Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

March 29, 2006

Office of the Comptroller of the Currency
Public Information Room
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Docket Number 05-21

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket No. OP-1246

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Attention: Comments

Office of Thrift Supervision
Regulation Comments
Chief Counsel's Office
1700 G Street, N.W.
Washington, DC 20552
Docket Number 2005-56

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on proposed guidance to lenders on "non-traditional" mortgages released for public comment on December 29, 2005.[1] MICA strongly endorses the proposed guidance, which we believe is a carefully-considered response to growing risks that will protect and stabilize the mortgage market without any undue or adverse impact on credit availability or cost to current or prospective home owners.

As noted, you have proposed these new prudential standards as guidance, not a formal rulemaking. This provides institutions with

[1] Interagency Guidance on Nontraditional Mortgage Products, *Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, National Credit Union Administration, December 29, 2005.*

considerable flexibility to ensure they adjust internal controls, capital and consumer protections as needed to meet borrower needs. However, guidance can create the impression that compliance is voluntary and that institutions will not be held accountable by examiners for substantive deviations or for unduly slow implementation that amounts simply to ignoring the guidance. The agencies in May, 2005 issued very strong and appropriate guidance on second liens,[2] but a range of press accounts have raised questions about the degree to which this guidance has in fact been reflected in industry practice.[3] Failure to ensure that guidances are in fact respected undermines the credibility of your agencies' statements and may force you in the future to act only through binding, detailed rules that may not be suitably flexible and forward-looking. We would urge the agencies, therefore, to add to the final guidance language detailing the nature of enforcement actions examiners may take and the timetable on which this will occur should institutions fail quickly to bring mortgage-lending practices into accord with the final standards.

The mortgage industry has taken recent and commendable steps to address high-risk mortgages. For example, the Mortgage Bankers Association has released a detailed paper which, in part, discussed non-traditional mortgages and their risks to borrowers.[4] The National Association of Realtors has similarly issued a consumer advisory.[5] However, your guidance is necessary because all of these statements are voluntary and many will not reach customers trying to choose the right product for them in the complex array of products presented to them. A recent Federal Reserve study has rightly demonstrated that many vulnerable borrowers of complex adjustable-rate mortgage products do not understand their terms, may pay higher rates with complex products and, thus, are more exposed to payment shock.[6] The industry outreach statements also do not address the prudential implications of non-traditional mortgages, which require the internal controls, regulatory capital, and reserves rightly referenced in the guidance. The agencies also correctly note that lenders cannot substitute an expectation that loans will be sold to the secondary market for these safeguards, and we would note that this is particularly true for first liens issued in conjunction with simultaneous second liens that boost the combined loan-to-value ratio of the mortgage above 80% for the reasons discussed in detail below.

[2] *Credit Risk Management Guidance for Home Equity Lending, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, May 16, 2005.*

[3] *More Pressure Seen on Loan Standards ..., Jody Shenn, American Banker, November 15, 2005.*

[4] *Housing and Mortgage Markets: An Analysis, MBA Research Monograph Series No. 1, August 23, 2005, Mortgage Bankers Association.*

[5] *Banker's Group Issues a Caution on Home Loans, www.realtors.org, August 24, 2005.*

[6] *Brian Bucks and Karen Pence, FRB Finance and Economics Discussion Series: Do Homeowners Know Their House Value and Mortgage Terms?, January, 2006.*

MICA would like to emphasize the following points discussed in depth in this comment:

- We strongly commend the regulatory agencies for this guidance and urge its rapid adoption, together with clear indications to the industry and examiners that its provisions must be implemented or material enforcement actions will result.

- Data on the rapid increase of non-traditional mortgages show clearly the urgent need for this guidance. These data make clear also that second liens issued at the same time to the same borrower of a mortgage first lien (simultaneous seconds) are not only a key indicator of the "risk layering" referenced in the guidance, but also a serious source of credit and liquidity risk in and of themselves.

- The agencies rightly note that credit scores alone are not a reliable indicator of credit risk. Initial loan-to-value (LTV) ratios should be expressly included as a key risk factor. Further, they should be computed for supervisory and capital purposes keeping in mind the complexities of non-traditional mortgages, rather than the initial terms of such loans. For example, loan-to-value ratios in negative-amortization mortgages should be calculated at origination based on the degree to which negative amortization can occur because the mortgage will become a potentially very high-LTV one when its caps are reached. Institutions that fail to take advance prudential and capital steps to insulate themselves from the risks of such high-LTV mortgages could face serious problems, especially under stress scenarios.

