1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126

St. Michael's House
1 George Yard
London EC3V 9DH
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

March 24, 2006

Ms. Jennifer Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., NW
Washington, DC 20551
Attn.: Docket no. OP-1246

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

The Bond Market Association (the "Association")[1] is responding on behalf of its members to the draft "Interagency Guidance on Nontraditional Mortgage Products" (the "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 (collectively, the "Agencies"). As you will observe below, the Association has for the most part limited its comments to the safety and soundness issue that the Agencies raised in the Guidance.

The Association commends the Agencies for taking this opportunity to address the many important issues that arise in connection with nontraditional mortgage products from both a consumer protection and a safety and soundness perspective. The Association also applauds the Agencies' decision to address their concerns about nontraditional mortgage products by providing their examiners and the institutions under their supervision with meaningful but flexible guidelines for addressing the issues identified by the Agencies. The Association believes that this approach is far more appropriate than enacting rigid restrictions that would stifle the ability of the financial industry to develop standards and practices that better reflect the complexity of the issues

---

[1] The Association represents securities firms, banks and asset managers that underwrite, invest, trade sell debt securities and other financial products globally. More information about the Association, its members and activities may be obtained from the Association's website at http://www.bondmarkets.com. Among other roles, the Association's members act as issuers, underwriters and dealers of mortgage and asset-backed securities, including the securitization of subprime mortgage loans. The views expressed in this letter are based upon input received from a broad range of Association members active in these markets, including members of the MBS and Securitized Products Division.

that arise in connection with nontraditional mortgage loans. The Association welcomes an open dialogue with the Agencies and other interested parties about the benefits and risks of nontraditional mortgage products, and the best ways to manage the latter.

Nontraditional Mortgage Products and Layering Risk Factors

THE BOND MARKET ASSOCIATION

First, we would like to offer a few general comments regarding the Guidance. We commend the Agencies for recognizing in the Supplementary Information that "[n]ontradtional mortgage loans offer payment flexibility and are an effective and beneficial financial management tool for some borrowers." We request that any final issuance include an affirmative statement that nontraditional loan products are not per se impermissible and may be perfectly appropriate under certain circumstances.

With respect to risk layering, we agree that nontraditional products combined with certain risk-layering features (such as reduced documentation or simultaneous second-lien loans coupled with borrowers with lower credit characteristics) could pose increased risk that lenders need to consider. We believe it is important for the Agencies to include an affirmative statement that the identified risk factors are not individually or collectively per se impermissible and merely are potential cautionary "yellow flags" for further consideration of mitigating factors when such risks are layered in a particular transaction. Finally, if adding a particular loan attribute does increase risk, lenders should have flexibility in deciding how to establish mitigating factors to account for additional risk.

Role of Capital Markets

In additional to these clarifications, the Association believes that any discussion of the risks associated with nontraditional mortgage products must take into account how deeply integrated the United States mortgage industry is with global capital markets. Selling and securitizing loans is one of the most important ways that financial institutions manage their risk exposure. In many parts of the discussion, however, the Guidance ignores the secondary mortgage market altogether. In the few places where the Guidance does discuss the secondary market, the Guidance takes a negative view of the idea that the secondary market is an appropriate risk management tool. The Association fully appreciates the Agencies' apparent concern that some financial institutions under their supervision might regard the secondary market as a panacea for every risk. But we respectfully submit that the Agencies are too dismissive of the extent to which access to capital markets contributes to the safety and soundness of the financial industry, and we encourage the Agencies to distinguish in the final Guidance between financial institutions that originate nontraditional mortgage products to hold in inventory for their own account and those that originate such loans with the intention to sell them into the secondary market.

The secondary mortgage market gets little more than a vague and passing mention throughout the introductory discussion and the entire discussion on "Loan Terms and Underwriting Standards." It is not until halfway through the discussion on "Portfolio and Risk Management" that the Guidance discusses the secondary market—and then only to provide institutions with the ominous (and we believe incorrect) warning that selling a loan on the secondary mortgage market actually provides a financial institution with

negligible protections from the credit risk associated with that loan. The Guidance reasons that, in order to protect its "reputation" in the secondary market, "an institution may determine that it is necessary to repurchase defaulted mortgages," even in the absence of a contractual obligation to do so. This, the Guidance says, is an "implicit recourse," which carries implications for an institution's risk-based capital requirements. In effect, the Guidance seems to say that for purposes of risk-based capital requirements, institutions (and examiners) should assume that even after the credit risk on a loan has legally moved on, a significant portion of the risk remains with the institution. The Guidance does not say exactly how much of this risk lingers with the institution, but the tenor of the discussion could lead an examiner to conclude that a substantial portion of the risk stays with the institution after the loan is sold.

