

Remarks by
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I am delighted to join CFA for this conference on “The Consumer in the Financial Services Revolution,” and to address this organization for the first time as Comptroller of the Currency. The CFA has a well-deserved reputation as a real leader in the area of consumer protection research, education, and advocacy. I want to especially commend your work in the area of consumer financial education, particularly your America Saves initiative. We sit on the steering committee for this fine organization, and we wholeheartedly support its efforts to help people achieve the twin goals of better understanding today’s savings, debt, and investment products, and creating a structure for building wealth.

Today I would like to talk about two consumer protection issues in the banking area that have been very much on my mind. The first is the assertion we sometimes hear – with which I strongly disagree – that national bank preemption has created a “regulatory gap” in consumer protection. The second is negative amortization, and especially its increasing prominence in retail credit products. Negative amortization – or “neg am,” as it is sometimes called – is what occurs when a consumer’s required minimum payment on a loan is less than the full amount of interest and fees due, resulting in an increase in the underlying principal owed – a practice that raises significant safety and soundness and consumer protection concerns. Both of these issues

are important to the OCC and to the CFA, which is why I want to raise them front and center today.

On the first issue, some of our critics have expressed concerns that when the National Bank Act preempts a particular state's law, say on predatory lending, it creates an unforeseen "regulatory gap" or "regulatory void" that leaves national bank customers in that state totally unprotected from abusive practices. A variation on that assertion is that national banks have been, or will become, a "haven" for predatory lending or other abusive retail practices. I disagree fundamentally with these assertions, for three reasons.

First, the OCC has extensive regulatory and enforcement authority under Federal law to protect national bank consumers, and I believe we have used that authority responsibly and effectively. One of our touchstone supervisory principles is that the integrity of a bank's operations, including how fairly and effectively it serves its customers, is inextricably part of its safety and soundness. This principle informs our approach to the many specific consumer protection responsibilities that Congress has entrusted to us.

For example, the Federal Home Ownership and Equity Protection Act addresses predatory practices in residential mortgage lending. The Federal Trade Commission Act, or FTC Act, prohibits practices that are unfair and deceptive. And national banks and their operating subsidiaries are subject to extensive Federal regulation of their real estate lending activities under an elaborate network of laws that includes the Truth in Lending Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Equal Credit Opportunity Act, and many others. These Federal laws reflect and implement policies similar to those underlying many of the state laws that address the same practices.

We have consistently used this federal authority, as Congress intended, to assure that national banks do not become involved in predatory or abusive lending practices. For example, last year we included anti-predatory lending standards in our preemption regulations. Earlier this year we issued guidelines addressing consumer protection issues in mortgage lending, identifying practices that would, under certain circumstances, constitute predatory, abusive, unfair, or deceptive lending.

And where we have found abuses, we have taken enforcement actions to remedy them. These include “unfair and deceptive practices” actions pursuant to the FTC Act, many of which have provided restitution to customers – an enforcement practice pioneered by the OCC among Federal banking agencies. In terms of prudential supervisory guidance, we have taken the lead in achieving corrective action by credit card issuers to address certain aggressive pricing practices and improve marketing disclosures. We also led the development of the overdraft protection guidance issued by the banking agencies, and we stepped in to separate national banks from unacceptable arrangements with payday lenders.

The examples I’ve just described are merely a partial list of the federal consumer protections that we apply and enforce with respect to national banks operating in all parts of the country. These standards, and the additional initiatives we have taken, belie the notion of a “regulatory gap” in assuring fair treatment of national bank customers. Because of these standards and OCC’s supervisory oversight, national banks have not been, and will not become, a “haven” for abusive or predatory lenders. To the contrary, I believe that consumers *benefit* from the standards and the comprehensive supervision we apply to national banks.

We see evidence of this benefit in the recently released data collected under the Home Mortgage Disclosure Act or “HMDA,” which tracked the number of higher-cost mortgage loans made by lenders of all kinds throughout the country. While most such loans reflect perfectly legitimate subprime lending to higher risk borrowers, they are also the “raw data” that regulators examine for evidence of unlawful lending discrimination. This data showed that national banks and their operating subsidiaries made far fewer higher-cost loans than state banks and their subsidiaries, state chartered holding company affiliates of banks, or state-chartered lenders unaffiliated with banks – supporting the conclusion that the OCC’s history of rigorous supervisory oversight has deterred lenders from using the national bank charter as the primary vehicle for higher-cost loans.

The HMDA example also leads me to my second important point about the regulatory “gap” issue, in this case involving OCC’s exclusive visitorial powers over national banks. The National Bank Act establishes the OCC as the exclusive examiner, regulator, and enforcer of laws applicable to the banking activities of national banks, including state consumer protection and lending discrimination laws that are not otherwise preempted. Critics argue that states also should be allowed to enforce non-preempted state consumer protection laws applicable to national banks, asserting that there can never be “too many cops on the beat.”