- The guidance should make more explicit the link between credit risk and the use of robust forms of credit risk mitigation (CRM) such as mortgage insurance. The agencies rightly propose to mandate more rigorous credit risk grading standards which would be tied to additional reserves and/or capital. However, CRM is mentioned explicitly only with regard to setting the allowances for loan and lease losses (ALLL). Consistent with the appropriate incentives now pending in the agencies risk-based capital rulemakings[7] and with the second-lien guidance, all measures of credit risk should take CRM into account.

Finally, MICA appreciates the new consumer protections proposed in the guidance. The agencies rightly note that non-traditional mortgages are often very complex and many have of late been offered to unsophisticated borrowers. Because many non-traditional mortgages are often also very high-LTV ones, borrowers are not only unaware of potential costs associated with these mortgages, but also ill-prepared for any personal or market events that adversely affect their ability to make timely payments. We encourage the agencies to retain in the final guidance the new disclosures and lender requirements.

I. Key Research Findings

In the attached appendix A, we present recent mortgage-market data from a variety of third-party sources that demonstrate the urgent need for quick action on non-traditional mortgage prudential guidance. In particular, we would like to bring to your attention information from SMR Research, an objective and independent mortgage market research source on "simultaneous seconds", as they are referenced in your guidance. These loans are also often called "piggyback" mortgages due to the way in which a second lien is structured atop a first one to evade secondary-market LTV requirements or otherwise to structure a loan around traditional prudential underwriting standards.

Simultaneous seconds are among the most troubling of the products in the emerging non-traditional mortgage product spectrum. In these mortgages, borrowers take out both a first and second lien at the point of home purchase or refinancing, with the combined loan-to-value (CLTV) ratios increasingly leading to loans with little, or no, borrower equity contribution. As *Dow Jones* has recently observed, "they may be called 'piggyback' loans, but some analysts worry they could behave more like the big bad wolf - huffing, puffing, and blowing borrowers right out of their houses via defaults."[8]

The banking agencies' second-lien guidance addressed piggyback risk with regard to second liens, and your pending guidance

[7] *Risk-Based Capital Guidelines; Implementation of New* Basel *Capital Accord, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, August 4, 2003. Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, October 20, 2005.*

rightly addresses the degree to which these structures threaten the underlying first lien. Higher loan-to-value ratios of the total loan increase the risks associated with the first lien. Further, lenders and investors holding first liens may not have ready access to data on the second lien, especially if it is a line of credit drawn down after origination. Thus, they have little information on the CLTV on which to base appropriate risk-management, reserve and capital decisions.

Initial LTV remains a major component of credit risk, and representations that credit scores or other underwriting criteria should be the principal determinants of credit risk and, thus, appropriate reserves, capital and risk management/mitigation are misguided. The importance of initial LTV in assessing credit risk continues to be recognized by academics, lenders, mortgage investors, rating agencies and regulators.[9].

MICA believes that simultaneous seconds with CLTVs greater than 80% possess risks that are inconsistent with prudent underwriting criteria. To back up this belief, MICA analyzed loan performance histories of 456,114 second-lien loans sold into the secondary markets in asset-backed securities. Loan level performance data and characteristics were obtained from data assembled by Loan Performance Inc. (see attached appendix B)

Controlling for FICO score, original term to maturity, and age of the loan, MICA found that second-lien loan performance varied significantly based on combined loan to value. Second lien loans with CLTVs between 81% and 90% performed 27% worse than second liens with CLTVs of 80% or less. As CLTVs went higher, the relative performance worsened exponentially so those with CLTVs over 95% performed over 200% worse.

Using MICA's net salvage distribution data as a means of estimating loss given defaults (LGDs) between first and second liens with various CLTVs, we found that LGD does vary significantly with CLTV. Indeed second liens with CLTVs of 90 in the data set suffered LGDs that were more than twice that of second liens with CLTV of

8Piggyback Loans May Increase Mortgage Default Risk, Danielle Reed, Dow Jones Newswires, August 26, 2005

[9] See for example, Calem and Follain, Federal Reserve Board Staff Paper, The Asset Correlation Parameter in Basel II for Mortgages on Single Family Residences, p.23 for results of joint FRB and MICA study of default and loss rates on 90% and 95% LTV mortgages; Also see Fannie Mae 2003 10-K, March 15, 2004, p.98: "The likelihood of default and the gross severity of a loss in the event of default are typically lower as the LTV decreases, all other factors held equal." Also, see Deloitte Touche Actuarial Review of FHA MMI Fund as of FY 2003, page IV-4. Table IV-3 shows cumulative claim rate for "high LTV" FHA-insured loans—loans with initial LTVs greater than 96% -- originated in 2000 are projected to be 7.94% versus 5.34% for loans with "medium" LTVs and 2.55% for those with "low" initial LTVs..

