March 29, 2006

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

Ladies and Gentlemen:

The Consumer Bankers Association ("CBA")[1] appreciates the opportunity to comment on the Proposed Interagency Guidance on Nontraditional Mortgage Products ("Guidance") issued

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[1] The Consumer Bankers Association is the recognized voice on retail banking issues in the nation's capital. Member institutions are the leaders in consumer financial services, including auto finance, home equity lending, card products, education loans, small business services, community development, investments, deposits and

by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration ("Agencies").

Thank you also for the generous 30-day extension in the time to comment. We believe the issues raised by the Guidance are significant, and the additional time allotted to comment will help to generate more thoughtful and ultimately more useful responses.

The Guidance, published in the Federal Register on December 29, 2005 (70 FR 77249), covers so-called "nontraditional mortgage products," which are described as including "interest-only" mortgage loans, where a borrower pays no principal for the first years of the loan, and "payment option" adjustable-rate mortgages (or ARMs) where a borrower has flexible payment options that may include minimum payments that can result in a period of negative amortization.

The Guidance is intended to address the "unique risks" posed to financial institutions by these product offerings, such as the potential for negative amortization. It pays particular attention to the layering of risk caused by combining these mortgages with other practices, such as making simultaneous second-lien mortgages and allowing reduced documentation in evaluating the applicant's creditworthiness.

Beyond the safety and soundness considerations posed by these products, the Guidance lays out a number of steps that can or should be taken by institutions making nontraditional mortgage products consumers to protect consumers—particularly nonprime borrowers—from the "payment shock" that may occur if they are not sufficiently qualified and do not appreciate these mortgage products' risks.

General Comments

The recent increase in the use of innovative mortgage products is an important issue, and we understand and appreciate the efforts of the Agencies to make sure that the safety of consumers and the soundness of the financial services industry are protected.

We also appreciate the general approach being taken in the Guidance: that is, to recognize that risk may be created by nontraditional features and mitigated through other features, and that the layering of risk demands more conservative underwriting. These are principles that responsible lenders have long understood.

However, we are concerned that the Guidance is premised on the belief that these mortgage products pose risks calling for unique and prescriptive guidelines. The Guidance notes that

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delivery. CBA was founded in 1919 and provides leadership, education, research and federal representation on retail banking issues such as privacy, fair lending, and consumer protection legislation/regulation. CBA members include most of the nation's largest bank holding companies as well as regional and super community banks that collectively hold two-thirds of the industry's total assets.

in many cases these products can be beneficial, due to their flexibility and ability to offer the borrower greater control over monthly expenses. This benefit could be lost to many if the greater flexibility is equated with an unacceptable level of risk. For example, the Guidance's requirement to underwrite at a fully indexed, fully amortized terms, assuming the highest possible rate and payment scenario, could discourage the use of payment option ARMs by covered institutions, to the detriment of many consumers.

The strict underwriting expectations of the Guidance, coupled with loan level stress testing, third party monitoring, and the other constraints of the Guidance, as enumerated below, may also cause some lenders to stop making these products available in some markets, or it may simply price some consumers out of these products, encouraging them to turn to the lenders who are not so constrained.

We also recommend, for the reasons set forth in detail below, that the disclosure requirements not become a part of any Guidance being adopted by the Agencies. We believe that these disclosure requirements, while well-intentioned, will only create confusion for consumers and creditors alike.

Some additional general comments follow, after which we provide more detailed comments on specific issues:

<u>Lack of uniformity</u>

By issuing a joint proposal, the Agencies appear to be seeking a measure of uniform coverage, which we applaud. However, the Guidance does not apply directly to those institutions not regulated by—or affiliated with an entity regulated by-- one of the Agencies. Therefore, uniformity applies only within a portion of the lending community. Others are free to adopt their policies without similar constraints. This puts the consumer at a distinct disadvantage when dealing with those institutions that are not covered by the Guidance. If these considerations are felt to be necessary to protect consumers entering into nontraditional mortgage transactions, they should not be applied only to some. Particularly in the context of consumer disclosures—where information is provided in part to permit consumers to make intelligent choices among the alternative providers—the broadest possible coverage is necessary.