I disagree. Enforcement resources are not infinite. It makes no sense for both federal and state officials to focus their limited supervisory resources on redundant enforcement actions against nationally chartered banks or their subsidiaries, especially when those institutions are already extensively examined and supervised by the OCC. We see this clearly in the context of HMDA, where the OCC’s comprehensive

supervisory approach includes the use of advanced statistical analysis; examiner judgment and consumer complaint information as screening tools to identify high risk banks; in-depth, on-site reviews by expert examiners necessary to reach a determination whether a fair lending violation has occurred; and an extensive array of enforcement tools to take corrective action. Our fair lending supervisory and enforcement record demonstrates our resolve to eradicate unlawful discriminatory lending practices from the national banking system.

Given these facts, and the reality of finite enforcement resources, the “multiple cops on the beat” argument simply does not fly – the more apt analogy for such an enforcement policy would be having all cops on the *same* beat, leaving other parts of the neighborhood inadequately protected. We recognize our responsibility to enforce Federal and applicable state laws for the national banking system, and we expect to be held accountable for how well we do that job. The same should be true at the state level. There are thousands of non-bank lenders and brokers that are not subject to bank-like examination and supervision, and these institutions are commonly cited as a significant source of abusive lending practices. I believe the maximum benefit for the citizens of any state would be for state officials to focus their resources on the practices of these and other entities over which they clearly have jurisdiction, while the OCC focuses on national banks and their subsidiaries. Indeed, I worry that, if there is a gap, it is created when state resources are diverted from areas where problems are known to exist, and where state authorities clearly have jurisdiction to achieve corrective measures.

I do believe, however, that enhanced information sharing and coordination among regulators, rather than duplication of efforts, would improve the ability of both federal and state regulators to address consumer abuses. We would welcome such collaboration.

This leads me to my third and final point on the so-called regulatory gap issue. Inevitably, there will be preempted consumer protection laws in particular states where no comparable law exists at the federal level. Such preempted laws will continue to apply to state banks in those states, but will not apply to national banks or to state banks in other states. This difference in regulation does not, however, constitute a regulatory “void.”

Instead, it reflects the very essence of our dual banking system and federalism. Justice Brandeis famously referred to the genius of our federal system as enabling a particular state to serve as a “laboratory” for new approaches to an issue – without compelling adoption of a particular approach by all states or as a national standard. That is, the dual banking system is built on individual states experimenting with different kinds of laws, including new consumer protection laws, that apply to state banks in a given state, but not to state banks in all states and not to national banks. If Congress believes a particular state’s experiment is worthwhile, it will enact that approach to apply throughout the country, not only to all national banks, but to state banks operating in other states that have not yet adopted such laws. When that happens, as it has on many occasions, the OCC’s role is to rigorously implement and enforce the resulting federal law with respect to national banks. Conversely, where Congress has not embraced the approach of a particular state and incorporated it into federal law, it is not the OCC’s role to adopt such an approach as a federal standard that applies to national banks operating

throughout the country. In short, some differences in consumer protection regulation between state and national banks do not reflect an unforeseen regulatory “gap,” but instead the intended and desirable result of having differences in approaches possible in our federal and dual system of state and national banks.

Let me shift gears now to the second major topic I want to address today, which is negative amortization as it relates to consumer loans.

As I said earlier, a neg am loan is one in which the lender allows the borrower to make minimum payments that don’t cover the full amount of interest and other fees that have accrued, with the unpaid deficit added to the underlying principal. With an increased loan balance, the interest accruing for the next payment also increases. And if the borrower makes another minimum payment that does not cover the increased amount of interest, the unpaid deficit – which has also increased – is again added to the loan balance. In this simple example, it is not hard to see how a borrower can fall deeper and deeper into debt, with the prospect of repaying the ever-increasing loan balance becoming more and more difficult.

Meanwhile, the lender typically books the fully accruing amount of interest and fees as income, whether or not the minimum payment covers the full amount due. Eventually, of course, the borrower will be required to repay the full amount of principal due, but if the principal has increased substantially over time due to the negative amortization, that may not be possible. In that case, the loan will have to be written down or written off, resulting in a loss to the lender and a substantial hit to the borrower’s credit rating.

I believe that neg am consumer loans raise substantial – and intertwined – consumer protection and safety and soundness issues. Too many consumers have been attracted to products by the seductive prospect of low minimum payments that delay the day of reckoning, but often make ultimate repayment of growing principal far more difficult. At the same time, too many lenders have been attracted to the product by the prospect of booking immediate revenue without receiving cash in hand, a process that often masks underlying credit problems that could ultimately produce substantial losses. Indeed, the neg am problem in credit cards had been building over a period of time because credit lines, account balances, and fees were all increasing, while minimum payment requirements were shrinking.

In issuing the interagency credit card account management guidance in 2003 to address a range of issues raised by these more aggressive industry practices, we decided to prohibit negative amortization in credit card accounts, except in very limited and temporary circumstances. We also strongly discouraged inappropriate fees and other practices that inordinately delay repayment of credit card debt. We did so because the safety and soundness and consumer protection problems raised by prolonged negative amortization in the unsecured credit card context were simply too substantial to address in any more limited way. As a result, our guidance directs lenders to require minimum payments at a level sufficient to amortize the current balance over a reasonable period of time. We have interpreted this minimum payment expectation to include all interest and fees, plus a portion of unpaid principal.

