Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D. C. 20052

Attention: No. 2005-56, regs.comments@ots.treas.gov

Dear Sirs:

Home Savings of America ("Home Savings") appreciates this opportunity to comment on the proposed Interagency Guidance on Nontraditional Mortgage Products ("Regulatory Guidance" or "Guidance") as that proposed Guidance relates to negatively amortizing optional payment monthly adjustable rate home mortgages ("neg am ARM" or "option ARM"). Home Savings' comment will be divided into six sections: (1) history of the option ARM, (2) financial analysis of the mechanics of the option ARM, (3) Home Savings' answers to the specific questions the Guidance propounded, (4) Home Savings' views on the underwriting guidance, (5) our views on the portfolio management guidance, and finally, (6) our views on the consumer disclosure guidance.

Turning to the first topic, the background of the option ARM, there is little historical review of the product in the Guidance. And yet option ARMs have a long history that seems relevant both to understanding the product and to evaluating this Guidance.

Twenty-five years ago, the predecessor to the Office of Thrift Supervision ("OTS"), the Federal Home Loan Bank Board, and the Office of the Comptroller of the Currency ("OCC") both issued regulations authorizing their regulatees to offer adjustable rate mortgages with negative amortization. (46 Fed. Reg. 24148 (April 30, 1981) and 46 Fed. Reg. 18932 (March 27, 1981)).[1] Then, when Congress passed the Alternative Mortgage Transaction Parity Act in

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[1] It is informative to read the detailed and lengthy discussions of the rationales developed by the two federal agencies for authorizing this type of adjustable rate mortgage and their analysis of the negative amortization risk. Sadly, it is also a trip down a very long memory lane for an old thrift guy.

1982, authorizing the federal banking regulators to pre-empt by federal regulation state-created limits on adjustable rate mortgage lending by state-charted entities, the federal thrift and national bank regulators specifically extended the authority to make neg am ARMs to state chartered mortgage lending entities. Congress and the federal agencies acted to authorize these alternative mortgage types because interest rates in the 1980's created severe asset-liability mismatches for the savings and loan industry which was caught holding large portfolios of long term, fixed rate mortgages. In response, because the federal government wished to encourage both sound interest rate risk management in its insured depositories as well as to increase the amount of affordable housing credit, the government authorized alternatives to the 30 year fixed rate home loan.

So, "alternative mortgages" were fostered by the federal government in response to a very real challenge to financial institution and housing market viability. And the government permitted sufficient mortgage instrument design flexibility so that lenders could craft variable rate instruments that were attractive and safe for both consumers and portfolio lenders. Yet the Guidance offers no commentary on whether that response was and is successful and whether the challenges then perceived are still present.[2]

It seems to this interested party that one would want to know, for example, how many insured depositories have failed because of alternative mortgages? Or, in all the commissions and commentary on consumer credit that have occurred over the last decade in connection with the many attempts to amend the bankruptcy law, what, if anything, is said that option ARMs?

In the same way, while the Guidance suggests that option ARMs have not been stress tested in the last 25 years, one wonders about that assertion. Certainly one cannot have experienced the last 25 years and think there have been no economic shocks or stresses on the West Coast where thrifts have made option ARMs for better

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[2] Indeed, the Guidance speaks little at all on one very important benefit of option ARMs—they permit institutions to readily manage their interest rate risk. In that regard, Home Savings commends the OTS Director for his very recent remarks reminding all of us about the importance of managing interest rate risk. As Director Reich noted, OTS so appreciates the importance of managing interest rate risk that it has a risk model that it runs quarterly for all its regulatees and for its examination staff.

than two decades . The Federal Deposit Insurance Corporation in its Winter 2005 *FDIC Outlook* writing about "Bank Performance after Natural Disasters," notes the following:

> The Loma Prieta earthquake, measuring 6.9 on Richter scale, struck the San Francisco Bay area at 5:04 pm on October 17, 1989. . .The earthquake caused 63 deaths and 13,757 injuries. More than 1,000 homes were destroyed and more than 23,000 were damaged. . The performance of 63 financial institutions was . . .compared. . .Except for a period immediately following the earthquake, the banks in the area generally reported at least as high a return on averge assets after the earthquake as they had in the quarters preceding the disaster. . .
>
> The Northridge earthquake occurred on January 17, 1994, at 4:30 am in Los Angeles, California. . . it was one of the most costly earthquakes in U.S. history. . . Our analysis compared the performance of 172 financial institutions headquartered in Los Angeles and Ventura Counties. . ***.It should be noted that the area most affected by the earthquake was already suffering from an economic downturn prior to the earthquake. . .*** (emphasis added). . .After the earthquake, the condition of the banks in the affected areas did not noticeably worsen relative to the larger groups.

In short, according to the FDIC we have had two major earthquakes and at least one significant economic downturn , and yet there is not any meaningful evidence proffered that the California thrifts of the time, the thrifts whose assets were at one point approximately 30% of the OTS regulated industry and who made loans throughout California, companies like Home Savings, Great Western, American, Glendale Federal, Coast Federal, California Federal, First Federal of California, Downey Savings, and World Savings, were significantly affected. Yet they made option ARM loans.

From the beginning of alternative mortgages, the federal banking regulator with the most expertise in adjustable rate mortgages and

in neg am option ARMs was the OTS because it was federal savings and loans, and particularly West Coast federal savings and loans, holding a significant portion of all thrift assets, who focused on option ARMs. One reads the press releases of the last ten years posted on the OTS website and gains a keener understanding of the unique role of the federal savings and loan in the American mortgage market and of the expertise of its regulator, the OTS.

Again and again, OTS demonstrates that it understands exactly what their regulatees are doing and the importance of what they are doing:

> Jonothan Fiechter on August 2, 1995: "Thrifts are also leaders in originating and holding adjustable rate mortgages—important mortgage vehicles that often make housing affordable for first-time home buyers. . .
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> Ellen Seidman Press Release September 12, 2000: "The thrift industry . . . made a higher percentage of adjustable rate mortgages (ARMs) than other lenders. An estimated 72 percent of second quarter thrift originations were ARMs compared to 30% for other lenders."
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> Ellen Seidman Press Release March 14, 2001: "While in places like California, where land and housing prices are high compared to income, factors other than financing are critical to affordable home ownership and innovative financing is still extremely important. She called real estate lending the bread and butter of the thrift industry."
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> OTS Press Release October 28, 2002: "OTS also reported that the market share of adjustable rate mortgage originations for thrifts rose sharply during the second quarter from 40 to 50 percent."

In addition to these exemplars, there is other data readily available which, again, demonstrates that the OTS has and does understand option ARMs.

OTS Mortgage Market Trends September 1997: "ARMs are most popular in the West Region, where almost half (48.4%) of the mortgages held by depositories have variable rates. Nineteen percent of the depository West region mortgages can negatively amortize. These products are the riskiest of the ARMs. . . The last two years have been an extremely benign period for mortgage credit risk, with both low, stable interest rates and generally rising home prices across the country. However, over the two year span, depositories have sharply increased their holding of mortgages that combine adjustable rates and high LTV ratios. This combination makes such mortgages highly risky. Should the economy experience an interest rate spike accompanied by an economic slowdown, delinquencies and defaults on such mortgages would likely soar. . . Although OTS does not collect information on LTV, the TFR data show that the thrift industry does have two-thirds of its mortgage portfolio in ARMs, equally split between COFI and non-COFI ARMs. Some of the ARMs held by thrifts can negatively amortize. This high concentration of ARMs suggests higher delinquency rates for thrifts. ***Yet the MIRS data indicate that S&Ls, on average, originate lower LTV mortgages than their competition.*** (emphasis added). As a result, thrift delinquencies tend to run at a lower rate than the rate for the other depositories reported by the MIC system, especially during the recent calm interest-rate period. As a final note, while adjustable-rate mortgages are riskier than fixed-rate mortgages, ***loan-to-value remains the dominant determinant of credit risk.*** (emphasis added).

