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Regulation Comments  
 Chief Counsel's Office  
 Office of Thrift Supervision  
 1700 G Street, NW  
 Washington, DC 20429  
[regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

Re: Proposed Guidance on Nontraditional Mortgage Products

Ladies and Gentlemen:

Downey Savings and Loan Association, F.A., is a federally chartered savings association headquartered in Newport Beach, California, with assets of \$17.1 billion at December 31, 2005. Downey Savings was formed in 1957 as a California-licensed savings and loan association and converted to a federal charter in 1995. Its holding company, Downey Financial Corp., was incorporated in 1994 and trades on the New York Stock Exchange and Pacific Exchange under the trading symbol of "DSL." Downey Savings appreciates the opportunity to comment on the proposed Interagency Guidance on Nontraditional Mortgage Products issued on December 20, 2005.

Since 1957, Downey Savings' primary mission has been to provide our customers with a vast array of financing options to promote homeownership in the areas we serve. We primarily originate and invest in residential (one-to-four units) real estate loans. At December 31, 2005, loans held for investment that were secured by first liens against residential one-to-four units represented approximately 86% of total assets.

We acknowledge the regulatory concerns relating to "nontraditional" mortgage products and the recent proliferation of these products in the mortgage industry. However, we believe that current regulatory guidance and regulations sufficiently address these concerns and that further restrictions are not necessary. As proposed, the guidance would place unnecessary restrictions on regulated financial institutions, but would not apply to non-regulated lenders offering these products. This would result in competitive disadvantages to regulated financial institutions without eliminating perceived inappropriate lending practices by non-regulated lenders (e.g. placing the consumer in a home he/she cannot afford). Further, when appropriately underwritten and managed, many of these products provide consumers with safe and convenient mortgage financing alternatives without creating undue risk to insured institutions. Also, certain of these products, such as payment option adjustable rate mortgages ("Option ARMs") mitigate a financial institution's interest rate risk exposure.



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Downey Savings has successfully originated Option ARMs for over two decades. At December 31, 2005, these loans represented approximately 91% of our residential one-to-four units' portfolio. While the proposed guidance refers to these loans as "nontraditional", these products are well known and have been in wide use in the West coast since the 1980s. Customer demand for payment flexibility has been the primary factor why this product has been so popular in our marketplace for so many years.

Since the debut of Option ARMs in the 1980s, lenders have experienced adverse economic conditions, including the high interest rates of the 1980's and depressed real estate values throughout California during the early 1990's. Based on Downey Savings' experience, Option ARMs have generally performed as good, if not better, than "regular" ARMs or fixed rate mortgages. This is because Option ARMs provide various payment choices that give customers the flexibility to manage their cash flow and endure periods of decreased income without defaulting on the loan.

To conclude that "nontraditional" equates to higher risk does not appropriately balance risk and compensating factors of these products. We agree that prudent underwriting standards are necessary to manage and mitigate any credit risks associated with Option ARMs. However, we believe that such standards and expectations are already covered in existing guidance and regulation, including the real estate lending standards set forth in Section 560.101 of the OTS Regulations. Consistent with regulatory standards and expectations, Downey Savings has adopted and implemented appropriate underwriting measures to mitigate credit risk associated with Option ARMs. Specifically, we qualify borrowers based on a fully-amortizing monthly loan payment calculated at a rate no less than the fully-indexed rate. Private mortgage insurance is required for loans, including Option ARMs, with loan-to-value (LTV) ratios greater than 80%, which is below the supervisory LTV limits suggested by OTS Regulations. In all cases, including reduced documentation loans, Downey Savings' underwriting procedures require an assessment of the borrower's ability to repay the debt without resorting to the liquidation of the collateral.

Regarding consumer protection issues associated with Option ARMs, customers benefit from payment and rate caps in addition to payment flexibility. Borrowers currently receive required disclosures explaining the features of their loan program. The proposed guidance, however, would effectively modify or amend regulatory disclosures provided by lenders pursuant to consumer laws and regulations, including the Truth In Lending Act and its implementing Regulation Z. Again, such requirements would not be applicable to non-regulated lenders, thus resulting in inequities in the mortgage industry. Notwithstanding the sufficiency of current disclosures, Downey Savings provides customers with a simplified ("plain English") disclosure further explaining the terms and risks (e.g. potential payment shock) associated with these loans.

