


**Washington Mutual**

**David C. Schneider**  
President,  
Home Loans

March 29, 2006

 Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G. Street, NW  
Washington, DC 20552  
Attention: Docket Number 2005-56  
[Regs.comments@ots.treas.gov](mailto:Regs.comments@ots.treas.gov)

Re: Proposed Guidance – Interagency Guidance on Nontraditional Mortgage Products  
70 FR 77249 (December 29, 2005)

Dear Sir or Madam:

Washington Mutual Bank appreciates the opportunity to comment on the Interagency Guidance on Nontraditional Mortgage Products (the "Guidance") that has been proposed by the federal banking and credit union agencies (the "Agencies"). Our comments on the Guidance are based upon the experience that we have gained from providing alternative mortgage products such as our "Option ARM" for over twenty years. They are presented below in two parts. First, we provide general comments regarding the application, interpretation and possible implementation of the Guidance. These comments track the outline of the three specific areas that are the focus of the Guidance. Second, we respond to specific questions asked in the preamble to the Guidance with regard to comprehensive debt service qualification standards.

**I. General Comments:**

Washington Mutual Bank agrees that different mortgage products pose different risks for lenders and that lenders should have appropriate robust underwriting and risk management standards to address these different risks. Washington Mutual Bank also agrees that lenders should provide timely and clear disclosure to consumers of the terms of the mortgage products that they offer. We support the Guidance to the extent that it will advance these principles in an effective manner and without unnecessarily harming the mortgage markets.

We are concerned that some parts of the Guidance as proposed will discourage or prevent responsible lenders from continuing to offer important mortgage products that have provided consumers the substantial economic and personal benefits of homeownership.

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We also believe that the Agencies' concerns with respect to consumer protection would be more effectively advanced by amending Regulation Z and other regulations that apply to all mortgage lenders.

### A. Overview of Guidance

#### Guidance Should Not Cover Home Equity Lending

The Agencies should make clear that the Guidance does not amend the recent guidance on home equity lending. Home equity lines of credit and junior lien home equity loans should be specifically excluded from the guidance.

#### Guidance Should Not Disfavor Alternative Mortgages

We are concerned that the Guidance's focus on interest-only ("IO") and payment option mortgage products and the use of the term "non-traditional mortgages" to describe these products reflect a concern by the Agencies that these products are more risky or less consumer friendly than other mortgage loans. Washington Mutual Bank and other institutions have been successfully offering payment option mortgages for more than 20 years through different interest-rate and economic cycles. Contrary to the Guidance's assertion, these mortgages have been tested in a "stressed environment." In fact, these mortgages have been considered more safe and sound for portfolio lenders than many fixed rate mortgages.

In addition, these mortgage products, when prudently underwritten, have provided substantial economic benefits to consumers by allowing borrowers to manage their cash flow by, e.g., using funds that might otherwise go to their mortgage payment to pay down other debt or to make other investments. Prudently underwritten alternative mortgage products have also allowed some borrowers who might otherwise have been precluded from participating in the housing market to purchase homes.

The need for lenders to develop such products and the benefit to consumers of such products were recognized by Congress in enacting the Alternative Mortgage Transaction Parity Act of 1982. In proposing the Guidance, the Agencies have not cited any past problems with these products to challenge this Congressional support for payment option or IO mortgages. While we understand the Agencies' heightened interest in these products as they take on new features and are offered by a broader array of lenders to a broader population, we are concerned that the worst-case scenarios assumed by the Agencies in the Guidance will cause examiners to discourage institutions from offering such products. To address these concerns, we recommend that the Guidance 1) not discourage lenders from offering these products; 2) refer to such products as "alternative mortgages," the term used in federal law and hereafter in this letter; and 3) not be based on theoretical worst-case scenarios.

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### Guidance Should Not Be Prescriptive

The Guidance appears to impose new specific mandates on federally regulated institutions offering these products, as opposed to providing general guidance to examiners and their regulated entities on how such products can be offered in a safe and sound manner. We recommend that the Guidance not prescribe certain practices and that the use of "should" in the Guidance does not mean "must," especially in the Guidance's discussion of "Recommended Practices."