OTS Examination Handbook Section 212 June 2005: "If lenders carefully underwrite NegAm loans with prudent loan to value percentages and monitor the loans closely, the added credit risk may be small and manageable. However, aggressively underwritten neg am loans without adequate controls raise supervisory concerns. In

addition, the credit performance of NegAm loans is particularly vulnerable in an economic environment of rapidly rising interest rates and stagnant or falling property values."

<u>OTS Quarterly Review of Interest Rate Risk June 2005:</u> "In most respects, the option ARM is very similar to the traditional COFI ARM that many large West Coast savings institutions have offered for many years. Both of these loan types have payment caps that can lead to negative amortization, and most of these loans are tied to a lagging index of some kind. One difference is that the option ARM also offers an interest-only payment option, whereas the traditional COFI loan does not. In addition, the bulk of option ARMs are tied to the MTA index, whereas most COFI loans are tied to the 11th-District Cost of Funds Index. The shift to using theMTA index has improved lenders' ability to securitize option ARMs. In the past, investors had little appetite for COFI-based securities, due to the difficulty associated with hedging these securities.
In the past year or so, option ARMs have undergone a major transformation,changing from a niche to a mainstream mortgage product. The tremendous growth
in popularity of option ARMs is striking. Standard & Poor's reports that for the first five months of 2005, option ARMs made up 25 percent of the prime and Alt-A mortgage securitizations that it rated. In contrast, option ARMs accounted for less than 5 percent of these same markets in the first five months of 2004. Option ARMs were originally used by wealthier, financially sophisticated consumers as a financial planning tool to earn a higher return on capital through better monthly cash flow management. However, many commentators argue that option ARMs today are being used largely by consumers to purchase houses that they could not afford otherwise. "

So one has to ask, then, given that the option ARM is a product[3] that was fostered by the federal banking agencies and has been regulated for 25 years and given that its risks and benefits have been recognized for that time period, what has changed and what is unique about option ARM design now that warrants this lengthy, quite prescriptive, Guidance?

One certainly cannot find a detailed analysis in the Guidance that compares to that found in the OTS Mortgage Market Trends of September 1997 that provides any insight on those two questions. At the beginning of the Guidance, there is the suggestion that the fact that (1) consumers like the product and (2) the secondary market likes it has increased its use and there is the comment that (3) simultaneous second liens and (4) reduced documentation underwriting heighten the risk of the neg am option ARM product.

Home Savings wonders if the unstated assertion behind the first two points is that neither consumers nor the secondary market know what they are doing, notwithstanding the product's two decades of seasoning. And one wishes for more precision in identifying what it is about simultaneous second liens and reduced documentation that uniquely creates risks for option ARMs unlike every other home mortgage product where those two "risk layers" may also be present?

Although the Guidance does not say this, one is tempted to speculate that what, in fact, is primarily causing regulatory concern is that in this particular interest rate environment (short rates steadily rising after a 40 year low), minimum payment rates (also known sometimes as "start rates") also hit bottom when interest rates did, but still remain low in relation to the now rising fully indexed rate. Because the spread between minimum pay rate and fully indexed rate may be historically wide (one major financial institution is offering a 1% pay rate and a fully indexed rate of 7%), the potential for immediate, significant negative amortization is high. So, for example, with a spread of 6% on an average loan size of, say, $350,000, the annual neg am potential is substantially higher than if the minimum pay rate was 4.0% so that the spread was 3%.

Of course this is just speculation, but if it bore some accuracy then perhaps a regulator could focus on this central concern, the

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[3] The option ARM is an old product. The interest only hybrid ARM, on the other hand, is a relatively new product.

historically wide spread between pay rate and fully indexed rate, which would explain why after 25 years there was suddenly Guidance—an interest rate environment unseen in 40 years-- and the regulator could focus as well on what was unique about underwriting neg am ARMs now that distinguishes them from underwriting neg am ARMs at other times and just as importantly distinguishes neg am ARM underwriting from the underwriting of other home mortgage products—the potential for significant amounts of negative amortization very early in the mortgage payment history. While the Guidance encourages lenders in setting introductory rates to "consider the probability of disruptive early recastings and extraordinary payment shock," that caution is buried in a list of other cautions and is hardly the focus of the Guidance. Yet an unusually wide spread between pay rate and fully indexed rate seems to be the only unique explanatory variable for the whole regulatory effort.