This implied recourse analysis depends on the factual assertion that an institution may feel compelled to repurchase defaulted mortgages simply to protect its reputation in the market. The Agencies do not point to any evidence of how frequently reputational concerns drive financial institutions to repurchase defaulted mortgages in the absence of any legal obligation to do so. Indeed, we believe the Agencies would be unable to uncover any such evidence, because we believe this assertion is simply incorrect. While there will be isolated exceptions to any absolute statement, we do not accept the assertion that financial institutions repurchase mortgage loans in the absence of any legal obligation to do so simply because of concern over reputation risk. Such gratuitous acts simply do not occur to any meaningful degree in the secondary market. Rather, the custom in the industry is for sellers to repurchase loans only if the loans breach in any material respect a loan-level representation and warranty. The Agencies, we understand, routinely do not take the position that such repurchases constitute recourse. The only credit risk of loss that sellers often retain after selling a loan into the secondary markets is the risk to repurchase a loan in respect of an early payment default, which usually is narrowly defined. The Association does not believe that this "implied recourse" argument is accurate as a matter of fact.

Moreover, if the implied recourse argument were carried to its logical conclusion, it would have profound implications for financial institutions. While the Guidance is directed only to nontraditional mortgage products, there is no principled way to confine this "implied recourse" analysis to such products, or even to confine this analysis to products that carry a higher level of credit risk. According to the Guidance, an "implied recourse" obligation might arise when the credit losses on a loan pool "exceed expected losses." The key here is the phrase "expected losses," which we assume refers to the losses that the market anticipated. If the underperformance of a loan pool relative to market expectations is what creates an implied recourse obligation, then the risk of implied recourse could be present with any pool of mortgage loans. Market expectations about the performance of a pool of loans take into account the underlying credit risk of the pool of loans. A pool of high quality mortgage loans is not presumptively more likely to meet market expectations than a pool of risky loans, because the market will have higher expectations for the former pool than the latter. If one were to carry the Guidance's implied recourse argument to its logical extension, one would expect financial institutions to feel the need to repurchase any previously sold mortgage loan that subsequently defaults in order to avoid reputation risk. This would mean that the

risk-capital implications of "implied recourse" that the Guidance identifies would apply equally to any type of loan, regardless of risk.

Monitoring Activities of Sellers

THE BOND MARKET ASSOCIATION

We also recommend that the Agencies amend the discussion in the Guidance regarding "Third-Party Originations," which in the Guidance includes loans received from both brokers and correspondents. We recognize the need for monitoring of third-party origination channels and generally support the existing analysis of this issue cited in the Guidance. We are very concerned, however, that the Guidance suggests that loan purchasers of correspondent loans could be considered legally responsible for the practices, such as marketing and disclosure practices, of correspondents that act independently and close loans in their own name.

We believe that the Guidance should give no direct or indirect support for the theory of assignee liability where loan purchasers would be held legally for the acts, errors, or omissions of the creditors from which they purchase closed and independently funded loans. This concept is inconsistent with both the common law of contracts and the well recognized "holder in due course" doctrine. While there are limited exceptions to this rule under the explicit provisions of certain federal and state statutes, such as the high-cost loan provisions of the federal Truth in Lending Act and certain state anti-predatory lending laws, as a general rule, loan purchasers are not responsible for the activities of their loan correspondents. In addition, holding loan purchasers responsible for the actions of correspondents, as the Guidance suggests, could dramatically alter current correspondent lending practices and eradicate many of the cost efficiencies associated with these arrangements. Finally, imposing an undue level of responsibility on loan purchasers for correspondent acts could chill the market and ultimately drive up costs for consumers, defeating the many benefits of nontraditional mortgage products.

