March 29, 2006

Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
VIA email: reg.comments@ots.treas.gov

Attention: Docket No. 2005-56

RE: Proposed Guidance: Interagency Guidance on Nontraditional Mortgages,
70 Federal Register 77249 (December 29, 2005)

Ladies and Gentlemen:

Guaranty Bank appreciates the opportunity to comment on the Interagency Guidance on Nontraditional Mortgage Products published in the Federal Register on December 29, 2005. We have been an originator and investor in the "Option ARM" market for over 12 years (in both whole loan and securitized form). Our Option ARMs have performed extremely well through the various economic cycles, as have those of many other portfolio lenders. However we have witnessed firsthand the deterioration in underwriting standards in the market in recent years. While many of the characteristics described in the Guidance document are symptomatic of this deterioration, we believe that **all of these characteristics need to be viewed in the broader context of an individual bank's underwriting and risk management policies and procedures**. In other words, we don't think that any of these characteristics, in isolation, can be judged to be innately risky, although the combinations of many of these characteristics have very clearly resulted in a generally riskier underwriting environment. We draw this rather self-evident distinction to make the point that **we believe it would be difficult for a regulator to put in place specific rules that would bring about the desired results without also having an adverse impact on the availability of credit to homeowners that is rationally priced**. Also, there is the broader risk that excessive regulatory focus on "nontraditional" products will have the effect of discouraging innovation, and innovation is not only commonplace but is also necessary, inside and outside of the financial services industry, as the wants and needs of consumers evolve. The now commonplace adjustable-rate mortgage was "nontraditional" 25 years ago, and the standard hybrid ARM was "nontraditional" a decade ago. "Nontraditional" is a moving target, and rules put in place to rationalize today's "nontraditional" product may not extend to tomorrow's "nontraditional" product. In fact, it is the existence of rigid rules that would likely serve in part as an impetus to innovation - purely as a way to

circumvent the rules - and any attempt by the regulators to put in place specific rules would always be "playing catch-up" with industry dynamics.

However we agree that some supervisory concern in this area is in order. Most of the major changes to product design and underwriting standards recently, taken as a whole, have been in the interest of improving affordability for the marginal borrower. These changes appear to be based on the tacit assumption that continuing home price appreciation and a strong economy will serve as a "safety net" for liberal underwriting and/or product design. While affordability is a problem in many local housing markets, it is unclear if the "nontraditional" products are the cause of, or the cure for, the problem (most likely a mixture of the two).

We will also point out that, at least in the short run, any changes to rules would be likely to handicap regulated originators/investors/servicers relative to their unregulated competitors, which would likely limit any potential "social policy" benefits emanating from the rule changes.

While risk "layering" has become prominent in mortgage origination, and many of the various risk facets have a negatively synergistic impact on credit risk, reliable tools are available to quantify this compounded risk exposure. Also, the ability to view the impact of these risk dimensions on a disaggregated or a combined basis means that originators are able to offset heightened risk along one dimension with lesser risk along a different dimension (such as a lower FICO offset by a lower LTV).

In any case, **we think the regulatory focus should be on the individual bank's policies and procedures, in the context of the bank's unique operating environment**, which would include the size of the aggregate exposure in the context of the size and composition of the rest of the balance sheet. Such policies and procedures should generically take into consideration any fundamental change in underwriting standards and/or product design, applying some kind of differentiated treatment.

Regarding the specifics of policy enhancements, for example (and these are strictly hypothetical), in the area of DTI, a bank could impose on itself a requirement that the borrower be qualified at the fully-amortizing payment on a fixed-rate "interest only" ("I/O") loan after the I/O period ends. With a teased, negatively-amortizing ("neg am") loan, the borrower could be qualified at the fully-indexed rate, with the underlying index stressed to some conservative, but reasonably possible, index level. Additionally, the policy could require that the teaser itself be set at a level that doesn't trigger a recast before the first "time-triggered" recast date (which is typically five years after origination), assuming the minimum payment is made. (An earlier recast could take place if the loan balance negatively amortizes to its contractual limit of, for example, 110% of the original loan balance.) Also along the DTI dimension, when used in the context of investor properties, the anticipated rental income could be ignored. While DTI is a statistic that attempts to measure the borrower's ability to pay, it does not quantify his/her willingness to pay.

