Remarks of John M. Reich, Director
Office of Thrift Supervision
to The Joint Conference of the Ohio Bankers League &
Illinois League of Financial Institutions
Colorado Springs, Colorado
September 22, 2006

Thank you for the opportunity to speak to this joint conference of the Illinois and Ohio Bankers Leagues. As a native Midwesterner from the cornfields of central Illinois – Mattoon, Illinois to be specific – I feel quite at home speaking to a group of community bankers from the Midwest. I began my own banking career 42 years ago in Champaign-Urbana, Illinois, with what was then the $25 million Busey First National Bank in Urbana. Much has happened in the intervening years, but a constant that has remained is America's unique focus on the importance of homeownership.

Today, I want to discuss a few housing-related issues that have emerged in response to recent economic conditions and the changing dynamics in the housing markets. First, I want to mention the unique and somewhat divergent economies and housing conditions in Illinois and Ohio. After which I would like to explore how the issue of mortgage fraud has taken hold in response to mortgage efficiency improvements related to growth in the housing markets. And finally, I will conclude with some thoughts on the pending interagency guidance on commercial real estate (CRE) lending.

In many respects, Illinois and Ohio have different economic conditions affecting your respective housing markets. Like the overall national economy, however, both states' economies are significantly affected by housing. This is both good and bad news.

Promoting the safe and sound financing of homeownership in the United States is the core of our mission at the Office of Thrift Supervision. OTS has 74 institutions headquartered in Ohio and 67 institutions in Illinois. Together, your states represent 17 percent of all the thrifts we regulate. These institutions range in size from very small community banks with assets less than $20 million to multibillion dollar regional banking organizations. Yet, most, if not all, share a focus in housing and mortgage lending.

Over the last ten years, residential lending has experienced unprecedented growth fueled by the convergence of three major factors:

(1) a growing economy;
(2) interest rates that have remained near forty-year lows; and
(3) general home price appreciation that has risen to extraordinary levels in some markets.

And some would add a fourth factor – innovative mortgage loan products.

However, there are definite signs the level of housing growth cannot be sustained. Thus, it's important we are prepared to deal with changes in national and local economies that may impact housing and mortgage lending risk. And it seems that you have some important lessons to offer from your unique and differing experiences in Illinois and Ohio.

While Illinois and Ohio have both felt the impact of the national housing boom, each state has differing economic conditions currently affecting housing. Illinois continues to experience an improving business environment with increased job growth and a relatively strong housing market. By contrast, Ohio is dealing with a more difficult business environment that includes slow home price appreciation and some price declines, combined with slow economic growth, especially in the manufacturing sector.

Housing Prices

According to the Office of Federal Housing Enterprise Oversight (OFHEO), U.S. home prices were 10.1 percent higher in the second quarter of 2006 than they were one year earlier. Despite the continued rise in housing prices, the rate of increase fell sharply and represented the largest deceleration in three decades.

Appreciation for the most recent quarter was 1.2 percent, or an annualized rate of 4.7 percent across the country. However, appreciation rates over the past year remain lowest in the Census Division that includes Illinois and Ohio (and Indiana, Michigan, and Wisconsin). That division registered home price appreciation of 4 percent for the June 2005 – June 2006 period and an annualized second quarter rise of 0.8 percent. In contrast, the Pacific Division (Alaska, Washington, Oregon, California, and Hawaii) ranked first in price appreciation with rates of 14.1 percent for the 12-month period and 5.8 percent for the second quarter.

Over the one-year period June 2005-June 2006, while the average rate of home price appreciation nationally was 10.1 percent, Illinois averaged 7.8 percent and Ohio averaged 2.1 percent. Of the fifty states, Ohio ranked 49th and Illinois ranked 31st nationally.

Current Housing Performance

At the end of the second quarter of this year, 0.14 percent of conventional prime mortgages were 90 days past due, with another 0.15 percent in foreclosure. For Ohio lenders, however, 0.30 percent of conventional mortgages were 90 days past due, with 0.60 percent of loans in foreclosure, a rate almost four times the national average. The past due and foreclosure rates for all Illinois lenders were more in line with the national averages, with 0.10 percent 90 days past due and 0.19 percent in foreclosure. The numbers for less than prime mortgages, including ALT-A and subprime mortgages, showed similar results, with Ohio significantly higher than national averages.