<u>Need for greater flexibility and clarity</u>

Guidance can be preferable to regulation by allowing those who are covered institutions to adopt it to their unique circumstances. Regulation is often more rigid. It cannot readily adjust to changes in the markets, both because it is bound to the statute that gave birth to it, and because the rule-writing process can be cumbersome and slow. Guidance, however, can be amended more readily to accommodate the rapidity of market changes. It may also be written to allow for flexibility of oversight and enforcement. A regulator relying on guidance in an examination can—at least in theory—allow the institution more leeway to adopt policies and procedures that suit its market and business plan, subject to safety and soundness considerations and an understanding of the intent of the requirements.

That having been said, it is also true that institutions subject to guidance of this kind are fully committed to complying with it, as much as if they are following a regulation. This is case if for not other reason than to avoid remedial action from their supervisory agency. That is why we are particularly concerned that this Guidance not become a quasi-regulation with detailed consumer disclosure requirements—applicable only to those institutions that are subject to it. Guidance is most effective when it provides broad parameters that allow institutions to employ judgment and experience within a framework. When it sets forth a detailed set of requirements, it is really only a regulation by another name. The flexibility that makes Guidance so beneficial is lost.

This proposed Guidance, if adopted, could easily be viewed as a strict set of requirements by examiners and others. It reaches for an unnecessary level of detail, and provides too many cases that could be viewed as prescriptive, when they ought to be merely descriptive.

Need for clear definitions

The Guidance provides no definition of "nontraditional mortgage' products. The closest thing to a definition is found in the opening passages of the Supplementary Information, where it states: "In recent years, consumer demand and secondary market appetite have grown rapidly for mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, often referred to as nontraditional mortgage loans, including "interest-only" mortgages and "payment option" adjustable-rate mortgages have been available in similar forms for many years." We recommend that a definition be provided to resolve a number of potential ambiguities. Flexibility is valuable in Guidance, as we have said, but not its coverage.

The above-referenced passage states that interest-only and payment-option ARMS are only examples of nontraditional mortgage products, leaving open the possibility that a product might be added to the list by a regulator in the course of an examination, with potentially serious consequences for the institution.[2]

On the other hand, the general statement of coverage implied by the opening phrase "mortgage products that allow borrowers to defer payment of principal and, sometimes, interest" appears to us to be *too broad* a definition, subsuming too much within the Guidance and leaving too much to the imagination. For example, normal (one might use the word "traditional") interest-only mortgages ought not to be conflated with those products that have lower monthly payments that can result in negative amortization. Interest-only products are not new; they have been offered safely and effectively for many years; and we are aware of no adverse consequences. It is really the addition of the prospect of significant negative amortization over a period of many years that creates the need for the Guidance. We

[2] "The Agencies will carefully scrutinize institutions' lending programs, including policies and procedures, and risk management processes in this area, recognizing that a number of different, but prudent practices may exist. Remedial action will be requested from institutions that do not adequately measure, monitor, and control risk exposures in loan portfolios."

recommend that traditional interest-only mortgage loans, without the possibility of negative amortization over many years, be excluded from coverage.

The definition of a “nontraditional mortgage” product is not clear in other respects as well. For example, we do not believe it is intended to cover home equity loans, as they are regulated by other guidance, but the Guidance does not explicitly exclude them.

Other products that ought not be covered by the Guidance include small business loans secured by a personal residence, non-consumer transactions generally (i.e. not covered by TILA), and home equity lines of credit. It would be very helpful to have a clear demarcation in this regard.

Institutional coverage unclear

About the scope of covered institutions, the Guidance states: “When finalized, the 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.”

While the regulatory agencies’ authority certainly extends to financial institutions that they regulate, the language quoted would appear to extend the authority to the nonfinancial institution subsidiaries of holding companies. We believe this is broader than the scope of coverage that has been claimed for similar guidance in the past, and at least calls for the agencies to refer to the authority upon which they are basing their claim.