80%, while second liens with CLTVs of 100% or greater suffered LGDs that were more than three times that of 80% CLTV second lien loans. MICA has also observed that second lien probability of default associated with a given CLTV is substantially higher than for a single loan first lien with an LTV equivalent to that CLTV. This holds true over a range of high ratios for CLTVs (over 80 CLTVs).

The credit rating agencies recognize the greater risk associated with piggyback loans, noting that the absence of accumulated equity also restricts borrower ability to maintain or improve their home. They have observed that, when a default occurs, the loss severity will be higher.[10] Reaffirming the agencies' approach to risk layer, analysts recognize that the layering of risk inherent in a piggyback loan with no borrower initial equity, high debt to income ratios and the possibility of an interest-only or other exotic first lien increases the overall risk to the holder of both parts of the piggyback mortgage.

II. LTV Recognition for Prudential Purposes

Since initial LTV is a key driver of credit risk, MICA believes the proposed guidance would be enhanced if more specific references to this factor are included in the final banking-agency standards. This should be done as discussed in detail below.

A. High-LTV Simultaneous Seconds are Non-Traditional Mortgages

The proposed guidance correctly provides a detailed discussions of simultaneous seconds, but it is not clear if the mandated additional risk management steps are required if a simultaneous second is not associated with an interest-only or payment-option mortgage (each of which is expressly defined as non-traditional). High-LTV seconds have risks in and of themselves even if not associated with these high-risk structures and thus require the prudential management, reserves and capital mandated in the guidance.

These risks include undue reliance on secondary markets for the first and/or second liens in simultaneous-second loan structures. The guidance rightly notes the liquidity risk that can occur when secondary-market sales are part of a bank's mortgage strategy, and MICA strongly supports the recommended prudential standards. However, this risk is particularly serious in connection with simultaneous seconds. The Fannie Mae and Freddie Mac charters expressly require that qualified

[10] *"Glenn Costello, a managing director at Fitch Ratings, explained that since second lien borrowers have close to 100% LTV, the lack of accumulated equity therefore restricts their ability to maintain or improve their homes. Additionally, the loss severity is higher for second lien loans." As reported in Asset Securitization Report, August 8, 2005.*

insurance be in place when the government-sponsored enterprises (GSEs) purchase mortgages with LTVs above 80% (12 U.S.C. § 1717(b)(5)(C) and 12 U.S.C. § 1454(a)(4)(C) respectively). Simultaneous loans are often structured solely to evade this requirement, intended by Congress to ensure that GSEs do not take undue risk. It has been difficult to win enforcement of these legal requirements in the current GSE regulatory regime, but MICA believes that effective regulation with a clear focus on prudential regulation and charter compliance will quickly bring the GSEs into compliance with this statutory mandate. Institutions with large positions in first liens associated with simultaneous seconds thus take on significant liquidity risk due to the potential quick shut-down of a major secondary-market outlet.

B. LTVs Should Be Correctly Calculated

MICA strongly concurs with the guidance's emphasis on payment-option mortgages, which can pose serious risks when – as is often the case – borrowers defer payments. This leads to negative amortization and, for adjustable-rate mortgages, the risk of serious payment shock when payment triggers are reached under higher interest rates. The numerous additional prudential, capital and reserve requirements associated with these loans are fully appropriate and should be reflected in the final guidance.

However, the guidance does not make clear how payment-option mortgage LTVs should be calculated. As a result, high-risk loans may not be included in current capital restrictions applicable to high-LTV mortgages.[11] This could permit lenders to develop large concentrations of high-risk loans which, even if backed by additional capital or reserves, could pose significant credit, liquidity, operational and interest-rate risk. To prevent this, MICA recommends that lenders be required to calculate LTV for payment-option mortgages based on the actual LTV resulting from customer use of the maximum number of minimum payments once the loan interest rate has been fully adjusted to its long-term rate. If the interest rate in such loans fluctuates up and down over time, then the LTV scenario should be based not only on the minimum payments noted above, but also on the maximum rate permitted under the terms of the loan.