The result is wide-ranging guidance covering a host of topics that are not unique to option ARMs and providing detailed, extensive, prescriptive instruction on a seasoned product which at least one regulator[4] has supervised correctly for 25 years. If the guidance was more precise perhaps the market could respond because it would be responding to a specific concern instead of a laundry list of possible issues.[5] Perhaps extremely low start rates would cease to be readily available.

But rather than speculate further, we should turn to the second topic of this comment, the mechanics of the option ARM. In examining those mechanics further, insights into the risks of the product and a keener understanding of its comparability to other mortgage products may be developed.

There are two primary points to be made in understanding the option ARM product: first, the product is the combination of an adjustable rate mortgage and a home equity line of credit ("HELOC") where the borrower draws on the HELOC line to make the first mortgage payment, thereby reducing the borrower's equity

[4] This is not to suggest that other regulators have not supervised it correctly, but rather reflects the author's limited experience with other bank regulatory agencies.
[5] To illustrate this point, one should compare this Regulatory Guidance with its pages of suggestions to the effort currently underway to achieve some regulatory burden relief on a distinct list of quite specific statutory provisions supported by a quite detailed analysis of the basis of the need for the relief.

in the property. Yet even though the combination of an adjustable rate first mortgage and a HELOC second is for practical purposes the same as or worse[6] than an option ARM, the regulatory rhetoric around HELOCs is far milder than that which appears in the guidance on option ARMs. For example, compare this language in the HELOC guidance:

> HELOCs generally do not have interest rate caps that limit rate increases. Rising interest rates could subject a borrower to significant payment increases, particularly in a low interest rate environment. Therefore, underwriting standards for interest-only and variable rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the long term and to absorb potential increases in interest rates.

with this language on the same problem in the guidance on option ARMs:

> Nontraditional mortgage loans can result in significantly higher payment requirements when the loan begins to fully amortize. This increase in monthly mortgage payments, commonly referred to as payment shock, is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, . . .For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to

[6] "Worse than" because with a HELOC, unlike an option ARM, the customer can use up large amounts of the equity in her home with one use of the line of credit unlike the option ARM which permits only modest amounts of equity to be used in any one month.

> 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. The amount of the balance increase should be tied to the initial terms of the loan and estimated assuming the borrower makes only minimum payments during the deferral period. Institutions should also consider the potential risks that a borrower may face in refinancing the loan at the time it begins to fully amortize, such as prepayment penalties. *These more fully comprehensive debt service calculations should be considered when establishing the institution's qualifying criteria.* (italics added)

If the requirements in the italics make sense for option ARMs why don't they make sense for any mortgage lender of any type of mortgage product, since every lender is on notice given the HELOC lending boom that there is likely to be a HELOC behind a "traditional" fixed first lien. It is one thing to call for an "assessment" of repayment capacity when underwriting a HELOC, and quite another to call for "comprehensive debt service calculations" when underwriting an option ARM. What about the design of the option ARM deserves this more rigorous test than that called for in making any other type of loan secured by residential real estate? Why is an increase in the HELOC payment called a "significant payment increase," but an increase in the option ARM payment called "payment shock?" Why does the option ARM guidance warrant three specific questions at the beginning of the proposed guidance on option ARMs, but the guidance on home equity lending does not? Given the mechanics of the two products, if the questions are relevant with regard to option ARMs they are certainly relevant to HELOCs as well.

To make the point in a different way, without regard to whether these questions are appropriate for either product, on what basis and for what reasons are the agencies distinguishing between the two products? <u>Every</u> draw on a HELOC is negative amortization. In fact, many commentators contend that permitting consumers to access their home equity is a good thing for both consumers and

for the nation. Indeed, one of the core functions of banking is to liquify assets (thereby reducing equity and creating "negative amortization") so that borrowers can invest the cash in other activities.