The Guidance incorporates by reference other FFIEC guidance (for example, the Guidance says that “the institution’s underwriting standards should comply with the agencies’ real estate lending standards and appraisal regulations and associated guidelines.” Text at fn. 4. See also footnotes 6, 8, 9, and 11). This effectively extends bank supervision and regulation to companies that are not FDIC-insured. Again, if the Agencies intend to broaden the scope of all these regulations, standards and guidelines through this vehicle, this is not the way to do it. A much clearer and more explicit treatment of the issue is called for, so that the comments can appropriately entertain the question.

Consumer Protection Issues

The Guidance sets forth an array of new disclosure requirements for nontraditional mortgage loans that are different from those mandated by TILA and Regulation Z. The purpose is certainly commendable: consumers should receive full disclosures of the terms of their loan products. As noted in the Guidance, borrowers need to have sufficient information to understand loan terms and associated risks prior to making a product or payment choice. This is true in all cases, not just in the case of the products deemed “nontraditional,” and laws such as TILA and RESPA were enacted for that reason.

It appears to be the intent of the Agencies in issuing this Guidance to address products that they believe the Truth in Lending Act (TILA), RESPA, and other consumer protection statutes inadequately cover. **However, for the reasons stated herein, we believe this is not the vehicle for new disclosure requirements**. As we have said, we think this Guidance can be useful to ensure that covered institutions effectively manage the risks associated with nontraditional mortgage loan products. However, our concerns with its overly prescriptive treatment, its lack of clarity, and its uneven application among lenders, are heightened in the context of consumer disclosures, because it would create too many compliance problems.

To the extent that the Guidance addresses consumer disclosure, it should be limited to ensuring that institutions are fully in compliance with existing applicable state and federal consumer protection laws and are not engaged in unfair or deceptive acts or practices. If, after examining the need, the Agencies find it is necessary to expand federal disclosure requirements, it should be done in a more traditional, uniform, and all-inclusive manner—ensuring that the rules are clear, useful, and applicable to all institutions that make such loans to consumers.

The lack of specific requirements in the Guidance, which is intended to provide flexibility in compliance, in fact creates a host of problems. Notwithstanding the fact that the Guidance is not a regulation, it is regarded, from a compliance perspective, as a quasi-regulation. For institutions that are examined for compliance, the language of such guidance is the basis for compliance policy, almost as much as a statute or regulation. The expectation of examiners often drives such policy, and examiners' expectations are formed by interagency policy guidelines.

Yet because it is drafted as Guidance and not regulation, vague and inconsistent terminology abounds. In some cases, it says, consumers should be "apprised" of information. In other cases, institutions should "provide" information or "disclose" information. Consumers should be "alerted" to any pricing premium. Such language varies throughout the Guidance. But consumer compliance calls for specificity: Is "alert" a higher standard than "apprise"? Does "provide" require a writing, but "disclose" can be oral? In one place, it says that advertisements should include "clear and comparably prominent information" that acts to "alert" consumers of certain facts. Elsewhere, however, information should be provided in a "clear manner and format." Are these different requirements in terms of the level of prominence, or the same?

In some cases, the disclosure requirements appear to be prescriptive, in other cases merely encouraged (but not required). In regard to negative amortization, for example, "product descriptions <u>should</u> include…corresponding examples showing [their] effect" on loan balance and home equity. However, in regard to payment shock, "product descriptions <u>could</u> specifically state the maximum monthly payment a consumer would be required to pay" when payment increases hit a maximum. Once again, it is not clear whether something different is intended or this is just reflective of a more relaxed writing style more typical of guidelines than regulation.