[11] *Interagency Guidance on High LTV Residential Real Estate Lending, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, October 8, 1999.*

III. Credit Risk Mitigation Should Be Clearly Recognized

MICA strongly supports the proposed reiteration of the need for effective credit risk management for non-traditional mortgages. The banking agencies rightly note that none of these innovative structures has been tested under adverse housing-price or macroeconomic scenarios, warranting considerable caution as lenders have rapidly increased their portfolios of high-risk product. Effective credit risk management of course includes reliance on and recognition of proven forms of credit risk mitigation (CRM), including mortgage insurance provided by highly-rated, well-capitalized, regulated mortgage insurers. We would note that the agencies' recent guidance on second liens[12] provides incentives for CRM reliance and MICA suggests that the first-lien guidance be clarified to ensure that incentives are evident for effective credit-risk mitigation.

The proposed guidance expressly recognizes that banks and savings associations that need under its terms to increase their allowances for loan and lease losses (ALL) may reduce required reserves if mortgage insurance (MI) is in place. MICA suggests that the guidance be clarified also to make clear that the additional capital requirements also mandated by the guidance may be offset if MI is in place. This is consistent with the overall intention of the Basel risk-based capital rewrite to align regulatory and economic capital, as well as presenting an appropriate capital incentive for reliance on proven CRM.[13]

The proposed guidance rightly addresses potential concentration risk in non-traditional mortgages (although it could, as noted, be improved for negative-amortization mortgages by the enhanced LTV calculation recommended above). However, it does not explicitly provide for reduced concentration risk by reliance on proven forms of CRM, as is done in the second-lien guidance noted above. MICA recommends that the agencies clarify the guidance to ensure that concentration risk is addressed as needed through CRM. As noted, secondary-market sales of high-risk loans may not be possible or could prove costly, and use of CRM as concentrations are gradually

[12] Credit Risk Management Guidance for Home Equity Lending, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, May 16, 2005.
[13] Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, August 4, 2003. Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, October 20, 2005.

addressed reduces safety-and-soundness problems while preventing any market disruption.

Finally, we would suggest that the guidance remind banks and savings associations that the risk-grading system stipulated by the guidance can and should raise or lower credit grades based on CRM reliance. This is not only an additional way to ensure appropriate credit risk management, but also consistent with recent proposed standards on credit risk issued by the Basel Committee on Banking Supervision.[14]

Conclusion

MICA would like to thank the banking agencies for the thoughtful approach to prudential management and consumer protection included in the proposed guidance on non-traditional mortgages. With the modifications recommended above, we think it will be a significant enhancement to the nation's housing-finance system. The new standards – flexible enough to ensure no borrower goes unserved – are urgently needed to address growing risks in an asset category that has increased to alarming proportions in an unprecedented period of time.

Please do not hesitate to contact me if you would like additional information or have any questions regarding these comments.

Sincerely,

Suzanne C. Hutchinson

[14] *Sound Credit Risk Assessment and Valuation for Loans, Basel Committee on Banking Supervision, November 28, 2005.*

APPENDIX A

Regulatory Analyses

The agencies are, of course, familiar with the results of the OCC's recent underwriting survey[15] and the Federal Reserve's recent senior loan officer opinion survey on bank lending practices.[16] However, before proceeding to assess recent research from other sources, we would like to note several key facts from these regulatory updates. The OCC and FRB work reinforces, we think, the urgent need for quick action on high-risk non-traditional mortgages.

The OCC survey found the first drop in overall credit underwriting standards in the eleven years of its work. With specific regard to factors commonly part of non-traditional mortgages, it found that "[h]igher credit limits and loan-to-value ratios, lower credit scores, lower minimum payments … less documentation and verification, and lengthening amortizations - have introduced more risk to retail portfolios." It also noted that "[b]ecause reduced payment requirements and extended amortization arrangements can mask credit risk, bankers need to develop broader, more discerning, and more forward looking approaches to measuring and monitoring risk in retail portfolios."

