David D. Gibbons
Senior Executive Vice President
Chief Risk Officer

March 29, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Public Reference Room
Docket No. 05-21
Mail Stop 1-5
Washington, DC 20219
VIA FACSIMILE 202-874-4448

Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Via Email Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn.: Docket No. 2005-56
VIA FACSIMILE 202-906-6518

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., NW
Washington, DC 20551
Attn.: Docket No. OP-1246
VIA FACSIMILE 202-452-3819

Re: Proposed Guidance – Interagency Proposed Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77249 (December 29, 2005) ("Proposed Guidance")

Ladies and Gentlemen:

HSBC North America Holdings Inc. ("HSBC North America") appreciates the opportunity to comment on the Proposed Guidance issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies"). HSBC North America is a financial holding company engaged in the origination, purchase, sale, and securitization of retail mortgages through both insured depository institutions as well as other non-insured entities in the United States and Canada. Our largest bank subsidiary, HSBC Bank USA, N.A., Wilmington, Delaware, operates more than 400 branches, which are located in the states of New York, Florida, Pennsylvania, New Jersey, California, Washington, Oregon, and the District of Columbia. Other HSBC

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North America subsidiaries with mortgage operations include HSBC Finance Corporation and HSBC Bank Canada.[1]

Through its subsidiaries, HSBC North America offers and funds a wide variety of mortgage products to retail customers with a wide range of credit profiles, including private banking customers, conforming loan customers, and nonprime customers. These products are and will continue to be important to us, and currently 11.5% of our real estate portfolio consists of mortgages that could be considered "nontraditional" and thus subject to the Proposed Guidance. That being said, we share the Agencies' concerns that lenders should exercise sound risk management that is appropriate to the size and nature of these particular retail portfolios. To this end, we maintain detailed, specific policies and procedures that apply to each of our product types, including specialized or enhanced underwriting where appropriate, as well as portfolio monitoring and reporting to enable adjustments where and when required to manage risk.

Scope and Applicability of the Proposed Guidance:

As an initial matter, we would suggest that the Agencies provide a clear definition of what they consider to be a "nontraditional mortgage," perhaps by outlining what combination of terms or attributes render a product "nontraditional" and thus subject to the requirements of the Proposed Guidance. This would help ensure that more standard mortgage products, for example, those with an adjustable interest rate (whether prime or non-prime) would not be unduly restricted, and that those which truly present added risk are appropriately subject to heightened risk management.

We would also suggest the Agencies clarify and limit, in the body of the Guidance, what legal entities it would cover. While the Preamble states that the Proposed Guidance would apply to "all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions,"[2] the text of the Proposed Guidance does not itself contain such a delineation. Our first concern arises with respect to a bank holding company subsidiary that is regulated by a foreign supervisor and is involved in retail mortgage activities outside of the United States. In this case, we would suggest that the Proposed Guidance state that it does not apply to the activities of that subsidiary which take place outside of the United States (e.g., where the borrower and the real estate are located in a foreign country). Secondly, the Proposed Guidance incorporates by reference certain existing publications and regulations issued by the Agencies, many of which apply to particular types of entities, such as insured depository institutions, but not to their nonbank affiliates which are often subject to a separate scheme of supervision and regulation by state supervisors and the Federal Trade Commission. In particular, footnotes 3 and 4 make reference to the Real

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[1] Because the Proposed Guidance was issued by the U.S. bank regulators, our comments, with the exception of those related to jurisdiction, are based on the activities and regulation of HSBC North America entities located and doing business in the United States.

[2] 70 F.R. at 77251

Estate Lending Standards issued pursuant to notice and comment following the enactment of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"), and the "Interagency Proposed Guidance on the Treatment of High LTV Residential Real Estate Loans," issued to clarify certain requirements in the FDICIA Real Estate Lending Standards.[3] Because these documents specifically apply to insured financial institutions and not to their uninsured affiliates, we suggest that the Proposed Guidance clarify that such referenced publications[4] continue to apply as originally intended, and that the Proposed Guidance does not purport to effect a change to the applicability of these rules or others intended primarily to ensure the safe and sound operations of insured depository institutions.

Finally, we note our concern that, because the Proposed Guidance does only apply to banks and their affiliates, a large portion of the mortgage industry will not covered, resulting in competitive inequality. Nonbank lenders that are not affiliated with insured depository institutions will be able to offer consumers products with terms that the banking industry may no longer be able to provide, and, as noted later in this letter, with disclosures that may not meet the Agencies' requirements.

Credit Risk/Safety and Soundness :

We share the Agencies' concern that, if improperly managed, nontraditional mortgages can pose safety and sound risks to lending institutions. However, the Proposed Guidance appears to set forth what appears to be overly prescriptive requirements for risk management, and we would suggest a more principles-based approach. Moreover, we would suggest that requirements related to risk management should reflect industry practices of monitoring and controlling for retail credit risk on a portfolio basis – not on a loan by loan basis. For example, retail lenders engage in stress testing and monitor risk concentrations by looking at segments of their portfolios – not by stressing individual borrowers with future scenarios.

In particular, we would submit that the proposed requirement to underwrite an applicant for the life of the loan is not feasible, is contrary to industry standards, and could have dramatic unintended consequences. Sound underwriting methodology is created by reviewing an individual's past credit performance and the performance and longevity of particular loan products. There is no current method or practice that we are aware of for reliably estimating an individual applicant's future income. Moreover, the information required to start doing this type of estimate could raise significant fair lending implications (e.g., how would lenders consider the fact that an applicant is 58 and may not survive to make the last payment on a 30-year loan? Or that an applicant lives in a

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[3] Interagency Guidelines for Real Estate Lending Policies, dated December 1992. See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS).

[4] Including other documents referenced in footnote 3, specifically: Interagency Agency Proposed Guidance on Subprime Lending (March 3, 1999); Expanded Proposed Guidance for Subprime Lending Programs (January 31, 2001); OCC Bulletin 2005-3 Standards for National Bank's Residential Mortgage Lending; OCC Advisory Letter 2003 - 7 Guidelines for Real Estate Lending Policies. 70 F.R. 77252

particular area where unemployment is rising?) Added on to this remote estimate, lenders would need to factor in possible interest rate changes and changes to market risk. In the end, we would suggest that compounding of all of these estimates would create enormous regulatory burden without any corresponding reduction in the credit risk associated with a particular loan or portfolio.

In addition to requiring underwriting systems that estimate future events, the Proposed Guidance would require lenders to assess each applicant's ability to service the debt, through final maturity, at the fully indexed rate, assuming a fully amortizing repayment schedule. We disagree with this approach to risk mitigation for alternative mortgages as an overly blunt tool that could unnecessarily eliminate the availability of these products. Rather, we would submit that safe and sound underwriting methodologies that are based on portfolio experience and borrower credit characteristics, exist and can be used to effectively manage risk and address customer needs.

We are also concerned by the recommendation that lenders set formal concentration limits on particular loan types. Our practices do not set formal limits based on the type of products offered (e.g., interest-only, reduced documentation, second lien, etc.). Rather, exposures are monitored based upon our internal risk assessment of a variety of factors. Currently, the credit products of most major banks enjoy wide geographic dispersion, which allows each bank to maintain a diversified portfolio and mitigate collateral risk. Although some banks may not have formal concentration limits in place, proper portfolio management monitoring and reporting is in place to avoid issues associated with excessive concentrations.

Finally, we are concerned that the requirement in the Proposed Guidance that lenders consider particular product features when establishing a reserve methodology is unworkable and conflicts with existing accounting policy and industry standards. Existing regulatory and accounting policy and guidance is sufficient to guide lenders in establishing appropriate reserves based on their experience, and to the extent risk at an institution is increasing in certain portfolios, allocating judgmental reserves.

Secondary Market/Wholesale

With our broad engagement in the mortgage industry, we impose standards and policies on our employees, our servicers, our sellers, and our brokers. We monitor and control for the risks raised by each of those parties. However, the language of the Proposed Guidance suggests that lenders and purchasers are potentially strictly liable for the actions of a third-party originator ("TPO") engaged in the marketing, sale, and origination of mortgages. This standard is not workable and, we submit, could have a dramatic effect on the structure and liquidity of the mortgage industry. In particular, the Proposed Guidance seems to suggest that additional due diligence by lenders may be necessary to identify non-compliance by TPOs of disclosure and marketing requirements. [5]

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[5] *See* 70 Fed. Reg. at 77254.

We would suggest that it is not reasonable to require institutions to ensure that TPOs are in compliance with laws and regulations, especially as they relate to marketing and borrower disclosure policies. Imposing such a requirement is not consistent with the structure of the retail mortgage market whose liquidity is dependent on the ability of lenders to easily sell mortgages in the secondary market. Most major lenders purchase loans from thousands of correspondents and bulk sellers, who in turn may purchase loans from other correspondents. It would be impossible for lenders to completely monitor the disclosure practices of all their correspondents without significantly increasing the cost and time required to purchase loans from TPOs. In particular, this would require lenders to manually review all loan files purchased from TPOs to ensure proper disclosure was provided to consumers, rather than sampling the files as is the current industry practice.

Currently, all mortgage brokers and correspondents must comply with TILA, and state-chartered entities must also comply with state advertising requirements. As a result, it appears superfluous to require every bank and lender to ensure compliance of such laws by third party brokers and correspondents. Because notice of TILA violations must appear "on the face" of the documentation when purchasing in the secondary market, we suggest that this concept in the Proposed Guidance may put a significant burden on loan purchasers that is not currently recognized by existing laws.

We note also that the banking industry has numerous generally accepted requirements and controls for approving and monitoring TPOs. These include, but are not limited to: appropriate licensing; minimum experience requirements; minimum net worth requirements; public records searches; watch and exclude lists; fraud product screening; and regular quality control reviews where compliance data is tested. In light of the fact that numerous safeguards already exist, lenders that purchase loans from TPOs should be entitled to rely on the representations and warranties given by the TPO regarding compliance with applicable laws.

We also would suggest that entities which securitize loans not be required to ensure that all loans in their pools comply with the requirements of the Proposed Guidance. Several provisions in the Proposed Guidance could be read to create such a requirement. Imposing such a requirement on securitizers appears even more problematic than requiring banks to monitor the practices of correspondents, as securitizers have even less practical capacity than their correspondents to control the marketing and disclosure practices of the originators of loans in a pool.

Finally, the Proposed Guidance states that, in order to protect its "reputation" in the secondary market, "an institution may determine that it is necessary to repurchase defaulted mortgages," even in the absence of a contractual obligation to do so. The Proposed Guidance considers such a repurchase "implicit recourse." In effect, for purposes of risk-based capital requirements, the Proposed Guidance assumes that even after the credit risk on a loan has legally moved on, a significant portion of the risk remains with an institution. The Proposed Guidance does not say exactly how much of

this risk stays at the institution, but the wording of this section could lead one to conclude that a substantial portion of the risk stays with the institution after the loan is sold. We are concerned that while the Agencies have asserted that institutions may feel compelled to repurchase defaulted mortgages simply to protect their reputation in the market, no examples or other evidence of this practice is provided. In contrast, it is our experience within the industry, that sellers repurchase loans only if the loans breach in any material respect a loan-level representation and warranty. Our understanding is that the Agencies do not take the position that such repurchases constitute recourse, as the only credit risk of loss that sellers often retain after selling a loan into the secondary markets is the risk to repurchase a loan in respect of an early payment default, which usually is narrowly defined. Thus, we suggest that the statements relating to "implicit recourse" be removed from the Proposed Guidance.

Consumer Protection:

The Proposed Guidance appears to require a "warning" label on particular products. We agree that the current regulatory scheme of mortgage disclosure may not successfully convey to consumers key factors to their borrowing decisions at a point in time where key decisions are being made. HSBC North America and other lenders have been working to fill that gap with certain best practices noted below. However, we would suggest that an additional way to address the problem, and serve all consumers, would be to require simple disclosures up front (e.g., in advertising) and require them across the industry. In essence, to the extent that the Agencies intend to affect the mortgage market we note that the Proposed Guidance covers one section of the industry only – insured depository institutions and their affiliates. To the extent that regulators are attempting to affect the market and protect consumers, a huge section of originators, brokers, buyers, and sellers would not be covered. In contrast, comprehensive Federal laws and regulations govern a broader spectrum of the residential mortgage lending industry. Many provisions in the Proposed Guidance that relate to disclosure incorporate requirements that have traditionally been regulated through the Truth in Lending Act ("TILA")[6] and Regulation Z.[7] To ensure the effectiveness of consumer protection initiatives and to ensure that regulated lenders are not placed at a competitive disadvantage, we suggest that consideration be given to amending already existing Federal laws and regulations such as the Real Estate Settlement Procedure Act ("RESPA"),[8] TILA and Regulation Z. We view this as a more inclusive approach that will not hinder the competitive mortgage marketplace and will help ensure that all consumers and lenders realize the intended benefits.

Along these lines, we note our support of the principle that consumers should be provided with sufficient, clear information to make an informed decision about the product and features that make sense for them, and to make that choice for themselves. To this end, many lenders are developing and using a variety of disclosures to help

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6 12 U.S.C. § 3806 *et seq.*; 15 U.S.C. §§ 1604 and 1637(c)(5) (2006).
7 12 C.F.R. Part 226 (2006).
8 12 U.S.C. § 2601 *et. seq.*; 42 U.S.C. § 3535(d) (2006).

consumers understand and choose among their loan options. In addition, the Agencies might consider reference to the document drafted by the Division of Consumer and Community Affairs of the Federal Reserve Board as the basis for a new, uniform booklet which would assist consumers in making informed decisions. Such a uniform booklet, written in plain English, would help customers to comparison shop between lenders. Other examples of methods used within the industry, to varying degrees, include a one-page loan summary highlighting key terms of the loan, a one-page summary of payment options provided with the Good Faith Estimate, and a one-page balloon loan disclosure. Other consumer protection practices used by some lenders include limiting debt burden to ensure affordability, ensuring loans provide consumers a tangible economic benefit, and implementing controls to help ensure consumers receive the lowest interest rate for which they qualify.

To the extent the Proposed Guidance appears to impose a duty on lenders to assess whether a particular product is suitable for a particular consumer, we are concerned that it may be inappropriate for lenders to underwrite or offer loans based on a subjective assumption as to whether a particular product is "suitable" for a customer. In effect, such a requirement, while well-intentioned, would appear to require lenders to steer consumers away from certain products, possibly in conflict with existing law and policy. Most lenders are not financial planners, and are not in a position to decide whether a particular mortgage product best serves an individual's life situation. Lenders are working to help consumers buy homes and consolidate debt, and are encouraged to do so by public policy. To this end, our subsidiaries do automate certain parts of the application process, so that the system identifies the products for which applicants are likely to qualify. If an applicant is eligible for multiple products, the product choice is based on that applicant's preferences with respect to loan terms and rate among the available products.

Particularly problematic is the Agencies' proposal that certain advertising material contain specific terms that trigger additional requirements under TILA. For instance, under the Proposed Guidance, where lenders disclose the benefits of nontraditional mortgages, they must also disclose the amount of payments and the timing of those payments.[9] Under TILA, if such disclosures are made, then additional, more onerous disclosures must also be provided. The Proposed Guidance should be modified so as not to require the use of TILA trigger terms in advertising. Alternatively, those requirements should be taken out of any guidelines issued by the Agencies and instead incorporated as amendments to Regulation Z.

We are also concerned with the Agencies' proposal that monthly statements include detailed information about a borrower's payment options.[10] This would be very expensive to implement and the quantity of information on each monthly statement may confuse the borrower. We would suggest that there are better approaches to provide borrowers with payment option information. Loan servicers can provide payment option

[9] 70 Fed. Reg. at 77256.
[10] 70 Fed. Reg at 77256.

information on their websites, with a reference to the website link on the monthly payment statement. Alternatively, payment option information can be provided to borrowers periodically, as a separate mailing, or as a separate page enclosed with the monthly statement. Another alternative is to allow lenders to provide borrowers with general payment option information that does not specifically describe each borrower's mortgage features. As a final note, to the extent additional disclosures are required, we respectfully request that the Agencies grant a 24-month transition period to adapt any new monthly statement requirements.

Finally, we respectfully requests that the Agencies exclude from any additional disclosure requirements borrowers who certify to the lender that the borrower has a net worth (excluding a primary residence) of a least $3,000,000.00. This is consistent with statements in the Proposed Guidance which imply that the purpose of the proposal is to protect unsophisticated borrowers from borrowing money and granting a lender a security interest in the borrowers home where the borrower does not fully understand the terms of the transaction and as a result may suffer financial hardships or even the loss of his or her home. Individuals with a net worth of at least $3,000,000.00 (excluding a primary residence) do not need the protection of receiving additional disclosures as they have access to an attorney or financial advisor, and thus the burden of the disclosure requirements would not provided any added benefit to the borrower.

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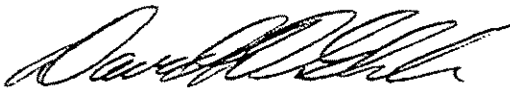
We appreciate this opportunity to submit comments on the Proposed Guidance, and support the Agencies' efforts to create nationwide standards on these issues. If you should have any questions or comments regarding this letter, please feel free to call me at the number listed below or Martha Pampel, Deputy Regulatory Counsel, at (847) 564-7941.

Sincerely,



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