It is also unclear how to reconcile some of the consumer protection measures in the Guidance with the requirements of federal or state law if they differ or conflict. The disclosures that the Guidance would require are not the same as TILA disclosures, but are sufficiently similar to create problems. For example, the Guidance calls for information to be provided in a "clear manner and format" such that consumers will notice it, can understand it to be material, and will be able to use it in their decision-making. TILA already requires disclosures to be provided in a "clear and conspicuous manner." Years of litigation and interpretation have fine-tuned the meaning of this phrase. Does the Guidance call for something different? Something more? If so, what is called for? The level of detailed interpretation that would be necessary is not possible (nor desirable) in the context of the Guidance. Yet institutions will be held accountable for compliance without any adequate explanation of the meaning.

Attempting to comply with the Guidance might also confuse consumers, and even result in liability for the institution under other regulations. To use the same example, an institution attempting to provide the additional disclosures in a "clear manner and format" may give them prominence over the TILA information. The relative clarity of the regulation-driven information would suffer, to the detriment of the consumers. The institution could then face class action liability for a TILA violation because of a good faith effort to comply with the new requirement of the Guidance.

The lack of clear requirements creates numerous problems. For example, it states: "Institutions should provide consumers with information at a time that will help consumers make product selection and payment decisions. For example, institutions should offer full and fair product descriptions when a consumer is shopping for a mortgage…". Yet TILA and RESPA both have defined sets of timing requirements for disclosures. Some disclosures are provided fairly early in the application process, while some may not be provided until loan closing. What additional disclosures are called for here, and when should they be provided? Who is to say when the disclosures should be given in order to be "at a time that will help consumers make product selection and payment decisions"? Who is to decide what is a "full and fair" product description? Language of this sort appears throughout the Guidance.

The interrelationship of the Guidance with regulatory requirements will create other problems. For example, the advertising language appears to call for information to be provided that operates as a "trigger" under TILA's Regulation Z. In the Guidance, an advertisement that emphasizes lower initial payments must provide clear and prominent information alerting the consumer, as relevant, that (a) the payments will increase, (b) a balloon payment may be due, and (c) the loan balance will not decrease and may increase. Yet, under Regulation Z, the inclusion of information about the amount and timing of payments is a trigger term for a host of more costly and onerous disclosures in the advertisement.

It should be noted that TILA's Regulation Z already requires that consumers be informed of the payment information critical to understanding these mortgage loan products.[3] This was intended to address the same kind of information as the Guidance. It calls for a complete description of the terms relevant to rate and payment changes for ARMs. Creditors must provide the disclosures at application or before any fee is paid, in order to make them more useful for comparison-shopping purposes. Unlike the Guidance, these disclosure requirements apply to virtually any creditor making such loans, not only those which are covered by the terms of this Guidance.

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[3] Regulation Z, section 226.19(b) states: "If the annual percentage rate may increase after consummation in a transaction secured by the consumer's principal dwelling with a term greater than one year, the following disclosures must be provided at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier:
(1) The booklet titled Consumer Handbook on Adjustable Rate Mortgages published by the Board and the Federal Home Loan Bank Board, or a suitable substitute.
(2) A loan-program disclosure for each variable-rate program in which the consumer expresses an interest. The following disclosures, as applicable, shall be provided:
(i) The fact that the interest rate, payment, or term of the loan can change.
(ii)The index or formula used in making adjustments, and a source of information about the index or formula.
(iii) An explanation of how the interest rate and payment will be determined, including an explanation of how the index is adjusted, such as by the addition of a margin.
(iv) A statement that the consumer should ask about the current margin value and current interest rate.
(v) The fact that the interest rate will be discounted, and a statement that the consumer should ask about the amount of the interest-rate discount.
(vi)The frequency of interest-rate and payment changes.
(vii) Any rules relating to changes in the index, interest rate, payment amount, and outstanding loan balance including, for example, an explanation of interest-rate or payment limitations, negative amortization, and interest-rate carryover.
(viii) At the option of the creditor, either of the following:
(A) A historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest-rate changes implemented according to the terms of the loan-program disclosure. The example shall reflect the most recent 15 years of index values. The example shall reflect all significant loan-program terms, such as negative amortization, interest-rate carryover, interest-rate discounts, and interest-rate and payment limitations, that would have been affected by the index movement during the period.
(B) The maximum interest rate and payment for a $10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan-program disclosure assuming the maximum periodic increases in rates and payments under the program; and the initial interest rate and payment for that loan and a statement that the periodic payment may increase or decrease substantially depending on changes in the rate.
(ix) An explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on either—
(A) the most recent payment shown in the historical example in paragraph 226.19(b)(2)(viii)(A) of this section; or
(B) the initial interest rate used to calculate the maximum interest rate and payment in paragraph 226.19(b)(2)(viii)(B) of this section.
(x) The fact that the loan program contains a demand feature.
(xi) The type of information that will be provided in notices of adjustments and the timing of such notices.
(xii) A statement that disclosure forms are available for the creditor's other variable-rate loan programs.
12 CFR 226.19(b) (*footnotes omitted*).