Still more troubling, the July FRB senior loan opinion survey finds that most banks reported their mortgage underwriting standards remained unchanged.[17] This is, however, in sharp contrast to information revealed from answers to special questions raised concerning "non-traditional" mortgages. Here, the FRB reports that:

> "More than one-half of respondent banks indicated that the share of nontraditional residential mortgage originations over the past twelve months was higher than it had been over the previous twelve-month period. Twelve percent of respondents noted that this share was substantially higher."[18]

It is, of course, hard to maintain strict underwriting standards and also substantially increase non-traditional mortgage originations. Many of these products pose significant new credit, interest-rate and other risks we shall discuss in detail below. To the degree that lenders are increasing non-traditional mortgage positions without tightening underwriting requirements, these risks become exacerbated. Failure to

[15] *2005 Survey of Credit Underwriting Practices, Office of the Comptroller of the Currency, June, 2005.*

[16] *Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, August 15, 2005.*

[17] *Ibid, p.3*

[18] *Ibid, p.4*

recognize non-traditional mortgage risk through changes such as the proposed more careful credit-quality analysis and use of increased credit risk mitigation means that initial steps to address heightened risk are not being taken. Combined with the fact that bank reserves are, according to the FDIC, at a 19-year low,[19] it would appear that lenders with large non-traditional mortgage positions are singularly ill-prepared for the risk clearly presented by high-risk, non-traditional mortgages. Of course, Katrina-related mortgage losses may strain some lender reserves, worsening the problems posed by high-risk mortgage products.

Recent Market Analysis

1. *Simultaneous Seconds*

MICA believes that new data from SMR research sheds important light on home purchase market trends in general and piggyback-mortgage trends in particular. Preliminary analysis of the 2004 HMDA data confirms the prevalence of purchase-related second mortgages first noted by SMR.[20] The most recent SMR survey was completed for all of 2004 and most of the first half of 2005 (January through May).[21] The updated analysis sampled over 2.3 million home purchase transactions in 2004 and over 800,000 transactions in the first half of 2005. It presents data on a county basis for 334 counties. Most importantly, SMR finds that:

- In the first half of 2005, 66% of all homes sold with financing – whether or not they were piggyback financings – had CLTV ratios above 80%. During this period, 38% of all sampled purchase transactions had CLTV ratios above 95% – up sharply from the 34% for all of 2004. The percentage of piggyback purchase transactions with CLTVs above 95% in 2005 was 60%, up from the 52% in 2004.
- Piggybacks comprised 48% of all purchase mortgage money originated in the first half of 2005, up from 42% in 2004. On a loan count basis, piggybacks were involved in 39.5%

[19] *Aiding Profits at Some Banks: Setting Aside Less, Valerie Bauerlein, The Wall Street Journal, August 22, 2005.*

[20] *New Information Reported Under HMDA and Its Application in Fair Lending Enforcement, Robert B. Avery et. al., Article released September 13, 2005 for the Summer 2005 issue of the Federal Reserve Bulletin. Article notes that "a significant minority of reported loans involve junior liens, particularly for home purchases. Among the loans to purchase owner-occupied homes, 13 percent involved junior (subordinate) liens."p.353. Data reported by HMDA probably understates actual piggyback market share given the voluntary and restricted nature of new second lien reporting by HMDA loan originators.*

[21] *The Home Purchase Market of 2005, August, 2005, available from SMR Research Corporation, www.smrresearch.com; See also Piggyback Mortgage Lending, SMR Research Corporation, November, 2004.*

of first-half 2005 transactions versus 33% of 2004 transactions.

- While California still leads in the percentage of piggyback loans, county-by-county analysis shows that there are other areas where piggybacks are now a huge share of total home purchase deals. Out of 334 counties analyzed, there were 70 counties – 21% – where piggybacks represented more than 50% of all home purchase dollars loaned in 2005. Counties where piggybacks are a significant factor now include many of the largest U.S. counties in population and mortgage market size in California, Washington, Colorado, Virginia, Arizona, Nevada, Oregon, Illinois, Georgia, Massachusetts, North Carolina, Utah, Florida, Texas and Missouri.