Our decision generally to eliminate neg am products in the credit card context has taken some time to implement, but we are nearly there. Some issuers were able to

implement the guidance in short order, while others, requiring more extensive alterations to their customer account agreements and operating systems, have taken more time. With very few exceptions, we expect all national banks to be in compliance with this aspect of the guidance by the end of this year.

In saying this, however, let me make one point perfectly clear. We recognize that the change in required minimum payments will make it more difficult for some existing credit card borrowers to pay the full amount of the increased minimum payments due. We have encouraged lenders to work with these borrowers to the maximum extent possible to avoid writing down the loan and cutting off the customer's credit. Lenders have a variety of tools to do this, including restructuring or deferring payments and, in appropriate circumstances, re-aging accounts. In addition, lenders always have the option of reducing high interest rates charged to delinquent borrowers – sometimes exceeding 30 percent of the outstanding loan balance – and/or waiving fees in order to reduce a minimum payment while still amortizing a modest amount of the outstanding principal.

And so, just as we come to the end of the neg am story in credit card lending, I fear we are at the beginning of one in the mass marketing of home mortgages. One of the new “non-traditional” mortgage products you may have heard about is the so-called payment-option ARM – a mortgage that allows borrowers to select from a menu of payment possibilities, ranging from a fully amortizing monthly payment to the neg am payment option that does not cover the outstanding interest. Such products have been available for quite a long time, but until recently had been provided primarily to a narrow group of very creditworthy borrowers who found differing payment options to be an attractive “cash management” tool over time. In this niche market – which is different

from the credit card market because of the collateral securing the loan – borrowers have generally had the wherewithal and sophistication to handle temporary periods of negative amortization without jeopardizing their ultimate repayment of principal.

In the last two years, however, we have seen a spike in the volume of payment-option ARMs, which are no longer largely confined to well-heeled borrowers who can clearly afford them. Increasingly, they are being mass marketed as “affordability products” to borrowers who appear to be counting on the fixed period of exceptionally low minimum payments – typically lasting the first five years of the loan – as the primary way to afford the large mortgages necessary to buy homes in many housing markets across the country. And as the loans become more popular, the prospect of using them to penetrate the subprime lending market cannot be far behind.

The fundamental problem with payment option ARMs, other than the growing principal balance due to negative amortization, is payment shock. A traditional 30-year fixed-rate mortgage requires the borrower to amortize the principal balance through equal payments over the 30-year life of the loan. In contrast, a typical payment-option ARM is a 30-year mortgage that permits five years of negative amortization by allowing a borrower to make very low minimum monthly payments during that period. Beginning in the sixth year, the borrower must begin paying the full amount of interest accruing each month, and must also begin amortizing the increased principal over the remaining 25-year life of the loan. The combination of these factors can produce sharply increased payments in year six. For example, a typical payment-option mortgage of \$360,000 at 6 percent can produce a monthly payment increase of nearly 50 percent in that year,

assuming no change in interest rates. If rates rise to just 8 percent, the payment increase when amortization begins would nearly double.

To the extent that they are planning for such contingencies, many payment-option-ARM borrowers calculate that they will be able to sell their property or refinance the mortgage by year six. But if real estate prices decline – and there already is evidence of softening in some markets – these borrowers could face the bleak prospect of loan balances that exceed the value of the underlying properties. In that case, selling the property or refinancing the loan would not be a viable escape valve for avoiding huge payment shocks.

In these circumstances, do consumers really understand the potential consequences of the neg am feature inherent in a payment-option ARM? Is this an appropriate product to mass market to customers who may be looking at the less than fully amortizing minimum payment as the only way to afford a larger mortgage – at least for the five years before the onset of payment shock? And are lenders really prepared to deal with the consequences – including litigation risk – of providing such products in markets where real estate prices soften or decline, or where interest rates substantially increase?

I fear the answer to all these questions may be “no.” That is one reason why, if all goes according to plan, the Federal banking agencies will propose new guidance with respect to nontraditional mortgage products by the end of this month. While the guidance will cover many other issues besides negative amortization and payment option ARMs, these will certainly be central among the topics addressed. I am mindful of the history of neg am products in credit cards, and I recognize that the nationwide mass marketing of

neg am mortgages is in its infancy. As a result, I firmly believe that the guidance should draw clear lines about appropriate standards for qualifying borrowers for payment option ARMs that explicitly take into account potential payment shock. Put another way, lenders should not encourage or accept applications from borrowers who clearly cannot afford the dramatically increased payments that are likely to result at the end of the five-year, low minimum payment period. Disclosures should also be clear, timely, and meaningful. And lenders should have very substantial controls in place to manage the potential risk of such loans.

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In closing, let me say that, for many years, the OCC has worked constructively and productively with the CFA. I pledge to continue that work, with open and honest dialogue, during my tenure as Comptroller. This is not to say that we haven't had our disagreements. But that has never stopped us from finding common ground to produce results on a number of important consumer protection issues, and I will work hard to continue finding that common ground.

Thank you very much.