Suggested Modifications to the Guidance

As noted above, we request that the Agencies include affirmative statements that (1) nontraditional loan products are not per se impermissible and may be perfectly appropriate under certain circumstances, and (2) the presence of risk factors identified in the Guidance merely requires a financial institution to consider whether any risk mitigants are necessary, and that while the uncautious layering of risk, might require greater scrutiny to ensure prudent risk management, the risk factors identified in the Guidance are not individually or collectively per se impermissible.

The Association also asks the Agencies to reevaluate the role that the secondary market can play in addressing the issues raised in the Guidance. We ask that the Agencies include in the introductory discussion a statement recognizing the secondary market's role. For example, the Agencies might consider adding the following paragraph after the third bullet point in the introductory discussion:

> The precise steps that an institution should take to manage these risks will depend on a number of different factors. For example, an institution that regularly sells the nontraditional mortgage

loans it originates into the secondary market without recourse will necessarily have a different risk management strategy than an institution that maintains nontraditional mortgage loans in its portfolio. The institution that relies on the secondary market will place more emphasis on originating loans to conform to investor standards pursuant to loan purchase agreements. The risk management strategy for an institution that maintains most of the loans that it originates in its own portfolio would likely focus more on how to monitor loan performance. Each institution must assess how to best implement the principles and guidelines in this Guidance in light of the institution's unique situation and business model.

THE BOND MARKET ASSOCIATION

Additionally, in the "Loan Terms and Underwriting Standards" discussion, we recommend that the Agencies expressly recognize that an institution that plans to sell loans in the secondary market may consider investor underwriting guidelines. As the Agencies recognize, a financial institution cannot completely abdicate responsibility for ensuring that its underwriting practices reflect prudent lending standards. However, the Association believes that it is a prudent lending practice for an originator to adapt its underwriting standards and practices to investor expectations if the originator intends to sell the loan soon after origination. We ask that the Guidance expressly recognize that it is appropriate for an institution's underwriting standards and loan terms to reflect the standards and guidelines set by its investors, even if those standards might in some cases be different from what the institution would set itself were it planning to retain the loan in its portfolio.

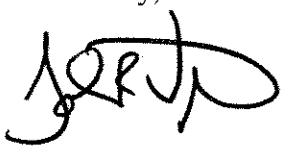
We also ask that the Agencies temper the "implied recourse" discussion under "Portfolio and Risk Management Practices." The Association does not believe that implied recourse is as significant a liability for financial institutions as the Guidance seems to imply. We ask the Agencies to revise this discussion in a way that more clearly acknowledges that selling loans on the secondary market without recourse is an effective way to manage risk. In acknowledging this, the Agencies can still warn institutions to be cognizant of the fact that they might still have repurchase obligations, and that legal liability for violations of law might not pass with ownership of the loan. However, the Association asks that this be presented in a way that does not overstate the risks or downplay the effectiveness of secondary market sales as a way to mitigate credit risk exposure.

Finally, with respect to the discussion on third party originations, we request that the Agencies make it clear that the Guidance does not make loan purchasers of correspondent loans legally responsible for the practices, such as marketing and disclosure practices, of correspondents that act independently and close loans in their own name.

The Association appreciates this opportunity to provide its views to the Agencies in connection with the important topics addressed in the Guidance. If it would be helpful to the Agencies, we would be happy to make Association staff and member firm personnel available to meet and discuss any of the points raised in this letter. Please

address any questions or requests for additional information to Michael Williams at 202-434-8400.

Sincerely,



John R. Vogt
Executive Vice President

cc: Gregory Nagel, Office of the Comptroller of the Currency
Michael S. Bylsma, Office of the Comptroller of the Currency
Stephen Van Meter, Office of the Comptroller of the Currency
James Leitner, Federal Deposit Insurance Corporation
April Breslaw, Federal Deposit Insurance Corporation
Ruth R. Amberg, Federal Deposit Insurance Corporation
Richard Foley, Federal Deposit Insurance Corporation
William Magrini, Office of Thrift Supervision
Maurice McClung, Office of Thrift Supervision
Richard Bennett, Office of Thrift Supervision
Cory Phariss, National Credit Union Administration