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Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: 2005-56

RE: Docket No. 2005-56 – Proposed Interagency Guidance on Nontraditional Mortgage Products

Dear Sir or Madam:

First Federal Bank of California (FFB) appreciates the opportunity to comment on the Proposed Guidance – Interagency Guidance on Nontraditional Mortgage Products ("Guidance") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the "Agencies"). FFB is a well capitalized $10.4 billion federal savings bank with its headquarters located in Santa Monica, California, with 30 branch offices and six loan offices throughout California.

FFB acknowledges the need for Interagency Guidance on Nontraditional Mortgage Products. As a lender in the high cost market of California, FFB has been making negative amortizing option ARM loans for over twenty three years. During this period, which included various economic and real estate market down turns, FFB did not experience a single loss due to the fact that the loan was a negative amortizing option ARM loan. The negative amortizing option ARM loans were developed to help portfolio lenders mitigate interest rate risk without the need to enter into risky derivatives. Within the last few years there have been many entrants into the market making these types of loans available to a larger portion of the consumer market. In addition, stated income, high LTV, and longer amortization periods have become

common place. We believe the Guidance provides various useful recommendations for not only the origination of nontraditional mortgages, but in the monitoring and management reporting.

FFB further believes that the option ARM in and of itself is not a high risk loan, but as the Guidance suggests, when coupled with other layers of risk it can become a high risk loan. However, this is not unique to option ARM loans. Traditional mortgages would also be considered high risk when multiple risk layers are included. Lenders need to manage these risk layers through the application of other mitigating factors. When developing programs, lenders need to counter the higher risk aspects of a program by enriching other credit features. For instance, higher LTV programs should require higher credit scores, lower loan amounts, etc. than similar lower LTV programs.

Lenders with a history of underwriting the option ARM have established underwriting standards that compensate for these various risks. These lenders have been able to provide consumers an alternative to the traditional 30 year fixed rate mortgage to provide borrowers with flexibility in managing their finances without the institutions experiencing higher levels of default or loss. New entrants to the market who have limited experience with the product should receive additional regulatory scrutiny and monitoring.

FFB strongly encourages the Agencies to consider the negative impact the Guidance will have on its institutions, and consumer access to credit. Non-federally regulated mortgage lenders account for a large portion of the mortgage market. Without having to adhere to the restrictions of the Guidance these lenders are at a competitive advantage to those subject to the Guidance. Federally regulated institutions will have higher costs and more restrictive qualifying criteria, which will hamper production and raise the cost of credit. Many of the recommendations in the Guidance have been a standard part of FFB's practices for many years (e.g., underwriting all loans at the fully indexed note rate, regardless of any discounted pay rate). Additionally, since the Guidance was published in December 2005, FFB has taken further measures that are consistent with the intent of the Guidance. While FFB has altered some of its programs[1] in accordance with the Guidance, other lenders have not. The result has been a significant decrease in loan volume as borrowers are choosing other lenders with less restrictive programs. Adoption of the Guidance in its current form will have a similar impact on other federally regulated institutions as they conform to the Guidance. Without consistent enforcement across

[1] Greater restrictions have been implemented on stated income programs for the purpose of migrating a greater proportion of production into full documentation loans, and programs with elevated payment shock given the current interest rate environment have been eliminated. Furthermore, prior to issuance of the Guidance FFB raised its discounted payments to account for changes in the Federal Funds rate that have occurred since mid-2004.

all channels and similar restrictions on non-federally regulated lenders, we believe federally regulated institutions will lose significant market share.

FFB respectfully provides the following comments regarding specific items within the Guidance that we believe are overly restrictive, or which may need further explanation within the final Guidance.

Guidance and Recommended Practices versus Requirements – FFB urges the Agencies to clarify that the Guidance is not regulation, that it may not be appropriate for every institution in every circumstance, and that deviation from the general recommendations in the Guidance would not in itself subject an institution to criticism. Individual institutions originate loans of varying risks, and should have systems to manage those risks. Applying this Guidance as a rule of operation would not be appropriate for all institutions. Institutions originating higher risk loans may require more robust risk management tools than an institution originating lower risk credits. A one size fits all approach would not be prudent. For example, we do not believe that a concentration in Option ARM loans is inherently risky, particularly for an institution such as FFB that has met its QTL requirements with ARM loans for many years, with no risk to safety and soundness.

Consistency of Enforcement – Various items noted in the Guidance are vague, such as “strong risk management standards”, and “capital levels commensurate with the risk”. FFB urges the Agencies to be consistent in their enforcement of these guidelines so as to not create a disadvantage to those institutions whose supervisory agency takes a narrower approach to interpretation than another agency.