Indicative of the pace at which the markets are changing, new mortgage products exacerbate the risk associated with piggyback loans. For example, one lender has just brought out a mortgage that combines an 80% first lien and a 23% second to combine to a 103% initial loan-to-value ratio. Minimum credit score on this product is a 620.[22] As one analyst has noted, "with no equity in these homes to start and no principal contribution during the early years of what can be a very long mortgage obligation, [lenders originating these loans] are accepting the risk that home prices will continue to rise or that their mortgagors/customers will continue to perform in the event prices stagnate or fall."[23]

2. *Negative-Amortization Loans*

Suggestions that lenders have not revised their underwriting criteria as noted above are particularly troubling when reviewed in light of recent data on negative-amortization (neg-am) mortgages, often also called option adjustable-rate mortgages (option ARMs). Recent data from S&P indicate that only 16% of option ARM borrowers provide full documentation and that about 75% of these borrowers now skip mortgage principal-and-interest payments in any given month.[24] *Bear Stearns* estimates the percentage of skipped payment borrows at 65%, but both estimates are significantly higher than the 20% comparable figure estimated by *Bear Stearns* in the spring of 2004. Bear Stearns has also noted that in recent months more than half of neg-am borrowers have made negatively amortizing payments at least two months in a row.[25] Failure by underwriting standards, reserves and

[22] *Option One Introduces 103 and 80/23Purchase Loans, www.oomc.com, August 4, 2005*

[23] *And Now For Some Irony, Peter DiMartino, RBS Greenwich Capital Daily, August 18, 2005*

[24] *S&P Option Arm Criteria, Brian D. Grow, presentation at Bear Stearns Mortgage Credit Roundtable, August 15, 2005, slide 14.*

[25] *Is Choice or Necessity Driving Option Arm Use?, Jody Shenn, American Banker, August 23, 2005.*

capital to reflect so sharp an increase in risk profile from neg-am loans may well have very serious consequences as interest rates rise and/or home-price appreciation cools. Indeed, S&P has also noted that possible payment shock awaiting neg-am borrowers is a main concern for the ratings agency.[26]

3. Credit Risk

One of the usual arguments against growing risk in non-traditional mortgage products is that borrowers understand these risks and are well positioned to absorb them. This may have been the case when non-traditional mortgages were limited to wealthy purchasers as a tool for cash management, however, it is no longer the case as these mortgages are being offered to first-time homebuyers and unsophisticated borrowers. Credit analysts are increasingly wary of this trend, with one recently noting, "the trend has been to create a consumer class armed with 700-plus FICOs that are increasingly being offered a range of innovative (and untested) lending products,"[27] Moreover, as S&P has noted, option ARMs are now offered to a new segment of borrowers – those with lower FICO scores and less documentation – to make higher priced homes more affordable by allowing borrowers to qualify for a larger loan amount.

Credit risk is further exacerbated by the very high loan-to-value ratios associated with non-traditional mortgage products. The borrower's equity in the house has long been proven to be the key determinant in mortgage credit risk. With an equity position, borrowers can withstand personal or macroeconomic shocks because, if forced to sell a home, the mortgage can be paid off in full. Without equity, borrowers may have to bring money they do not have to the closing table, worsening market problems and potentially creating a downward spiral in home prices that leads to still more mortgage default and, then, still more foreclosures.

Some have suggested that banks are not at risk because non-traditional mortgages are largely securitized. As the Federal Reserve data cited above make clear, this is not the case for many banks. However, even to the degree that loans are securitized, serious risks for individual institutions and the financial system as a whole remain. A recent blue-ribbon industry panel, the Counterparty Risk Management Policy Group, provides an in-depth and very-concerned view of the higher-risk segments of the mortgage securitization market. It notes:

[26] *Ibid.*

[27] *Report Scores FICO-Based Lending, Teasers, Isabelle Lindenmayer, American Banker, September 8, 2005.*

> "A significant rise in the interest rate environment or a deterioration in economic conditions could result in pressures on borrowers, lenders and the mortgage markets generally. There is some potential that such pressures could be aggravated by the significant increase in the use of non-traditional mortgages and by the difficulties in hedging interest rate risk on the part of market participants including the two very large housing related GSEs."[28]

The Policy Group also notes as a top concern the scarcity of qualified credit analysts and the degree to which credit risk assessment is done in conjunction with, not independent of, business decisions.[29]

Ratings agencies are also noting disturbing securitization trends: "People who are stretching to buy houses and have an option ARM as a first lien and the second is a HELOC would be of greatest concern," according to Sarbashis Ghosh, a senior director in the residential mortgage-backed securities group with Fitch Ratings. "We often see option ARM pools with 40% piggyback loans," he said.[30]

Finally, arguments against high credit risk in non-traditional products are often based on current mortgage delinquency and foreclosure rates. However, as noted above, the mortgage-risk picture is changing very quickly, with huge jumps in, for example, piggyback mortgages with very-high CLTVs.