### Guidance Should Allow For Flexible Implementation

In addition, the statement in the Guidance calling for its consistent implementation is contrary to the notion of regulatory guidance and could mean that experienced providers of alternative mortgages would be subject to the same examination scrutiny as institutions that have not offered these products in the past. The risk with such a dictate is that valuable products offered by experienced lenders that have not posed safety and soundness problems will be taken away from the consumer. The Guidance should explicitly recognize that experienced institutions' proven safety and soundness practices are "best practices" and will not need to be changed or modified because of the Guidance.

We understand that the Agencies may have concerns that new entrants to the alternative mortgage market may not have the underwriting or portfolio and risk management expertise that experienced lenders may have. Such concerns are best addressed on an institution-specific basis as a supervisory matter, not by imposing new restrictions on all regulated entities and their affiliates as if the Guidance were a regulation. At the end of the day, the case-by-case evaluation by examiners is critical. Examiners should understand the need to apply the Guidance flexibly and with good judgment.

### Guidance Does Not Cover All Lenders

The call for consistent application also is not possible given that the Guidance would apply only to federally regulated entities and their affiliates. Consumer finance companies, mortgage banks, and other state-regulated lenders and brokers not affiliated with federally regulated entities, many of which are new to offering alternative mortgages, would not be subject to the Guidance. If the Guidance unnecessarily restricts federally regulated entities from offering these products, it will place such entities at a competitive disadvantage in a very competitive mortgage marketplace. Thus, unnecessary restrictions actually do a disservice to safety and soundness.

### New Types of Controls for Monitoring Third Parties Should Not Be Required

We are also concerned that the Guidance requires a lender to impose additional controls regarding its loan consultants and third party originators that are specific to alternative mortgages to ensure that the loan originators' practices are consistent with the lender's

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policies and procedures. While a lender is responsible for the acts of its own employee loan consultants, it is virtually impossible for a lender to control the practices of mortgage brokers or correspondent lenders. A large lender may deal with literally thousands of mortgage brokers and hundreds of correspondent lenders each year and any single broker or correspondent may deliver only a small number of loans to the lender. Although such a lender may re-underwrite a broker originated loan and provide its own program disclosures to the broker's customer if the loan will close in the lender's name, the lender cannot effectively or economically monitor the sales practices of each of the brokers with whom it does business.

The lender is even further removed from a correspondent lender's practices. A correspondent sells a loan that it has closed in its own name and with its own funds to a lender/purchaser. In some cases, the correspondent will underwrite the loan to the lender/purchaser's guidelines and in other cases the correspondent will underwrite the loan to general investor guidelines. A lender/purchaser will confirm that the loans it purchases are acceptable to it from an underwriting perspective, but it is impossible for a lender/purchaser effectively or economically to monitor the sales practices of all of the correspondents from which it purchases loans. While lenders can provide training and materials explaining their products to mortgage brokers and correspondents, lenders should not be expected to monitor the interaction between a third party and its customer.

### **B. Loan Terms and Underwriting Standards**

#### Underwriting Should Not Be Based on Future Scenarios

We agree that when a loan is underwritten, the borrower must have a demonstrated capacity to repay based upon information available at that time. Washington Mutual's Responsible Mortgage Lending Principles provide that we only make and purchase mortgage loans where the borrower has a demonstrated ability to repay. With such underwriting, a well-informed consumer is in the best position to make the decision regarding which mortgage product best suits his or her needs and to assess the risks associated with his or her situation in the future, not banks or regulators.

The Guidance, however, could be read to require lenders to forecast a borrower's capacity to repay based on information unknown about a borrower at the time of origination, such as a borrower's payment patterns, a borrower's future income, a borrower's ability to refinance the loan, and interest rate projections. Such scenario-based underwriting is not a best practice used by experienced lenders of these loans. Not only is such underwriting highly speculative, but it could unnecessarily exclude qualified borrowers. Such a practice also imposes an additional level of subjectivity to the underwriting process. Underwriting should only use information available at the present time and not be based on forecasts or possible future scenarios.

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### Specific Underwriting Criteria Should Not Be Prescribed

The Guidance recognizes that lenders use a number of factors in underwriting alternative mortgages. Experienced underwriters of such products use a borrower's credit score in combination with other key underwriting criteria, such as the loan's loan-to-value ratio ("LTV"), the borrower's debt-to-income ratio ("DTI"), the loan's purpose, the amount of loan documentation, and the type of loan appraisal. The Guidance should avoid prescribing specific criteria for different loans types and purposes, and would better capture industry practices and promote responsible innovations if it addressed the broader issue of borrower ability and willingness to pay (which we discuss in further detail below). In other words, the Guidance should not affect an institution's business model and pricing strategy with regard to such products as long as the products are fairly offered to consumers and are safe and sound.