The second point to be made on the design of option ARMs is that discussions about the cost of the cash flow flexibility without considering the benefits of the cash flow flexibility are one-sided. One-sided, because the borrower, presumably, does not put the savings from the mortgage obligation's reduced cash flow demand in the mattress, but rather deploys the cash in some economically beneficial way. Examples of this use of the cash include investing in a retirement plan, paying off high interest credit card or auto loan debt, saving for a child's college education, using it in a business, or otherwise investing the proceeds.[7] In other words, an increased monthly payment on a home mortgage is only "shocking" if the borrower's total financial position is worse off. For example, if the borrower pays off 18% credit card debt for two years, while making the minimum payment on an option ARM, presumably at the end of two years, shifting to the fully amortizing mortgage payment at a 7% or 8% rate will not be shocking, but rather far less burdensome.

Why isn't it reasonable for a lender to evaluate the credit record of a borrower and possibly conclude that this borrower's financial history and employment and other information suggest that the borrower is economically rational and mature enough to decide how to manage their cash flow? If based upon the data supplied, a lender cannot reasonably draw the conclusion that a homeowner is capable of managing her cash flow responsibly and for the lowest interest cost, perhaps rather than erecting hurdles to consumers borrowing on their mortgage at the lowest interest rate available to them, the regulators should bar lenders from letting consumers use credit cards to finance their purchases. Or perhaps regulators could bar a lender from extending more than one credit card to every American family.

Alternatively, if a lender cannot reasonably conclude that a borrower can manage their cash flow responsibly by choosing from time to time to borrow a small amount monthly against their home

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[7] Of course it is possible for borrowers to misuse the cash flow saved by making only the minimum payment; that possibility is one reason there are underwriters. But a discussion of the misapplication of man's free will is beyond the scope of this Comment Letter.

equity (say, $1,500[8]) by making the minimum payment in a particular month instead of the fully amortizing payment, perhaps regulators should bar draws on home equity lines where a "reckless" consumer can borrow 20% of the entire value of her house in one quick transaction (say, $112,000[9]). The fact is that meaningful negative amortization from an option ARM cannot, by design, be created in one ill-considered moment. But the negative amortization of a home equity line can be. Perhaps it is home equity lines that should be redesigned.

The best summary of this comment letter's point on the design of option ARMs has been made by Herb Sandler, Chairman of World Savings, and Russell Kettell, the Chief Financial Officer of World Savings, when they observed during a presentation at a Lehman Brothers equity investors conference within the last 12 months that in 25 years of making option ARMs World Savings had been unable to identify a single borrower who defaulted as a consequence of the design of the loan product, while World had been able to identify borrowers who defaulted because of unemployment, divorce, or illness.

Having considered the design features of the option ARM , this comment letter now turns to its third point—answering the questions posed by the draft guidance:

The draft guidance's first question is as follows:

> "(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?"

Home Savings is not prepared to describe in detail in a public letter what its underwriting practices are with regard to option ARMs, but it does in fact, as appropriate, take into consideration the

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[8] If the spread between the minimum pay rate and the fully indexed rate is 4% and the average loan balance is $450,000, then roughly the difference in monthly payment between the minimum pay rate amount and the fully amortizing monthly amount is $1,500.

[9] If the loan balance of $450,000 is 80% of the value of the house, then the house is worth $562,000, so a 20% home equity line would allow the borrow to extract $112,000 with one check in one moment.

borrower's ability to service a mortgage debt larger than the amount originally borrowed in underwriting the option ARM loan, *just as it does, where appropriate, for other types of mortgage loans which it makes for portfolio.* Home Savings does not know what "comprehensive debt service qualification standards" means. Home Savings is very reluctant to encourage federal regulators to specify underwriting standards, remembering that none of the earlier quite detailed and lengthy specificity prevented the savings and loan crisis of the 1980's.

The draft guidance's second question is as follows:

> "(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."

