HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

1001 PENNSYLVANIA AVENUE, N.W.
SUITE 500 SOUTH
WASHINGTON, D.C. 20004
Tel. 202.289.4322
Fax 202.289.1903

John H. Dalton
President
Tel: 202.589.1922
Fax: 202.589.2507
E-mail: johnd@fsround.org

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Office of the Comptroller of the Currency
250 E Street, S.W.
Public Reference Room, Mail Stop 1-5
Washington, DC 20219
Attn: Docket No. 05-21
regs.comments@occ.treas.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: Docket No. 2005-56
regs.comments@ots.treas.gov

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

Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn: Docket No. OP-1246
regs.comments@federalreserve.gov

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

Dear Sir or Madam:

The Housing Policy Council of The Financial Services Roundtable appreciates the opportunity to comment on the proposed Interagency Guidance on Nontraditional Mortgage Products ("the Guidance").

The Financial Services Roundtable formed the Housing Policy Council in 2003 to focus on mortgage finance issues of significance to consumers, the economy, and the members of the Roundtable. Today, the Housing Policy Council consists of twenty-two financial services firms that provide mortgage credit to consumers. We estimate that the member companies of the Housing Policy Council originate over 62 percent of the mortgages in the United States.

Our letter is divided into three sections. First, we offer some general comments on the Guidance. Second, we offer some comments on specific sections of the Guidance. Finally, we address the questions posed in the notice accompanying the Guidance.

I. General Comments

A. We Support the Issuance of a Guidance

The Housing Policy Council supports the issuance of a regulatory guidance that addresses alternative mortgage instruments. Although our member companies have offered alternative mortgage instruments for many years, we recognize that these products have increased in popularity in recent years. Thus, we believe it is appropriate for the federal banking agencies to provide the industry with safety and soundness and consumer protection standards to guide the development and issuance of such products.

Moreover, we believe that, with the exception of new consumer protection standards, the issuance of a guidance is preferable to the issuance of a regulation. Properly designed, a guidance can give direction to the industry and examiners, yet permit institutions and examiners a greater degree of flexibility than a more formal regulation. These products have developed to meet the evolving needs of consumers in today's housing market. Thus, institutions need some degree of flexibility in the design and structure of the products. An overly prescriptive guidance or more rigid regulation could significantly diminish the provision of these or other similar instruments to the detriment of consumers seeking to enter the housing market.

B. We Urge the Agencies to Clarify the Scope of the Guidance

The Guidance identifies two examples of so-called "nontraditional" mortgage products (interest-only mortgages and payment option mortgages), but suggests that other, unidentified, mortgage products also would be subject to Guidance. While we do not believe that the Guidance need define what constitutes a nontraditional or alternative mortgage, we believe it would be useful for the Guidance to describe some of the attributes of alternative mortgage products. In so doing, institutions – and examiners – can have a better understanding of when the standards in the Guidance apply and when they do not.

For example, we recommend that the Guidance explicitly state that it does not apply to HELOCs. HELOCs already are subject to a separate, and specific guidance. We see no need for additional guidance regarding such products. Moreover, unless some of the prescriptive standards in the proposed Guidance are modified, the application of the Guidance could force lenders to discontinue some practices, such as underwriting interest-only HELOCs solely on the borrower's ability to make the interest payment.

Additionally the Guidance does not differentiate between interest-only and payment option ARMs with respect to underwriting and risk management standards even though these products are structured and designed to meet different borrower needs and preferences. Interest-only loans are clearly intended to be an affordability product, allowing borrowers to qualify with a lower nonamortizing payment. This lower payment is applicable for an extended term. Given typical loan durations, fixed term interest-only payment periods meet consumer needs while limiting the likelihood of exposure to unmanageable payment increases. Interest-only products do not result in an increase to the principal amount of the loan.