Sustaining Housing

An important aspect of a successful housing market is sustainability through effective job growth and creation. As many of you are aware, this is currently a difficult issue in Ohio and, to a lesser extent, in Illinois. According to information available from state profiles compiled by the FDIC, Ohio's unemployment rate was 5.2 percent at the end of the second quarter of 2006, and 5.1 percent for the same period in Illinois. Our understanding is that while the job market is somewhat stable in Illinois, employment growth continues to be a concern in Ohio, especially in areas heavily dependent on the manufacturing sector.

The Keys To Your Success

All of this suggests that the banking environment in Illinois and Ohio, in particular, is less than optimal. Yet, most of you have not only found a way to survive, but also remain safe, sound and profitable. Why and how is that so?

Based on information we have obtained from field examinations in Illinois and Ohio, it appears that you are particularly adept at containing costs, managing risks and, most importantly, effectively managing your customer relationships.

The keys to your success include full and balanced disclosure of loan terms and risks to borrowers so that all parties understand the risks involved – which I place in the category of effective customer service. The institutions we regulate in Ohio and Illinois engage in careful underwriting and evaluation of a borrower's willingness and ability to repay a mortgage loan. While this seems fundamental to effective mortgage lending, these standards often slip in stressed markets. Generally, this has not happened in your institutions. However, you are also not immune to some of the problems arising from the successes and struggles of the mortgage markets, chief among these being mortgage fraud.

Mortgage Fraud

Mortgage fraud is an aspect of mortgage risk that is often ignored. Yet, mortgage fraud is a growing occurrence in many local markets, and often spreads and affects wider regional economies.

While lenders and consumers alike benefited significantly from lower interest rates and the mortgage boom of the past several years, the sheer magnitude of mortgage lending activity has itself affected the markets. Over the last several years, mortgage lenders faced with higher loan volumes have developed ways to cut costs and create efficiencies in the mortgage underwriting process. And the recent moderation in housing has added pressures to exploit these efficiencies in an effort to capture demand while retaining short-term profits.

In particular, our examiners have seen:

- increased reliance on automated underwriting processes,
- automated property valuation processes,
- relaxed underwriting standards,
- heavy reliance on unaffiliated third parties, and
- the introduction of new and more creative loan products that increase affordability for the borrower.

While these efforts have enabled lenders to respond quickly to growing demand, they are also facilitating mortgage fraud in record volume. And mortgage fraud is contributing to significant losses to financial institutions and borrowers alike. According to the FBI, federally regulated institutions alone reported over one billion dollars in losses due to mortgage fraud in FY 2005.

While mortgage fraud occurs throughout the country, it is more prevalent in certain places. It is worth noting that according to the 2006 report from the Mortgage Asset Research Institute (MARI), Illinois is one of the top five states experiencing mortgage fraud, and Ohio is in the top ten.

Although there is no one source for identifying total mortgage fraud, there are several places we can look for information regarding fraudulent mortgage activity. Currently, it is estimated that approximately 22,000 mortgage related Suspicious Activity Reports (SARS) will be filed in 2006. That compares with fewer than 10,000 in 2003. In other words, reports of suspected mortgage fraud in an otherwise mature and highly developed market are expected to more than double in just three years.

And first payment and other early defaults are also increasing. An in-depth review of early payment defaults revealed that between 45 to 50 percent of first payment/early default loans has some form of misrepresentation. A search of news stories related to mortgage fraud reveals daily accounts of scams, investigations and convictions. Meanwhile, institutions are increasing their expenditures to identify and eliminate mortgage fraud, law enforcement is working more fraud cases, and consumer advocates are trying to increase fraud awareness.

What is mortgage fraud? Mortgage fraud occurs both inside and outside financial institutions, and seems limited only by the imagination and resourcefulness of its perpetrators. Third parties involved in the mortgage origination process, including real estate agents, appraisers, brokers, settlement agents and others, account for a significant portion of mortgage fraud. But mortgage fraud is also facilitated by the actions of insiders seeking to benefit from various mortgage scams. In short, mortgage fraud has many faces. Among the practices reported on mortgage fraud-related SARS are:

- falsifying loan application information;
- identify theft;
- misrepresenting a loan’s purpose;
- the misuse of loan proceeds;
- appraisal fraud; and
- fraudulent property flipping.