The same specific circumstances support the use of reduced documentation to underwrite option ARMs as that which support the use of reduced documentation to underwrite all other types of home mortgages, including home equity loans—the other material in the file and available on the borrower, including the detailed credit report (which is far more than a credit score) and the appraisal (which is far more than an estimate of value). Reduced documentation loans are a common feature of 30 year fixed rate loans purchased by Fannie Mae and Freddie Mac. Why is it prudent to underwrite a fixed rate loan purchased by Fannie with an 80% LTV with stated documentation, but it is not prudent to underwrite a 65% LTV option ARM with a 115% recast ceiling with reduced documentation? The question suggests there is something unique about option ARMs. The process for assessing repayment ability of an option ARM does not seem to Home Savings necessarily in all cases to require peculiar rules with regard to documentation of income or in some cases assets.

Given Home Savings does not make subprime loans, we have no view on the subprime question.

The draft guidance's third question is as follows:

> (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 products?

The last question in this paragraph is quite simply alarming. The option ARM was born in the crucible of the high interest rates of the early 1980's; a large portion of the thrift industry collapsed during that period because of untoward interest rate risk occasioned by holding long-term fixed rate instruments; both Chairman Greenspan[10] and Bill Gross[11] of PIMCO have commented publicly that adjustable rate mortgages can be better for consumers than fixed rate mortgages; and industry studies demonstrate that an adjustable rate mortgage is frequently less expensive for the customer over the long term than a fixed rate mortgage.[12] Why would bank regulators do anything that could be understood by the industry as imposing a special underwriting burden on the origination of adjustable rate mortgages?

No, the Guidance should not address the consideration of future income. Most fixed first mortgages are subsequently followed these days by a second lien that is a home equity loan. Given that knowledge, then logically, if a option ARM underwriter must consider future income because there is the possibility of a greater

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[10] Greenspan, Speech February 22, 2004, to the Credit Union National Association as reported in the February 23, 2004, Wall Street Journal. "The Federal Reserve staff estimates that homeowners would have saved tens of thousands of dollars" had they held adjustable-rate mortgages rather than fixed rate mortgages during the past decade."

[11] Gross, PIMCO Investment Outlook December 2003. "If you choose to buy or refinance a home, I have perhaps a controversial recommendation: avoid the 30 year fixed rate mortgage."

[12] Both World Savings and First Federal Savings Bank of California have historically circulated flyers that explain that in most, but not all years, when comparing the interest costs of a fixed rate loan and an adjustable rate loan taken out at the same time, the adjustable rate loan saves the consumer money.

debt obligation on the mortgage in the future, then every first lien mortgage underwriter, even of fixed rate or hybrid mortgages, should do the same because the likelihood is just as great, or even greater, that there will be negative amortization accumulated on a HELOC which their borrower will have to service in the future as well.

The notion that the only possible future occurrence for which regulatory guidance is required is that of negative amortization on an option ARM home mortgage is curious. There is data on the 1003 which clearly puts the average underwriter on notice of other, ineluctable events, more likely than option ARM neg am, which will affect the borrower's debt service capacity. For example, perhaps the 1003 lists children aged 16 and 18. Should the underwriter of a fixed rate mortgage consider the possibility of college tuition? What if the 1003 reveals the borrowers are 52 and 54 living in a small Midwestern town? Should the underwriter of a fixed rate mortgage consider the quality and quantity of the borrowers' retirement plans; the President's comments on the viability of Social Security, the energy costs of living in a rural area three years from now, the cost of health insurance and nursing care? In short, Home Savings believes that trodding the path of future events could make consumer lending quite the adventure in forecasting.

Home Savings makes home mortgages, not financial plans.

And we believe that is what our customers want us to do.

The fourth point in this comment letter is Home Saving's views on the draft guidance on underwriting option ARMs. As Home Savings understands the Guidance on this topic, the regulatory agencies make these points:

1. The option ARM loan should be underwritten at the fully indexed rate assuming the borrower makes a fully amortizing payment. RESPONSE: Home Savings believes most option ARM lenders do this. It certainly does.
2. The option ARM loan should be underwritten as if the borrower makes only the minimum payment for several years and the resulting loan balance at the fully indexed rate generates a much larger monthly loan payment which should be the basis of the underwriting. This is called "fully comprehensive debt service calculations." RESPONSE: Home Savings believes that future events both positive and negative for any particular borrower are difficult to forecast. That is one reason it takes collateral. In addition, credit

reports (as distinguished from credit scores) provide some insight about a borrower's historical ability to service debt and manage her finances. In any event, negative amortization, at worst, is simply the accumulation of additional debt in modest sized increments. If the possibility of future debt accumulation is significant as an underwriting matter, it would seem it is relevant for all types of mortgages, not just neg am option ARMs.