### **C. Portfolio and Risk Management Practices**

#### Concentration Limits Should Not Be Prescribed

We also oppose the Guidance's insistence that concentration limits be set for certain loan types, for loans with certain characteristics, and for loans acquired through third parties. We agree that concentrations should be monitored for riskier exposures and that some level of portfolio diversification is necessary. This monitoring can be done in the form of concentration triggers that result in a management response, rather than limits set down as part of board policy. These concentration triggers should be based on each institution's portfolio and business model. The goal should be risk diversification in areas where pricing may not compensate for risk in stressed scenarios. The key point is to set up controls so that portfolio concentrations are monitored.

### **D. Consumer Protection Issues**

We agree that it is important that consumers understand the terms and features of the mortgages that they are considering. We also agree that consumers find it beneficial to have such information early in their search for the appropriate mortgage loan. Alternative mortgage loans are already subject to disclosure requirements under Regulation Z which applies to all individuals or businesses that regularly extend consumer credit that is subject to a finance charge. The Guidance calls for only regulated lenders to provide information specific to alternative mortgages that is similar but not identical to the disclosures required under Regulation Z. The different disclosure standards may very well cause more consumer confusion at the time of application rather than less. We believe that any new disclosure requirements should be addressed within the framework of the existing regulatory requirements so that consumers receive consistent disclosures from as many types of lenders as possible.

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While we comply with the current legal requirements, we also want to ensure that our mortgage customers understand the features of the loan products that they are considering when they are shopping for a mortgage. To that end, we and other lenders have developed disclosures for specific types of alternative mortgage products beyond the disclosures required by law.

We support the recommendation in the Guidance encouraging lenders to "provide consumers with information at a time that will help consumers make product selection." To effectuate this goal, we recommend that the Federal Reserve Board update its *Consumer Handbook of Adjustable Rate Mortgages* ("CHARM") booklet to include a discussion of alternative mortgage products. The CHARM booklet is provided to the consumer at the time the consumer begins shopping for a mortgage loan. A revised CHARM booklet would provide some consistency in the description of the advantages and risks of alternative mortgage products that would help the consumer shop for a mortgage loan.

We are concerned that including recommended consumer practices in the Guidance, along with a discussion of laws that prohibit unfair or deceptive acts or practices, could have unintended consequences. Some people could interpret the recommendations to mean that lenders who have not been following the Guidance's practices have engaged in unlawful activities. We do not believe that this would be a correct interpretation of the law or that the Agencies intend such an interpretation. If the Agencies do include a discussion of consumer protection issues in the Guidance, then the Guidance should be explicit that failure by a lender to follow the recommended practices does not mean that the institution is engaging in unfair or deceptive acts or practices.

## II. Responses to the specific questions posed by the Agencies:

Our comments in Part I above touched on many of our concerns with the Guidance. In Part II of our letter, we provide specific answers to the questions posed by the Agencies in the preamble to the Guidance.

***(1a) Should lenders analyze each borrower's capacity to repay the loan under comprehensive debt service qualification standards that assume the borrower makes only minimum payments?***

No. As noted above, we strongly disagree with the use of any scenario-based analyses in underwriting as the result would be inconsistent underwriting standards over time. In addition, the modeled relationship among losses and certain factors may change with different scenarios. Forecasting models based on future scenarios may conflict with forecasting models based on historical performance, resulting in dissonance in the qualification and pricing determinations at the underwriting stage.

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The Guidance suggests three scenarios for calculating payment behavior (of increasing conservatism). More conservative scenarios could be prudent for determining portfolio management strategies and for evaluating portfolio risk under stressed conditions (e.g., capital adequacy). However, to underwrite using a measurement of payment capacity based upon a worst-case scenario of significant negative amortization restricts credit to consumers that could realize tangible economic benefits from these more affordable loan products.

***(1b) What are current underwriting practices and how would they change if such prescriptive guidance is adopted?***

A borrower is able to qualify for a loan based upon several determinants of the borrower's ability and willingness to pay. Factors such as credit score, LTV, and DTI are predictive of a borrower's ability to pay, with credit score and LTV factors historically being much stronger predictors than DTI. An assessment of willingness or incentives to pay based upon personal credit history and loan type is also an important factor that is considered in the underwriting process.