Availability of Affordable Housing – The use of nontraditional mortgage products provides a means by which individuals can participate in homeownership that would not otherwise be able to service a traditional mortgage. This is most notable in high cost markets, where affordable housing is scarce. We believe borrowers must exhibit an ability to service a fully amortizing loan, but the nontraditional mortgage provides flexibility for borrowers where their mortgage expense is exceptionally large. This flexibility allows the consumer to manage their finances in a way which best works for them.

“Nontraditional” Mortgage – Option ARM loans have been successfully provided by lenders for more than twenty years. Experienced lenders have adequate systems and controls in place, and there has been a sustained market for the product. The term “nontraditional” is a misnomer given the long history many lenders have had with option ARM loans. FFB suggests “Alternative” mortgage as more appropriate terminology.

Loan Terms and Standards

Lagging Index – Footnote 5 of the Guidance suggests that institutions which price loans tied to a lagging index in which the pricing "may be significantly different from the rate on a comparable 30-year fixed rate product" should use a "credible market rate" to qualify the borrower and determine repayment capacity. The Guidance suggests that lenders should assume a higher payment within the first 12 months of the loan (assuming a 12 month lagging index) and the underwriting should account for the expected increases. The Guidance should clarify this point and define "credible market rate" and provide a reference source so that lenders may utilize similar information when qualifying an applicant. Additionally, the Guidance should specify how lenders should address the lagging index in a declining interest rate environment.

Managed Spread Between Introductory Rate & Fully Indexed Rate – The Guidance suggests a method for managing the spread between the introductory rate and the fully indexed rate. The Guidance is vague in this respect, and as such, an institution may be subjected to subjective regulatory scrutiny and criticism. Consistency in interpretation and enforcement is necessary so as to not put institutions regulated by one agency at a competitive disadvantage to institutions regulated by another agency. To that end the Agencies should provide further clarification of their expectation for institutions' management of the rate spread.

Payment Shock – The Guidance refers to payment shock, which typically occurs when the reduced payment or interest only period ends, and the loan is then fully recast at the current balance over the remaining loan term. The change in payment may be significant when compared to the minimum payment; however, the Agencies also need to consider how this recast payment compares to the initial qualifying payment. When a lender underwrites to a fully indexed and amortizing payment, the payment change compared to the qualifying payment is substantially less when compared with a reduced payment. FFB acknowledges that a borrower may adjust their life style based on their available cash flow, and that a sudden change in payment would have a negative impact on cash flow and could affect a borrower's ability to service a loan. However, if an institution prudently underwrote the loan a borrower would typically have the income to support this change (assuming there were no material adverse changes in a borrower's financial position).

Risk Layering – We acknowledge that nontraditional mortgages combined with various risk layers may pose heightened risk. This is also true of traditional mortgages, that when combined with various risk layers would also have a higher risk profile. However, the fact that multiple risk layers exist does not necessarily mean a loan is high risk. Prudent underwriting considers mitigating factors that lessen credit risk, and these factors are taken into account when deciding to approve or deny

credit. The fact that mitigating factors are present should not be lost on the Agencies when analyzing risk layering.

Portfolio Risk Management Practices

Capital Levels – The Guidance provides a broad and vague requirement for higher capital levels commensurate with the risk characteristics of the institution's nontraditional mortgage loan portfolio. Without specific structure this places greater responsibility on examiners, and does not provide lenders with sufficient direction in managing their institutions on a daily basis. A requirement for maintaining higher capital should be addressed through the existing Risk Based Capital framework so as not to create unequal capital requirements amongst institutions.

Stress Testing – The Guidance indicates that stress testing, which assumes rapid deterioration in one or more factors, should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels. In proposing utilization of stress testing to establish underwriting standards, the Agencies should clarify their expectations. Although lenders need to consider negative market factors when originating and monitoring credits, it would be unreasonable to expect an institution to manage its origination process to insulate itself from a perfect storm of catastrophic events. To do so would significantly reduce the availability of credit, and leave federally regulated institutions at a severe competitive disadvantage.

Concentration Limit – Third Party Originators – FFB has successfully originated loans via third party originators for many years. We employ quality control methods on every transaction, and our delinquency ratio indicates that these controls have been effective. The Guidance contains additional restrictions, including proposed concentration limits related to this origination source that will add to the cost of origination without providing additional safety and soundness to the loan origination process. The use of third party originators also provides operating efficiencies to the institution, particular given the highly cyclical nature of the business. Utilizing a system of mortgage brokers allows an institution to spread their risks, including operational and geographic. Additionally, utilizing this system has allowed the Bank to originate loans in diverse ethnic populations which might prefer to work with loan originators in their own community. Accordingly, we oppose any limitation on the use of third party originators.