Downey Savings has also successfully originated reduced documentation loans since the 1980's. Reduced documentation loans have also become highly sought by customers who demand expediency and simplification in the mortgage process. In fact, most customers prefer to pay a higher interest rate in order to reduce the level of paperwork in the mortgage process. We do not believe that this trend is likely to be reversed. Again, we believe that current guidance and regulations set forth appropriate standards and expectations for prudent underwriting standards and risk management practices associated with reduced documentation loans and, in general, regulated financial institutions have implemented appropriate measures to mitigate the risk. For example, Downey Savings typically requires a better credit history (higher FICO scores) and lower LTV ratios for these products. Further, while income is not verified for these programs, employment is typically verified verbally prior to the funding of the loan. Also based on Downey Savings' experience, reduced documentation loans, including nontraditional loans, typically perform as good, or better, than full documentation loans.

Finally, the guidance, as proposed, is vague and broad in scope and, much like the Subprime Lending guidance, subject to interpretation by individual supervisory staff, which may result in subjective and inconsistent application between agencies and even within the same regulatory agency thereby furthering inequities in the mortgage industry.

Following are our specific comments to the questions or issues raised in the proposed guidance in the same order as they appear in the guidance.

#### Questions posed by the Agencies

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

As noted earlier, Downey Savings qualifies borrowers using a fully-amortizing monthly loan payment calculated at a rate no less than fully-indexed rate based on the original loan balance. We believe this method is appropriate and should be used by regulated financial institutions. Each month, borrowers have the choice of several payment options. Only one of these payment options ("minimum payment") may result in deferred interest or negative amortization. Usage of the "minimum payment" options varies from customer to customer and month to month. Some borrowers use it all the time, while some borrowers use it only occasionally and some may never use it at all. To assume that all borrowers will choose to always make the minimum payment is speculative and unfounded based on historical experience. This approach may adversely impact the qualification of numerous borrowers who may never use the minimum payment option.

***(2) 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? What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? Please include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.***

As noted earlier, reduced documentation loans are highly sought by borrowers who want expediency, less paperwork and an overall simpler mortgage process. Again, based on our experience, when appropriately underwritten, these loans perform as good, if not better, than full documentation loans. Whether a traditional or "nontraditional" mortgage (as defined in the proposed guidance), good credit history and adequate collateral are key elements in loan payment performance and ultimate losses sustained. As such, reduced documentation programs usually require a better credit history and lower LTVs.

To further mitigate risks associated with reduced documentation loans, employment is usually verbally verified prior to funding. Also, underwriters are trained to evaluate the reliability of the stated income or assets giving consideration to factors such as the type of employment and experience indicated in the application, asset accumulation and historical payment performance. Downey Savings also uses pre-funding anti-fraud tools that verify employer information and other data reported in the loan application.

The risk with reduced documentation loans is the unreliability of income or asset information reported in the loan application for credit decision purposes. However, unreliable income or asset information is not limited to reduced documentation loans. Full documentation loans do not assure the lender with reliable information in the loan application/file. The use of "superior quality" forged income or asset documentation has been on the rise. Companies promising delivery of "real looking" paycheck stubs or "renting" assets for the temporary use of customers are flourishing on the Internet. As such, restricting the use of reduced income loans is not the answer to higher quality loans. Rather, employment of prudent underwriting practices and adequate compensating factors (such as credit history and borrower equity) will ultimately reduce the risks associated with reduced documentation loans. Again, we believe current guidance and oversight are adequate in this respect.

***(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?***

Forecasting future income is not appropriate when underwriting any type of loan, whether a traditional or "nontraditional" mortgage loan. It is not reasonable to assume that such forecasting of income could be done accurately or be consistently applied.

#### LOAN TERMS AND UNDERWRITING STANDARDS

For Option ARMs, we concur that these loans should be underwritten based on a fully amortizing loan payment calculated at a rate no less than the fully-indexed rate. However, the borrower should be qualified based on the original loan balance, rather than assuming the borrower makes only minimum payments. As noted earlier, such an assumption is highly speculative and unfounded based on historical experience. It would also prevent numerous borrowers who may never or seldom use the minimum payment option from qualifying for mortgages with regulated financial institutions and force them to non-regulated lenders. As for Interest Only loans, the current practice is to qualify borrowers based on the interest only payment. This practice is modeled after underwriting practices acceptable in the secondary market, including the Government Sponsored Entities (GSEs).

The proposed approach to qualify borrowers at the higher loan amount for Option ARMs or based on fully-amortizing loan payments in the case of Interest Only loans does not consider the effect of prepayment speeds for "nontraditional" mortgage products. Historically, both Option ARMs and Interest Only loans typically prepay prior to the expiration of the interest only period or prior to reaching the maximum negative amortization amount for an Option ARM.

We agree that all lenders should exercise appropriate due diligence to ensure that the borrowers are able to repay the debt, as structured, in a timely manner and without resorting to the liquidation of the collateral. However, as noted earlier, if appropriately underwritten, reduced documentation loans can satisfy such requirements without the attendant income documentation.

As noted in the proposed guidance, all lenders should consider the spread between the introductory ("teaser") rate and fully-indexed rate. During rising rates, low introductory rates will undoubtedly accelerate payment recasting and potential payment shock for those borrowers that consistently choose to make the minimum payment. Nonetheless, borrowers are qualified based upon a fully-amortizing loan payment at the fully-indexed rate. As proposed, the guidance sets forth a vague standard to the setting of introductory rates. Specifically, the guidance proposes that institutions should consider ways to minimize the probability of early recastings and extraordinary payment shock. Again, such an approach assumes that the borrowers will always choose the minimum payment option. We believe that potential payment shock due to early recasting is better handled by management through prudent monitoring and loan servicing practices, which would include the development of accurate and timely reports and strategies to deal with those borrowers that constantly choose to make the minimum payment. Ongoing communications with these borrowers are also appropriate.

As a general rule, all non owner occupied investor loans (whether traditional or "nontraditional") should be underwritten to ensure the borrowers are qualified to service the debt over the life of the loan and are subject to equity and credit history standards commensurate with the risk of a non owner-occupied investor loan.

#### PORTFOLIO AND RISK MANAGEMENT PRACTICES

We concur that prudent monitoring and loss mitigation practices are necessary to manage the risks of all loan portfolios, including those defined as "nontraditional." In general, management and directors should set forth acceptable levels of risk through company policies. While certain levels of diversification are advisable, we oppose the guidance's call for concentration limits, especially for "nontraditional" products. Customer demand for these products is high; therefore, arbitrary concentration limits imposed on a financial institution may impact its ability to serve the needs of its customers or simply maintain a viable business strategy. As noted earlier, Downey Savings has held Option ARMs in its residential loan portfolio for decades and, to date, our portfolio's performance (as measured by the level of historical charge-offs) has outperformed the averages of OTS' regulated institutions.

While we believe appropriate capital levels should be maintained for the various loan portfolios, we are troubled by the guidance's suggestion to maintain sufficient capital to reflect the effect of stressed economic conditions. Similar to the subprime interagency guidance, the agencies are vague in their definition of 'stressed economic conditions', leaving much to the subjective interpretation and application of regulators. Stress tests should consider reasonable "worst case" scenarios for delinquency and losses given plausible and realistic interest rate, housing and default scenarios. We are concerned regulators may not be either consistent or reasonable when evaluating stress tests assumptions.

The guidance advocates procedures to monitor third-party loan originations, especially their compliance with all particular laws and regulations, with particular emphasis on marketing and borrower disclosure practices. Downey Savings agrees with the need for ongoing monitoring of the quality of third-party loan originations and swift handling of identified problems, such as early defaults, incomplete documentation and fraud, and has implemented appropriate controls to do so. However, it is unrealistic to expect financial institutions to monitor brokers' disclosures and marketing materials. To ensure accuracy in disclosures, Downey Savings has elected to provide borrowers with new disclosures.

Finally, the guidance sets forth management information and reporting expectations. While the suggestions are useful and appropriate, we believe that each institution is responsible for developing appropriate reports as part of its credit risk management program. Reports should be tailored to the institution and meaningful to the user. As appropriate, the reports may be modified or expanded at the request of regulators.

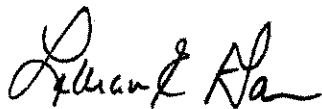
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## CONSUMER PROTECTION ISSUES

We agree with the agencies overall concern that disclosures given to the customer clearly and accurately explain the features and risks of the selected loan program. However, as proposed, we believe the guidance would further confuse already complicated disclosures. Further, the changes proposed would only apply to regulated financial institutions without adequately protecting those consumers borrowing from less regulated lenders. If new or clearer disclosures are required, it is only appropriate that these efforts be addressed with modifications to Regulation Z. Further, the guidance is redundant with regards to regulatory expectations of compliance with all applicable consumer laws and regulations. This is already addressed in existing regulation and monitored through compliance programs and examinations.

Finally, regarding the agencies suggestion to adopt "mystery shopping" and call monitoring programs, we believe that financial institutions are already operating under regulatory expectations to develop and maintain appropriate compliance programs that monitor the institution's overall compliance with all consumer laws and regulations. Each institution should continue to have the flexibility to implement appropriate procedures that complement their operations and compliance program and effectively manage and monitor such compliance.

Respectfully,



Lillian E. Gavin  
Executive Vice President  
Chief Credit Officer