Industry practice for calculating DTI on nontraditional mortgage products is as follows: For IO loans, a DTI is calculated for borrowers based upon the IO loan payments at the starting interest rate (fixed for a specified time period, usually 5 years). For payment option loans, a borrower's DTI is calculated based upon the fully indexed rate assuming that payments are fully amortizing. These types of mortgages do introduce greater uncertainty about the borrower's ability to make increased monthly payments, say at the expiration of an IO period or the recast of a payment option loan. It is important to note, though, that the borrower's capacity to repay is analyzed based upon information available at origination.

For a payment option loan, the calculation of DTI based on the potential payment shock from negative amortization would be highly speculative. This would require a long-term forecast of interest rates to calculate the negative amortization resulting from a borrower making only minimum payments. While such an analysis is important for portfolio management and determining capital adequacy, it is inappropriate to use in lending decisions. Such underwriting could exclude otherwise qualified borrowers, especially if the forecasts are conservative with respect to credit risk.

It is also generally recognized that certain loan purposes do not provide strong incentives for repayment when compared to a first lien on a primary residence. Examples of loan purposes with lower repayment incentives mentioned in the Guidance include loans for non owner-occupied investor loans and simultaneous second-lien loans with high combined LTVs.

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Finally, underwriting payment option mortgages with a reduced initial interest rate spread for riskier borrowers is recognized as a sound practice. This underwriting decision is made at the transaction level using policies that are part of risk-based pricing. However, such policies cannot be made uniform across institutions, as different features of a product may be used to mitigate risk.

***(2a) What specific circumstances would support the use of the reduced documentation feature commonly referred to as "stated income" as being appropriate in underwriting nontraditional mortgage loans?***

For "stated income" loans, other compensating factors such as a lower LTV, a high FICO score, or good liquidity are used to mitigate the risk. Advertised low-doc programs such as stated income loans provide homeownership opportunities for borrowers who might have difficulty verifying income (such as business owners or borrowers with commissioned, seasonal, or non-documented incomes). The increased risk with such loans is recognized and compensated for with other factors and possibly increased pricing.

However, low documentation does not imply increased risk in the case of "efficiency process programs" where borrowers have income or asset verification waived due to the quality of their credit, presence of sufficient cash reserves, or other compensating factors. Such recommendations are often the output of automated underwriting models that are standard in the industry, such as Desktop Underwriter (Fannie Mae), Loan Prospector (Freddie Mac) or DAX (S&P).

***(2b) What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances?***

The mortgage industry offers various forms of low-doc options, such as stated income verified assets ("SIVA"), stated income stated assets ("SISA"), or no income no assets ("NINA") where no income or asset information is provide in writing or verbally. The appropriateness of such low-doc programs in conjunction with alternative mortgages would depend upon the individual circumstances of each borrower and whether the low-doc option was offered to the borrower for efficiency based upon their excellent credit standing or sought by the borrower.

***(2c) Please include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.***

If a subprime channel were to offer reduced documentation mortgage loans, then these loans should be priced and offered according to the assessed credit risk of each borrower and transaction. Such mortgages are not necessarily inappropriate or predatory for



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subprime borrowers. The offering of such loans to subprime borrowers should be recognized as risk-layering and underwritten accordingly.

*(3) Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?*

Future events such as projected income growth or interest rate forecasts should not be included in the underwriting or loan approval decision. As noted above, basing DTI on forecasted interest rates brings in an unnecessary level of subjectivity into the underwriting process and may disqualify otherwise qualified borrowers. Allowing for the consideration of future income, say for a new graduate that may realize a substantial increase in income versus an individual with a steady but constant income, could also open an institution to uncertain legal risk.

Instead, the projection of future income is a factor the borrower may want to consider in choosing a loan. Borrowers must decide based on their expectations of future income and other factors, such as the planned length of stay in their homes, whether a loan product is appropriate for them. If after a borrower takes an IO or payment option loan, he or she realizes that this choice provides an uncomfortable level of uncertainty in payments, then the borrower will likely have options to refinance at a fixed rate to mitigate this risk. It is a best practice for institutions to monitor payment patterns and negative amortization and to offer constructive options to borrowers as a part of active account management.

This concludes our comments on the Guidance. Again, we appreciate the Agencies providing us the opportunity to present our concerns and to provide information on how we offer alternative mortgages. If you have any questions regarding our comments, please feel free to contact me at 206-490-3859.

Sincerely,



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