Consumer Protection Provisions

FFB strongly supports proposals to ensure adequate and fair disclosure to consumers regarding the loan programs that FFB offers. The Guidance suggests a number of ways in which an institution offering nontraditional loan programs can give an applicant a balanced picture of the benefits and obligations arising under these

programs. The Guidance should address, however, the fact that loans that are originated by third parties such as mortgage brokers likely involves disclosure and advertisement by those originators that the financial institution does not control, nor should be responsible for provided the lender itself provides sufficient disclosures. Furthermore, the Guidance provides recommended practices for promotional material. While FFB fully supports these recommended practices, we note that advertising requirements are governed by the Truth in Lending Act (TILA). If the Agencies' intent is for lenders to strictly adhere to these recommended practices, consumers would be better served through amendments to the TILA. Changes to the TILA would ensure uniformity in advertising amongst lenders and allow consumers to have a better understanding of the similarity or differences between lenders or programs through the use of common terminology and disclosures.

The following comments are in response the request for comment on specific topics.

1) 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?

Lenders should take into consideration a fully amortizing, fully indexed loan payment when underwriting a borrower's capacity to repay under its traditional debt ratio limitations. Loans should not be underwritten to the minimum payment. However, assumptions regarding a borrower's repayment practices should be considered under a comprehensive debt service qualification analysis. Consideration should be given to the borrower's ability to service a fully recast payment based on the loan program's recast projections.

FFB has historically underwritten, and continues to underwrite, to the fully indexed interest rate and amortization schedule. Although a loan program has a reduced minimum payment option, or interest only payment option, these payments are not considered in the underwriting of a loan. A secondary analysis assuming maximum negative amortization is also performed. We do not foresee significant changes will be necessary based on the proposed Guidance.

2) What specific circumstances would support the use of the reduced documentation feature commonly referred to as "stated 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 comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.

Stated income and reduced documentation loans should be appropriate for nontraditional mortgages under the same circumstances as traditional mortgages. The risks associated with stated income relate to the validity of borrower income, which is exclusive of the loan product. Considering that loans are underwritten assuming a fully indexed interest rate and full amortization, the same due diligence in analyzing an applicant's income should be performed regardless of mortgage type. The common perception in nontraditional mortgages, coupled with stated income, is that applicants are looking for a specific payment and the primary risk is an applicant exaggerating his or her income to qualify for a loan with that payment level. However, considering that an applicant must typically qualify for a fully indexed and amortizing payment, their qualifications would be similar to that necessary for a traditional mortgage. Since a lender should review the stated income in light of the other information obtained about the borrower (occupation, credit history, etc.), a case could be made that it would be easier for an underwriter to recognize the overstatement of income on a nontraditional mortgage since the distortion of income would have to be greater to qualify at the projected fully indexed payment versus a traditional amortizing payment loan.

Lenders should be able to treat a subprime borrower similarly on traditional and nontraditional mortgages. In granting subprime loans to borrowers, a lender should have sufficient due diligence processes and mitigating credit factors at least equivalent to those for traditional mortgages.

3) 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 product?

Nontraditional mortgages contain unique elements that differentiate them from traditional mortgages. Consideration of these complexities should be undertaken during the origination process. The Guidance should provide lenders with direction on how examiners would view utilizing future income in qualification standards. FFB does not believe that future income increases should be anticipated when determining an applicant's ability to qualify for the loan. However, if an institution chooses to utilize a more complex analysis, whereby it also analyzes the borrower's ability to absorb a recast of payments at a higher dollar amount based on a product's parameters and limitations (such as payment change limitations, and a maximum negative amortization limit), it should be able to estimate some level of future income gains. FFB would expect that under the Guidance, any employment gains should be limited to no higher than published inflation data. Further, if an institution chooses to utilize a complex analysis of future events, changes in interest rates could also be

considered. However, should the Guidance address this area, it should be specific in how to treat and forecast changes to interest rates. If a precedent is set for utilizing future interest rate increases, would it then also be appropriate for a lender to assume declining rates in a declining rate environment? If this is a matter addressed in the Guidance, then in order to ensure some degree of consistency, the Guidance must be clear in its discussion of future interest rate changes.

Again, thank you for the opportunity to comment on the proposed guidance and your consideration.

Best regards,

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