Monthly payments

According to the Guidance, monthly statements must provide information that enable consumers to make responsible payment choices, including information about the consequences of various payment options. It states, "For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that this payment would result in an increase to the consumer's outstanding loan balance due to negative amortization." Statements also could provide (a) the current loan balance; (b) the portion of the previous payment allocated to principal and interest; and if applicable (c) the amount the principal increased.

These monthly payment disclosures that appear to be mandated by the Guidance would be costly to implement, and raise numerous application questions.

For example, it is not clear if all this information is in fact required on statements supplied every month. Some products do not have regular monthly statements as features. Does this require that every nontraditional mortgage provide statements every month? If the statements are provided every month, are all the disclosures mandated on every statement, or only when triggered by a payment option?

The cost of programming and printing the information that seems to be called for by the Guidance would be excessive, and for many lenders might not be worth undertaking to offer these products. These costs (at least for programming, if not for printing) would be reduced somewhat if the information could be provided in a generic form, rather than identifying loan-specific information as it changes monthly.

We strongly suggest that the Agencies, rather than developing a parallel set of requirements to deal with the few mortgage products deemed to be nontraditional, requirements which will apply only to some financial institutions and which will create redundancies and confusion, employ the existing regulatory requirements to ensure that consumers are well-informed. Enhance the consumer brochure that is provided at application, or if it is determined to be necessary, reconsider the TILA disclosure requirements. Either would be a more effective approach to the issue.

Monitoring

The Guidance states that lending personnel "should be monitored through, for example, call monitoring or mystery shopping, to determine whether they are conveying appropriate information."

Lenders often use mystery shopping and call monitoring as part of comprehensive compliance programs; however, these can be extremely costly. If financial institutions feel constrained by the Guidance to employ mystery shopping and call monitoring for nontraditional mortgage products, this will be one more reason they will be discouraged from offering these products. If, as stated in the Guidance, these products offer flexibility, and are

beneficial for some borrowers, the unintended consequence would be to harm these borrowers by making fewer such products available in the marketplace.

Compliance standards and suitability

Most of the emphasis in the Guidance is on making information available to consumers so that they can make informed choices. We concur that this should be the object of consumer credit regulation. The Guidance offers a multiplicity of standards for determining the adequacy of disclosures. Some of them suggest that a disclosure is only adequate if the consumer understands and appreciates the information being provided. While this is an appealing concept, it is largely unworkable for the lender, who cannot know for certain whether they have met their compliance responsibility, and are subject to endless second guessing. The Guidance, for example, requires that the disclosures be provided in such a way as to enable consumers to "prudently consider the costs, terms, features and risks" of the products. Elsewhere, it states that the creditor must ensure that consumers "clearly understand" the loan terms and risks. Still elsewhere, the information should enable the consumer to "make informed decisions and to use the products responsibly." We cannot argue with the principles being expressed. We are concerned rather with the practical application of such standards.

We also caution the Agencies to avoid the suggestion that institutions are responsible for ensuring that consumers obtain the product that is most appropriate to their needs. This "suitability" standard, borrowed from the securities industry, is overly paternalistic in this context, and is largely unworkable. While well-intentioned, it would force all lenders to become financial planners, understanding far more about the needs of their customers than the lending process generally permits, or indeed than most consumers would wish.