In contrast, payment option ARMs are designed to provide borrowers additional payment flexibility over the life of the loan. These products offer options to homeowners with fluctuating incomes including the self-employed and borrowers whose incomes are bonus-driven. The product allows homeowners to access equity in the short term without incurring refinancing fees. Unlike the interest only product, however, the borrower is qualified using a fully amortizing payment at the fully indexed rate (or a predetermined interest rate, whichever is greater). While this product has the potential to increase the principal loan amount, the borrower is qualified from the start to make a payment that is greater than the amount that would allow the loan to negatively amortize.

By applying the same standards to these very different products, the Guidance will have the effect of unnecessarily limiting the availability of products that have benefited many borrowers. If the Agencies believe guidance is needed to address these products, it must recognize the distinctions and tailor the Guidance accordingly.

Finally, the Guidance could be read to require securitizers to make sure that all the loans in the pools they securitize comply with the Guidance. This could be quite problematic as securitizers have a limited capacity to control marketing and disclosure practices. We recommend that the Guidance clarify that it does not impose such a requirement.

C. We Believe the Guidance Should Strike a Better Balance Between Safety and Soundness and Product Innovation

We acknowledge that the alternative mortgage instruments present risks that institutions should measure, monitor and control. We also acknowledge that institutions should adopt appropriate risk management processes, policies and procedures to address these risks. At the same time, these instruments represent an innovation in mortgage finance that has helped thousands of consumers achieve the American dream of owning a home. Therefore, it is important that the Guidance strike an appropriate balance between safety and soundness and product innovation.

Unfortunately, in its current form the Guidance does not achieve this goal. While the background statement that prefaces the Guidance acknowledges that these mortgages offer payment flexibility and are an effective and beneficial financial tool for some borrowers, the text of the Guidance itself includes no similar statements. Indeed, the very first sentence of the Guidance implies that these products, by their very nature, are not “conservatively managed.” As a result, the Guidance leaves institutions, and more importantly examiners, with a one-sided impression of these products. We respectfully recommend that the Guidance be modified to acknowledge that these products can be beneficial for many consumers. Indeed, we would note that as far back as 1982, in the Alternative Mortgage Transactions Parity Act of 1982, Congress found that "alternative mortgage transactions are essential to the provision of an adequate supply of credit…"

Similarly, we are concerned that, in its current form, the Guidance could cause examiners to conclude that institutions must adhere, strictly, to the practices and policies set forth in the Guidance. The Guidance is quite prescriptive in structure and tone. It not only recommends a variety of specific practices, but in some instances it also cautions that institutions will be subject to remedial or corrective actions for failure to adhere to or avoid certain practices. For example, the Guidance provides that "The Agencies will carefully scrutinize institutions' risk management process, policies, and procedures…[and] remedial action will be requested from institutions that do not adequately manage these risks."

We acknowledge that remedial actions may be required whenever an institution engages in an unsafe or unsound practice, or otherwise violates a law or regulation. On the other hand, the practices recommended in the Guidance may not be appropriate in all cases, especially for institutions that have offered these products successfully for many years. Therefore, we respectfully recommend that the Guidance explicitly state that the practices recommended in the Guidance are *best practices*, which institutions are encouraged, but not automatically required, to follow.

II. Specific Comments

A. The Underwriting Standards Should Be Less Prescriptive

We acknowledge that in issuing alternative mortgage products, institutions should follow enhanced underwriting standards. However, we are concerned that the standards proposed in the Guidance are overly prescriptive.

An example of excess detail in the qualification standards is the directive for institutions to evaluate a borrower's ability to repay the loan "by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule." It is not standard practice within the industry to qualify a borrower on the basis of future income or other events in the borrower's life that may impact an ability to repay at maturity. Indeed, we know of no current method for reliably making such estimates.

Implementation of this provision could make it harder for some customers to borrow needed funds (including for new homes) and perhaps could even destabilize some real estate markets. For example, on a 30-year loan with a 10-year I/O period, it is unclear whether "fully amortized underwriting" requires that the numerator include a 20-year versus a 30-year amortization amount. Using a 20-year rule would cause the loan to be underwritten on a more stringent basis than a 30-year fixed rate loan.