The mortgage market has become highly sophisticated in using one risk dimension as an offset to another (as in the FICO / LTV trade-off described above), and also pricing the product to cover the (net) higher or lower risk caused by this "composite" of credit characteristics. However the individual bank's underwriting/pricing should implicitly recognize that, even if the incremental risk is fairly captured in the price differential, the models the bank uses probably assume that a critical mass has been achieved in the size of the portfolio for the pricing to fairly capture the portfolio's aggregate realized risk profile. If the portfolio is not large enough to achieve that critical mass, then idiosyncratic behavior could come to dominate actual portfolio experience. As such, pricing should probably be seen as a way to influence the underwriting process, rather than "cover" the borrower's anticipated behavior. For example, a 50 basis point higher coupon due to low documentation could be viewed as an incentive for the borrower to provide more complete documentation. But for that individual loan, the 50 basis points will probably not cover the loss incurred if the loan defaults at the first payment reset on an Option ARM. But those extra 50 basis points might cover the incremental risk of $100 million of identical loans on a pooled basis. The important point is **a bank with a small exposure to a segment of the market shouldn't rely on differentiated pricing as a "bail-out" for liberal underwriting**. This same principle extends to loss-reserving, which should in some way capture the heightened potential for idiosyncratic behavior resulting from a portfolio too small to have achieved the critical mass implicit in the loss-reserving assumption.

While stress-testing could be implicit at the underwriting stage, **the policy might mandate periodic stress-testing of the pre-existing portfolio as a whole**. Key credit parameters (such as FICO, "market" LTV, and ideally, new lien positions) could be updated before the portfolio stress test is undertaken. This would ensure that the bank is monitoring the "forest" as a whole, not just the individual "trees" at the time they are "planted." Such a macro analysis would highlight concentrated risk exposures, such as a heavy Southern California exposure, or a heavy concentration of payment "shock" due to recasting projected for the first quarter of 2008. Additionally, **the policy might empower an oversight committee to establish balance sheet limits** – by loan type, geography, documentation, etc. – either absolute dollar, or a percentage of portfolio (or total assets, or capital), to prevent excessive concentrations from occurring at the time of origination. This same committee might also set gross production limits (dollars per quarter, for example). Excessive production of a particular loan type, or documentation, etc. over a finite time period might reflect overly aggressive pricing in favor of the borrower, and/or adverse selection (as the bank's competitors are more rationally evaluating and pricing the risk dimensions).

In addition to stress-testing, **the policy could mandate formal surveillance which "raises flags" in response to, or even in anticipation of, credit stress**, such as delinquencies above some pre-defined threshold among reduced documentation loans or loans in Southern California. In the area of anticipated credit stress, loans which have a large build-up of neg am could be flagged, since the degree of neg am can be "managed" by the borrower depending on his payment choices. A borrower who consistently makes only the minimum payment might be "stretching" to make his payments. Additionally,

the policy could require higher underwriting standards for loans that are originated and/or serviced by others, relative to "home grown" loans.

We also don't believe that a policy should differentiate mortgages based on whether they are "prime," "alt-A," or "subprime," although the policy should explicitly take into consideration anti-predatory lending laws and regulations. We believe the barriers among these three categories are crumbling, if they ever had any economic legitimacy in the first place. Many loans don't fit neatly into one of these categories, and forcing a loan into one category might impose on it inappropriate policy restrictions.

The relative complexity of these "nontraditional" products suggests that the policy should require an extra degree of disclosure to the borrower. The "selling point" for these products is the low initial monthly payment. And in the case of purchase money mortgages in particular, the borrower is often cash-strapped and distracted (selling the old house, buying furniture, changing schools, job transfer, etc.), such that the potential for payment shock in the future hasn't been given appropriate consideration. More importantly, bank disclosures should be readable, short, and take into consideration the unique risks of such products, including concrete, simple examples of reasonably possible future payment scenarios, with the explicit warning that future interest rate environments and/or home price environments may not permit a refinancing "bail-out."

Again, we are <u>not</u> recommending that the regulators mandate these specific examples of underwriting and portfolio management policies. We believe that, in the ever-changing mortgage market, sound underwriting and prudent judgment cannot be "legislated." And we are not suggesting that the examples are an exhaustive itemization of policy components. Our point is that **the incremental risk posed by "nontraditional" mortgage products – the ones in question today as well as future generations – can be managed prudently through a comprehensive policy, designed and executed by the regulated institution, subject to regulatory oversight**.

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If you have any questions regarding our comments, please contact me at 8333 Douglas Avenue, Dallas, TX 75225, Attn: Jack Falconi or by phone at 214-360-4865.

Sincerely,

/s/ Jack Falconi
Chief Economist & Investment Manager
Guaranty Bank
OTS Docket #8534
Austin, Texas

cc:
Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation