures should be in everyone's interest. The question is not whether we should strive for this goal, but more so the best way to achieve this goal.

Market Practices

Many of the most egregious problems related to mortgage fraud – such as falsifying income, inflating appraisals, or deceiving customers – are currently illegal under existing statutes. Federal agencies such as HUD, the Department of Justice, and the Federal Trade Commission are aggressively pursuing perpetrators of mortgage fraud. State authorities have also taken numerous actions. At the most basic level, we must ensure that our law enforcement agencies have the resources necessary to fight mortgage fraud at all levels.

Another issue that should be considered is inconsistency in the practices of participants in the mortgage market. Mortgage brokers have often been singled out as the main problem, and it appears that many of the mortgages that are currently under stress were arranged by mortgage brokers. But that is not the complete story as in many cases mortgage brokers were arranging loans based on lax underwriting standards developed by mortgage originators who could then fund these loans through securitization transactions arranged by investment banks. Nonetheless, issues of mortgage fraud, whether committed by mortgage brokers or other mortgage originators, have been a long-standing problem, and much of the focus has been on entities that are licensed at the state-level, where the degree of regulation varies.

Unfortunately, this is not a new problem, although the scale of the problem we are facing today is larger. It is especially difficult for States to monitor the actions of individuals that move their operations across state boundaries. In response to this problem, State regulators have started an effort geared toward uniform licensing and education requirements for mortgage brokers. We support this effort, but it remains unclear whether State regulators will be able to complete successfully this task on a national basis. Additional efforts to encourage the development of a more consistent licensing, education, and monitoring system for mortgage originators are worth considering and such a system could help to weed out some of the bad actors.

As we take a closer look at what caused some of the problems in the subprime market we should look at all aspects of the transaction. Much of the focus has been on practices of mortgage brokers and originators. I have no doubt that some mortgage brokers and originators engaged in deceptive and predatory practices in marketing loans to people that they did not understand or have the ability to repay. Just as important, and not said as often, I have no doubt that there was an abundance of borrower-level fraud as well. Some people chose to inflate their income or mislead a lender into thinking the property was to be owner occupied as opposed to being an investment property. Both of these practices have a profoundly negative effect on the mortgage market.

There are legitimate calls for creating a uniform national predatory lending standard. This is a very important issue that is quite complex. Great care must be taken when considering a national predatory lending standard or banning certain practices so as to not overly constrain credit availability. What some people consider a predatory practice or loan could be a useful product for some borrowers as long as they fully understand it. Achieving the right balance here is critically important.

The Federal Reserve is engaged in a comprehensive review of its authority under the Home Ownership and Equity Protection Act (HOEPA), including its authority to define broadly unfair and deceptive practices that would apply to the entire mortgage industry. I have spoken with Chairman Bernanke and I have confidence that he will carefully consider what actions to take in this area. It is clear that the Federal Reserve has the ability to reach all mortgage loan originators through a rulemaking under HOEPA. This provides the Federal Reserve with the opportunity to inject greater uniformity and objective standards into the mortgage origination process.

Capital Markets Issues

As I noted earlier, capital markets generally, and mortgage markets more specifically, have changed dramatically in the last 25 years. We at the Treasury Department are committed to being a leading force in better understanding some of the important issues raised during the recent period of market disruption. The PWG has already begun reviewing four important issues. First is financial institutions' liquidity, market and credit risk practices, including treatment of complex credit products and conduits. The second is accounting and valuation procedures for financial derivative instruments, particularly for complex, narrowly traded products that become difficult to price in times of stress. Third is basic supervisory oversight principles for regulated financial entities, especially given exposures to off-balance sheet, contingent claims. And fourth is the role of credit rating agencies in evaluating structured finance products. In addition, because these issues have global consequences, we have asked the Financial Stability Forum (FSF) – a body of finance ministries, central banks and regulatory bodies from leading financial centers created after the Asian financial crisis – to also examine these issues.

Conclusion

Mr. Chairman, in conclusion, I want to thank you for holding this hearing. Under the President's leadership, the Administration is working diligently to help mitigate the impact of rising foreclosures on homeowners and the economy. I appreciate having the opportunity to present the Treasury Department's perspectives on these important issues and look forward to working with this Committee and the Congress in the weeks and months ahead. Thank you and I welcome your questions.

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