Similarly, on a 3/1 or 5/1 ARM, it is unclear whether a lender can use the rate that will apply during the 3-5 year period or the higher rate that kicks in after that period. This issue is magnified if discount points are taken into account because points lower the interest rate only during the 3-5 year period. If lenders cannot underwrite using the 3-5 year rate and/or cannot take the impact of discount points into account, the Guidance could impact needed credit and destabilize real estate markets.

Additionally, the proposed qualification standards require institutions to apply a “worst case” scenario when calculating balance increases that accrue from a negative amortization provision and caution against over-reliance on credit scores. While this may be appropriate in many cases, we do not believe it is appropriate in all cases.

To address these concerns, we respectfully recommend that the proposed underwriting standards be revised to be more general, and less prescriptive, in nature. For example, institutions could be generally advised to consider all relevant factors in underwriting a loan, including an evaluation of the borrower’s ability to repay the loan. A more general underwriting standard would recognize that institutions need some flexibility in underwriting mortgages that are designed to meet nontraditional consumer needs.

Finally, as noted above, the underwriting standard fails to distinguish between interest only and payment option mortgages.

B. Simultaneous Second-Lien Loans May Be Appropriate In Many Cases

The Guidance notes that simultaneous second-lien loans could result in reduced owned equity and higher credit risk. Nonetheless, such loans may be perfectly appropriate for many borrowers. We respectfully recommend that the Guidance be modified to acknowledge this fact, otherwise examiners may be inclined to criticize such structures in all cases.

C. Concentration Limits Should Focus On Loan Portfolios Not Individual Loans

The focus of the Guidance on specific types of loans, especially concentration limits for specific types of loans, exceeds existing industry practice. Nor do we believe that such concentration limits are necessary as long as an institution implements appropriate diversification strategies. Therefore, we respectfully recommend that the concentration limits be modified to focus on portfolios, not individual types of loans.

D. Institutions Should Not Be Held Accountable For The Actions Of Third Parties

The Guidance states that institutions that use third parties to originate loans should “ensure the quality of the third-party originations and compliance with all applicable laws and regulations…" (Page 23) We acknowledge that institutions have an obligation to ensure that third party relationships do not create undue risks for the institution. However, we do not believe it is appropriate, or even feasible, to require an institution to police a third party's compliance with all applicable laws and regulators.

Third party originators are separate legal organizations, typically unaffiliated with the institution. While an institution may be able to impose some conditions on the standards and practices of third parties through contractual terms or conditions, such terms or conditions cannot "ensure" that a third party will adhere to all applicable laws or regulations.

Therefore, we respectfully recommend that you modify the references to third party relationships to more closely tract the terminology in OCC Bulletin 2001-47. That Bulletin emphasizes an institutions responsibility to "review" and "monitor" legal compliance by third parties.

E. The Proposed Consumer Protection Provisions Should Be Substantially Modified

We acknowledge that institutions have an obligation to inform consumers – in an accurate and timely manner – about the terms and conditions associated with alternative mortgage instruments. However, for the reasons given below, we believe that the proposed consumer protection standards in the Guidance are neither necessary nor appropriate.

First, as a threshold matter, we are not aware of any empirical evidence that supports the need for additional consumer protection standards. Indeed, it is our impression that, in general, these products have been purchased by borrowers with higher incomes and an ability to fully evaluate the terms and conditions of the products. Before recommending a new level of disclosures and other consumer protection standards on these products, the agencies should conduct an analysis of characteristics of the borrowers who use these products, and then determine if there is a need for new consumer protection standards.

Second, we believe that existing federal consumer protection laws and regulations adequately address the consumer protection risks cited in the Guidance. The Truth-in-Lending Act requires lenders to fully and accurately disclose applicable loan terms and conditions. The Federal Trade Commission Act prohibits lenders from engaging in unfair or deceptive acts or practices. Furthermore, various agency advisories, such as the OCC's anti-predatory lending regulation, prohibit certain practices. Rather than impose a new disclosure regime on institutions that is not based upon any empirical evidence, we respectfully recommend that the Guidance reinforce the obligation of institutions to comply with existing consumer protection laws and regulations.