Because of the number of participants in the mortgage lending process, the numerous steps and opportunities for abuse in a mortgage transaction, and the innumerable ways fraud is committed, fraud prevention is difficult. Successful fraud prevention requires an increased level of awareness and vigilance. And it doesn’t help that the prosecution of mortgage fraud is a low priority in many jurisdictions – a fact well known by many professional fraud practitioners.

Who is harmed by mortgage fraud? Certainly, lenders suffer tremendous losses as a result of fraudulent mortgage activity. But to be successful in reducing fraud, it is important to understand its many actual and potential victims and the aggregate, extraordinary costs of this crime. These include the following:

- <u>Borrowers</u> – This includes consumers who purchase a home that has been flipped, and individuals whose mortgage application has been altered by a broker or other professional. Some borrowers end up losing their home to foreclosure, while others lose down payments and/or their credit is ruined.

- <u>Lenders and Investors</u> – Foreclosures that are the result of fraudulent loans nearly always result in a financial loss to a lender/investor.

- <u>Other Lenders/Investors</u> – In many instances, lenders and investors with properties in neighborhoods affected by real estate fraud can suffer collateral losses, including deteriorating property values.

- <u>Neighbors</u> – As with other lenders and investors, the property values of neighbors may decline as a result of foreclosures in a neighborhood.

- <u>Neighborhoods</u> – In some instances, entire neighborhoods may be affected when abandoned homes become targets for vagrants and other undesirables.

- <u>Cities</u> – Rampant mortgage fraud can extend to entire parts of a city. In addition, urban blight from abandoned properties often imposes a greater pull on services such as fire and police, exacerbating budget constraints caused by a reduced tax base as a result of reduced property values.

Today, mortgage loan decisions are made remotely, usually by loan officers with no first-hand knowledge of the property, borrower or seller in a transaction. In many instances, all of the relationships among the parties to a mortgage loan transaction can be measured in a matter of hours, if not minutes. There is no doubt innovations in mortgage lending have produced efficiencies and competition that are often good for lenders and borrowers. However, while they have made borrowing easier and more "user" friendly they have also made it more "abuser" friendly.

In a typical mortgage transaction today, anonymous borrowers are the total of their credit score and their social security number. Financial institutions rely heavily on third parties to find, process and underwrite borrower loan applications and their properties. Usually, a lender never sees the borrower or the security property for a mortgage loan. Instead, many lenders depend on a broker to send them business, an appraiser to properly value the property, and a title company to research the history of the property. Borrower anonymity has made it easier for fraud to develop – whether it is fraud for profit (broker/professional fraud), fraud for housing (fraud by a borrower), or predatory lending (fraud against a borrower).

While mortgage fraud is generally perceived as an isolated transaction-by-transaction criminal activity, it is engaged in systematically on a wide-scale basis. But this also presents the opportunity to combat predatory lending and mortgage fraud on a large scale. One state's experience provides an excellent example of what can be accomplished via a collaborative effort to combat predatory lending.

While it once had the highest rate of reported mortgage fraud cases in the country, collaborative efforts to combat predatory lending have driven this Southeast state's mortgage fraud rate down significantly. Local, state and federal law enforcement officials, judges, lenders, borrowers, real estate professionals and community residents joined together to form a coalition. And that coalition helped to reduce significantly the predatory lending activities that were ravaging many of its neighborhoods, particularly in highly concentrated urban areas.

Galvanized by outrage at the damage to families' and neighbors' quality of life and safety, the coalition effected change at many levels, including mortgage transaction and legal reforms, as well as changing attitudes and providing resources to law enforcement agencies to pursue fraudulent mortgage activity.

While this state's story focuses primarily on the effects of combating predatory lending, it is important because it illustrates that collaboration results in success. Too often financial institutions are suspicious of borrowers when fraud is discovered. Many times, the borrower is also a victim and may be a strong ally in identifying and eliminating a source of fraud.

There are many tools available to lenders to help identify and avoid fraudulent transactions. One such resource is FFIEC's white paper on the Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties, issued in 2003. The Mortgage Bankers Association has also developed tools and resources for lenders, including databases for exchanging and tracking fraud transaction information. And there is access to any number of other resources that I encourage you to utilize – and my staff is available to any of you who wish to explore this issue more fully.

I urge all of you to familiarize yourselves with all of the aspects of mortgage fraud; to understand the red flags; to be vigilant with third parties involved in the lending process; and to develop systems and controls that aid in the detection and prevention of mortgage fraud. And I particularly urge you to ensure your underwriting standards are not relaxed to the point that you are no longer able to identify the borrower; to assure the value of a security property; and/or independently to verify borrower income and capacity for a loan repayment.

Let me give you an example of the efforts taken by one association we regulate. This thrift originates first and second mortgages all over the country through a network of branches, loan brokers and correspondents. Until recently, it had determined the technology available to detect fraud was not sufficiently sophisticated to be useful. Recently, however, the institution developed two fraud detection software programs for its pre-funding underwriting process. Today, the institution runs automated valuation models (AVMs) against every appraisal and orders tax returns on every borrower. While this is expensive, it appears to be money well spent. It has been well documented that crooks avoid institutions with strong pre-funding internal controls.

I recognize that being vigilant in fraud detection and prevention is expensive and resource intensive. Just when you think you've put a good detection system or practice in place, the perpetrators are on to something new. It is difficult to stay ahead of the problem. However, I believe if we work together to educate one another and our constituents, significant progress can be achieved. This requires each of us, including federal, state and local officials, to assist in the development of new and better fraud detection methods.

CRE Guidance

The final issue I want to discuss today is the pending commercial real estate lending guidance proposed by the federal banking agencies earlier this year. I am certain many of you are aware of the guidance, but I am not certain whether we have done a good job explaining the basis for issuing it in the first place.

The proposed guidance was issued in response to the rapid growth in CRE concentration levels at insured institutions with assets between $100 million and $10 billion, which probably mirrors the profile of many institutions in this room. While there has been moderate growth in CRE lending by the smallest and largest depository institutions, annual growth in CRE lending by small-to-midsized community banks and small-to-midsized regional banks has risen dramatically the last eight years.

As I testified to before the House Financial Institutions Subcommittee last week, the proposed guidance is intended to remind institutions that credit concentrations can pose substantial risks and that these risks should be assessed and appropriately addressed. In particular, the guidance stresses that risk management practices should be commensurate with the level of concentration risk present at an institution.

The draft guidance drew numerous comments, including concerns with the potential impact on community lending. It is important to note that the proposed guidance is not intended to diminish the vital role of community banking in providing credit for business and real estate development. Rather, it is intended to preserve the health and continued profitability of the institutions that serve community lending needs.

Other comments on the guidance were that it will impose additional burdens on depository institutions and that thresholds set forth in the guidance will be viewed as hard limits by examiners and the industry. As a former community banker, I am keenly sensitive to both of these issues. My expectation is that the guidance should be viewed only as a reference by the industry and our examiners – a fact that I stressed to House

Financial Institutions Subcommittee Members last week. In fact, the proposed guidance is not prescriptive and does not impose any limits on the amount of CRE lending that an institution may conduct. It merely seeks to ensure that institutions maintain sound underwriting and risk management and review practices to monitor their CRE credit exposures.

Industry comments also noted that various CRE loans have vastly different loan characteristics and should not be viewed as a single risk category. I believe this is a valid point. As set forth in the CRE guidance, we expect institutions to assess their exposure to concentration risks based on their own portfolio experience, and to take appropriate actions to manage these risks. The guidance is not intended to impose limits or thresholds above which CRE activity is suspect or barred. And I have been very clear about my discomfort with numerical thresholds set forth in the proposed guidance. I believe that each institution has to evaluate its own CRE risk exposure. While it is our job as regulators to oversee and supervise this process, we should not be micromanaging how you choose to structure your lending portfolio, provided, of course, that sound risk management and underwriting techniques are in place at your institution.

In light of the comments we received, the CRE guidance is in the process of being redrafted by the FBAs. It is my hope that we will modify the guidance to address the comments, to clarify the underlying theme of federal banking agencies' risk management expectations for the industry, and to make sure the guidance conveys this intent more clearly.

Thank you for the opportunity to visit with you today. I will be happy to answer your questions.