3. In underwriting option ARMs there should not be over-reliance on credit scores. RESPONSE: In underwriting any loan, there should not be over-reliance on credit scores. Why single out option ARMs?
4. In underwriting option ARMs, lender should not make collateral-dependent loans. RESPONSE: What is a collateral-dependent loan precisely?
5. In underwriting option ARMs, lenders should be wary of risk layering, especially when there are "low docs" and simultaneous second liens. RESPONSE: Home Savings is unclear why the relative timing of the placement of the second lien is a particular underwriting concern. Of what significance on the question of repayment is whether a second lien goes on day one or day 65?
6. In underwriting option ARMs, one should rely on reduced documentation cautiously. RESPONSE: Home Savings would commend the IndyMac Bank comment letter for a discussion of at least the secondary market view of low documentation loans. And, again, why single out option ARMs for this caution?

   Here, it may be appropriate for Home Savings to acknowledge that the Guidance's concern with several of the underwriting challenges raised therein are fairly generally. Indeed, Home Savings does not want its Comment Letter to be understood as denying the importance of underwriting vigilance and discipline. But the Guidance simply fails to explain what it is about option ARMs that is worthy of special underwriting caution inapplicable to other types of mortgages and why this caution is particularly appropriate now.

7. In underwriting option ARMs, lenders should avoid simultaneous second liens. RESPONSE: With the exception of the last sentence of the section that discusses this issue, there

is nothing in the Guidance that bears uniquely on option ARMs.

8. In setting the introductory interest rate, "institutions should consider ways to minimize the probability of disruptive early recastings and extraordinary payment shock." As the reader knows at this point in this Comment Letter, Home Savings believes that this is, in fact, the nub of the regulatory concern. Home Savings is only aware of two or three ways to accomplish the stated objective of reducing the probability of disruptive early recastings, e.g., secular interest rates decline over time, something that has happened in the past, but is certainly not within the control of the lender; higher pay rates, something which Home Savings supports; higher recast ceilings (e.g., 125% vs. 110%); and making the first recast period 10 years rather than 5 years.
9. Home Savings has no remarks on lending to subprime borrowers or on investment properties as it is not in either of those lines of business.

The fifth point in this Comment Letter is Home Savings observations on the proposed Guidance's suggestions for managing a portfolio of option ARMs. Here again, the most salient point is to wonder why this Guidance is aimed particularly at option ARMs.

There seems to be the unspoken notion underlying the Guidance that 30 year fixed rate loans are good for American consumers and anything else is either likely to be too complicated or too "risky" for the average American. Further, the inference seems to be that any lender that offers any product but a 30 year fixed rate loan is somehow "taking advantage" of the borrower. And yet the basis for those inferences is unclear. And the "Wisdom of Crowds" seems to be that more choice in mortgage design is appreciated.

It is certainly true that the risks and disadvantages of 30 year fixed rate loans are not carefully explained to borrowers by the primary purveyors of 30 year fixed rate loans—the Government Sponsored Enterprises ("GSE's"), but that silence cannot be understood as proof there are no risks and disadvantages. Indeed, 30 year fixed rate loans work wonderfully for GSE's who can hold the paper and manage the interest rate risk because of Congressionally granted prerogatives. As a result, of course, they are prepared to create an environment where the language used to describe the instrument—"traditional"-- makes the product sound like a core American value. Perhaps if lenders who offer 30 year fixed rate paper had to explain

not a "traditional" mortgage, but rather how much particular American consumer should be paying for a "long-term interest rate risk hedge", the rhetoric around the topic of "traditional" and "non-traditional" mortgages might be focused on the various product features instead of misconceptions created by the labels. One is, indeed, reminded of the adage that he who picks the language to be used in the debate, always wins. In this case, option ARMs characterized as "*non-traditional*" and creating "*negative*" amortization were born into this financial marketplace with a heavy, but unwarranted burden.