Third, some of the recommended consumer protection standards would be difficult to implement. For example, institutions are urged to offer full and fair product descriptions "when a consumer is shopping for a mortgage, not just upon the submission of an application or at consummation." How is an institution to know when the "shopping" process begins?

Fourth, in their current form, the required disclosures would, as a practical matter, end advertising for these products. The Guidance recommends that promotional materials include information on costs, terms, features and risks of these products, including information on payment shock, negative amortization (if applicable), pre-payment penalties, and the cost of reduced documentation loans. Advertisements simply cannot contain this volume of information.

Fifth, the proposed reviews to monthly statements would be expensive and difficult to implement. Loan servicers may have serious problems "including information about the consequences of selecting various payment options on the current principal balance" and explaining each option and noting the impact of each choice. For example, servicers will need guidance on timing. Does the monthly statement have to provide the payment option information every month, or every month that a payment option feature is triggered (which, in effect could be several times a year)? If this requirement is retained in the final Guidance, we recommend that the Guidance permit an annual or semi-annual disclosure and/or give servicers the option to provide customers with a "generic" (not loan specific) description of payment/options/features. We also recommend a 24-month transition to implement any such requirement.

Sixth, several statements in the Guidance indicate that lenders have an obligation to ensure that nontraditional mortgage loans are "suitable" for a consumer. For example, the Guidance includes the following statements:

> "Institutions should also ensure that consumers have information that is timely and sufficient for making a *sound* product selection decision."
>
> "… when promoting or describing nontraditional mortgage products, institutions should provide consumers with information that will enable them to make *informed* decisions and to use these products *responsibly*."
>
> "Promotional materials and descriptions of these products should provide information that enables consumers to *prudently* consider …"
>
> "Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make *responsible* payment choices…"
>
> "…using compensation programs that do not *improperly* encourage originators to direct consumers to particular products."

The consumer protection statutes cited in the Guidance impose an obligation on institutions to provide consumers with certain information (e.g., APR disclosures), and to avoid certain practices (e.g., unfair and deceptive practices). Existing federal laws and regulations do not impose an obligation on institutions to ensure that consumers use credit responsibly or prudently. Moreover, the notion of "responsibility" is impossible to evaluate. How is an institution to judge if a consumer has made a "responsible" or "prudent" decision? How would an examiner make such a determination?

Given the foregoing concerns, we respectfully recommend that the consumer protection section of the Guidance simply restate existing consumer protection laws and regulation and urge institutions to comply with such laws and regulations.

Alternatively, if the Agencies are convinced that changes in advertising, disclosure and related communications are necessary, amendments to Reg Z and TILA would be a more appropriate place to address those changes.

III. Questions

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 above, we believe that the Guidance should distinguish between interest only loans and payment option loans. Also, we do not believe that it is appropriate to apply a "worst" case scenario to all such loans. There are many variables that impact a borrower's ability to repay, and institutions should have the flexibility to evaluate borrowers accordingly. Appropriate stress testing is an answer to this concern.

What specific circumstances would support the use of the reduced documentation feature commonly referred to as "state 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 comments on whether and under what circumstances "state income" and other forms of reduced documentation would be appropriate for subprime borrowers?

Typically, borrowers who utilize reduced documentation must meet other underwriting standards, such as higher credit scores, lower LTVs, and lower DTIs.

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?*

As noted above, it is not standard practice within the industry to qualify a borrower on the basis of future income or other events in the borrower's life that may impact an ability to repay at maturity, and we know of no current method for reliably making such estimates.

IV. Conclusion

In conclusion, we support the issuance of a guidance on alternative mortgage instruments, but urge that the proposed Guidance be modified to be more balanced and less prescriptive.

With Best Wishes,

John H. Dalton

John H. Dalton
President, Housing Policy Council