4. *Concentration Risk*

A recent *Lehman Brothers* report, based on the OCC underwriting survey noted above, points to the concentration risk for some large banks in residential mortgage loan exposure.[31] While mortgages have a median of 20 percent of total loan exposure for all banks, several large banks have significantly higher exposures including Wells Fargo at 33% and Bank of America at 35%. It is, of course, unclear how much of these positions are in high-risk mortgages as noted, the Federal Reserve has found that some institutions indicate significant securitization activity. Yet, securitization by some lenders may indicate their own concern about the underlying risk associated with high-risk non-traditional mortgages. Indeed, one analyst of bank exposures has noted that "[t]here is a reason why the three largest

[28] *Toward Greater Financial Stability: A Private Sector Perspective, Counter Party Risk Management Group II, July 27, 2005*

[29] *Ibid. p.59*

[30] *Piggyback Loans May Increase Mortgage Default Risk, Danielle Reed, Dow Jones Newswires, August 26, 2005*

[31] *Lehman Brothers, Global Equity Research, United States, Bank Research Spotlight, August 8, 2005. See page 11.*

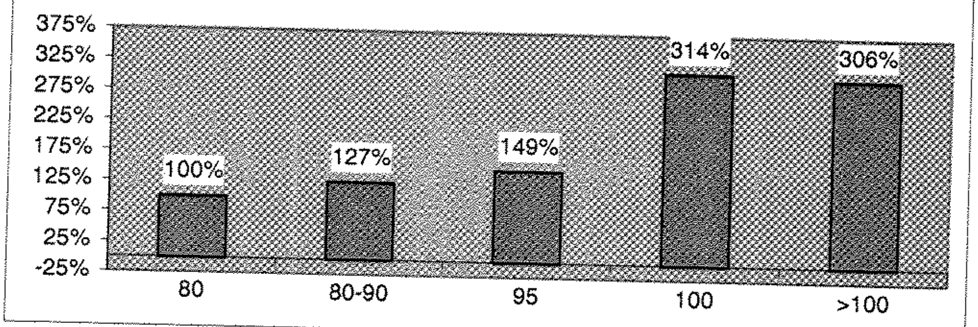
banks that make 40% of the nuclear mortgages [option ARMs] are selling 75% of the product despite its high yield. They smell the risk."[32] The question remains as to which lenders have not yet smelled the risk and which ones will still be carrying the exposure when it is too late.

[32] *Richard X. Bove, "This Powder Keg is Going to Blow", a report published by Punk, Ziegel & Co. as cited in the American Banker, August 18, 2005, Quotable, by Jody Shenn. The report goes on to note that once the prepayments on these mortgages begin "there will be no deep secondary market for the nuclear mortgages."[The author's term for these high risk loans.]*

APPENDIX B

Controlling for FICO score, original term to maturity, and age of the loan, MICA found that second-lien loan performance varied significantly based on combined loan to value. Second lien loans with CLTVs between 81% and 90% performed 26.7% worse than second liens with CLTVs of 80% or less. As CLTVs went higher the relative performance worsened exponentially.

Figure 3.
Second Lien Loan Performance By CLTV Relative To 80 CLTV Seconds



Using MICA's net salvage distribution data as a means of estimating loss given defaults (LGDs) between first and second liens with various CLTVs, we found that LGD does vary significantly with CLTV. Indeed second liens with CLTVs of 90 in the data set suffered LGDs that were more than twice that of second liens with CLTV of 80% while second liens with CLTVs over 100% or greater suffered LGDs that were more than three times that of 80% CLTV second lien loans. (See table below.)

Gross Loss Given Default Estimates For Second Lien Loans By CLTV

CLTV	**100**	**97**	**95**	**90**	**85**	**80**	**75**
First Lien Size	78.7%	78.7%	78.0%	75.2%	67.4%	61.7%	56.6%
Second Lien Size	20.7%	18.3%	16.4%	14.1%	16.4%	17.3%	16.8%
Second Lien LGD	95.2%	92.9%	89.8%	75.3%	46.7%	28.6%	7.7%

Notes: Average Second Lien Sizes By CLTV From ABS Study By MICA, LGD Estimates Derived Using MICA Net Salvage Distribution for 1990-2003. Assuming 7.5% Interest Rate and 18 Months Cost Of Carry.