One example of language that may impose a suitability requirement is in reference to the monthly statement. The Guidance states that the lender must provide information that enables consumers to make responsible payment choices. There is a big difference between the requirement to provide information, and the requirement to ensure that the consumer makes a responsible choice.

Loan Terms and Underwriting Standards

The Guidance states: "For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from the negative amortization provision."

This raises numerous questions and would appear to challenge many underwriting practices that are in use today, and that in some cases have been in use for a long time. In general, we

believe it is excessive to require that every loan be underwritten based on the worst-case assumption. Performance will vary depending on factors and conditions, and underwriting should be permitted to take these into consideration.

"Fully indexed rate" is defined in the Guidance to be the index rate prevailing at loan origination plus the margin that will apply after the expiration of an introductory interest rate. Presumably, the purpose, with which we concur, is to prevent underwriting based on "teaser rates." However, the language is broad enough to encompass a typical 3/1 or 5/1 ARM. We would urge you to clarify that this is not the intent. It is also not clear what effect discount points might be, where they lower the initial rate.

The underwriting of a payment option ARM is not clear from this description. Assuming a loan with three options, only one of which includes minimum payments that result in negative amortization, must the loan be amortized on a "worst case" scenario? That would call for the evaluation to assume minimum payments for the full permissible term, followed by amortization at the fully indexed rate of the balance plus accrued negative amortization. The impact of this would be to turn a competitive product that is attractive for many because of its flexibility and the ability to shift payment amounts as needed, into a product that would be beyond the reach of many consumers. We would encourage a clarification that this was not the intent.

Finally, it is not clear how points that buy down the rate would affect these products, since points paid to buy down an ARM generally apply only to the initial rate. If a traditional 3/1 or 5/1 ARM is not covered by this Guidance (which we assume to be the case), it would continue to be underwritten based on the initial rate, which can be reduced by the payment of points. The payment of points on payment-option ARMS, on the other hand, would not make the loan more affordable, and it would make these products even more unaffordable (and unavailable) to many consumers without the resources to pay the points and still qualify for the loan.

Portfolio and Risk Management

Stress testing

Loan level stress testing imposes is unnecessary and unprecedented. To impose it upon lenders undertaking nontraditional lending would significantly influence the ability of creditors to offer these products. Stress testing should be undertaking on a portfolio-wide basis, not loan by loan.

Third party originations and secondary market activities

The Guidance applies equally when a covered institution comes into contact with any loan covered by the Guidance. It states: "Institutions also should develop and use strong control systems to ensure that actual practices are consistent with their policies and procedures, for

loans that the institution originates internally, those that it originates through mortgage brokers and other third parties, and those that it purchases."

The Guidance states that institutions should have strong approval and control systems to ensure the quality of third party originations and compliance, with particular emphasis on marketing and disclosure. It also states, in the context of secondary market activities, that institutions involved in securitizations should consider the potential origination-related risks arising from nontraditional mortgage loans.

Since it is not always clear, on a loan-by-loan basis, what is a nontraditional mortgage, and it is generally not feasible for an institution to undertake a loan-by-loan determination of features in any case, this could have a significant impact on the market. Lenders would not be able to police every broker with whom they do business, and would be forced to stop purchasing these loans. The potential liability would put many institutions subject to this Guidance at a significant disadvantage or force them to eliminate their wholesale operations for these products—a result that could ultimately harm consumers by eliminating products that might be both desirable and suitable.

Brokers and correspondents are subject to the Truth in Lending Act and other consumer protection laws, and are subject to liability for violations. As independent companies, their legal responsibilities must be independently monitored and enforced by the appropriate agencies, and not imposed on the financial institutions with which they do business. Similarly, securitizers cannot ensure that all the loans in the pools they securitize comply with the Guidance. Neither are they in any position to monitor or control the marketing and disclosure practices of the financial institutions.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me.

Sincerely,

Steven I. Zeisel
Senior Counsel