Turning to the last point in this Comment Letter, Home Savings provides its views on the Guidance's suggestions on consumer disclosure. Home would encourage the regulatory agencies to separate the consumer disclosure Guidance from the underwriting and portfolio management Guidance.

There are several reasons for this suggestion. First, the Federal Reserve Board of Governors staff is working on sample disclosures as this proposed Guidance is being considered and it seems appropriate to give them a chance to do their work, particularly since this work is not referenced in the proposed Guidance, yet drafts are generally available.

Second, there is a consumer disclosure document which can be the basis of a more informed consumer—the Truth-in-Lending disclosure. Yet no suggestion is made in this Guidance to amend this disclosure. Home Savings would suggest that at the least when the disparity between the pay rate and the fully indexed rate is so wide that the loan recasts under standard Truth-in-Lending assumptions before the full time period to a first recast expires, that additional disclosures on negative amortization be required for the consumer. This would be one way to encourage lenders to shrink the spread between the pay rate and the fully indexed rate.

Third, all of the language in the proposed Guidance on "assuring" and "suitability" misunderstand fundamentally a lender's relationship with a borrower. And, given the Community Reinvestment Act, the Fair Lending Act, and the Equal Credit Opportunity Act, frankly create mischief. It is difficult to know how to tell a borrower that she is qualified for a particular loan but cannot have it because it is not "suitable" for her—for example, because the lender has no confidence that she has the ability to improve her earnings over the course of the next several years or

because the lender believes she has not demonstrated that she can manage her cash flow "responsibly?" Further, the notion of suitability is a tricky one, because the Guidance, by making this suggestion, implies that lenders offering adjustable rate mortgages must determine if the borrower is an appropriate user of adjustable rate credit, even though, no such suggestion is made for borrowers deciding to hedge interest rate risk or take on adjustable consumer credit debt. This double standard continues to befuddle this commenter.

In addition to these arguments against the admonitory language of the Guidance on consumer disclosure, Home Savings is also concerned that attempts to impose by Guidance an obligation to teach the consumer the advantages and disadvantages of option ARMs when the consumer starts to shop is impossible. Most of that shopping is done through mortgage brokers over whom the lender not only has no control, but may not even be considered by the broker to be the potential lender at the time the shopping process starts. In short, the Guidance simply imposes an unrealistic burden on lenders that cannot be met.

If there is a desire to have every lender with whom a consumer may start to shop educate the consumer early in the process, then the regulatory agency that imposes such a requirement needs to have more comprehensive authority over the mortgage market than the bank regulatory agencies currently do. You would disadvantage insured financial institutions to other types of lenders (e.g., mortgage brokers or mortgage bankers selling to REITs). That is why the recent interest of the Federal Trade Commission in holding a hearing on consumer disclosure of "non-traditional" mortgages is a more comprehensive and therefore more acceptable approach to this challenge. And of course, yet another reason why the Guidance needs to separate the consumer disclosure issue from the underwriting and portfolio management questions.

In summary, then the Guidance treads too lightly over the history of the option ARM, is one-sided in analyzing option ARMs, fails to explain the double standard for underwriting and portfolio management of option ARMs, treats the risk of small amounts of monthly negative amortization as alarming, but fails to address the potential of huge amounts of negative amortization from home equity lines, discusses only briefly what this commenter believes is the source of the real concern about neg am option ARMs, the spread between the pay rate and the fully indexed rate, and swirls

consumer disclosure admonitions until the Guidance can be read as requiring a lender to declare whether a loan product is "suitable" for home mortgage borrowers.

Home Savings believes the agencies, from their experience and supervisory performance in the last 25 years, should have more confidence in their deftness.

Sincerely Yours:

Dirk S. Adams
Chairman and CEO