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VIA UPS NEXT DAY AIR
Office of Thrift Supervision
Manager, Dissemination Branch
Information Management Services Division
1700 G Street N.W.
Washington, D.C. 20552

Attention: Docket #2000-34

COMMENTS AND SUGGESTIONS REGARDING "SUB-PRIME" LENDING

Gentlemen:

As the former Chairman and CEO of Magna Bancorp, Inc., and its wholly-owned subsidiary, Magnolia Federal Bank for Savings, I have a keen interest in home lending and appreciate the opportunity to respond to the proposed regulation and legislation on sub-prime lending. Prior to its merger in 1997, Magnolia Federal was a $1.3 billion thrift with offices throughout the State of Mississippi and Southern Alabama that specialized in non-conforming residential mortgage lending for its portfolio.

The financial press, the financial industry and regulators have coined the derogatory term "sub-prime" that is confused with all conventional home loans that fail to conform to secondary market requirements. Many quality (Grade A) customers with excellent security may not qualify for a FNMA, FHLMC, FHA or VA loan. The industry would be better served to re-define this segment as the "non-conforming market" (does not conform to the FNMA/FHLMC/GNMA agency standards) and then determine some method of segmenting the non-conforming market into multiple risk profile groups.

Other terms coined by consumer groups and repeated by the regulators have inflamed the issues and would convince everyone that a huge host of predatory lenders exist using unscrupulous practices to unfairly take homes with equity away from unsophisticated borrowers and profit from the foreclosures. In order for this to be true, there would have to be profit in foreclosures. In most states, the foreclosure process includes a public auction. Properties in foreclosure with large equities are usually sold to third parties who bid more than the lender. The financial institution records available to me do not support the notion that there is any profit

in foreclosures, and I certainly don't accept that a very large segment of the industry would engage in this practice without profit. The financial institution I am employed with (or the institution previous to merger) originates a large volume of non-conforming residential loans and has incurred 1497 home loan foreclosures in the past 5 years. The statistical information presented in the following paragraphs is derived from this base which we believe is large enough to be a reliable representative sample.

Loans to unsophisticated borrowers are most frequently below $60,000. During the last 5-year period 1331 out of the 1497 foreclosed loans had original loan balances below $60,000. Over 88% of the total loans foreclosed and 93% of resulting out-of-pocket losses on the disposition of the foreclosed properties occurred from these loans below $60,000. Cash gains were recognized on the sale of 512 of these properties and losses recognized on 819 properties. The net result from the sale of all properties foreclosed during the period was a net out-of-pocket loss of $4.17 million, an average loss of $3,133 per property. Actual losses are much higher when the imputed holding costs are taken into consideration.

I believe these foreclosure and loss results are consistent with the rest of the non-conforming home loan industry and support our contention that this type lending is not a huge Machiavellian scheme to disenfranchise unsuspecting borrowers for profit.

The interest rate risk attendant to long-term, fixed rate lending coupled with a period of historically high interest rates eliminated a substantial part of the thrift industry during the 1980s. Mortgage correspondent and brokers filled the resulting void and are now a major source of credit for individuals seeking home loans. In fact, it has been reported that approximately 70% of home loans today are originated through the correspondent/broker community. Borrowers are frequently under the impression that correspondent/brokers have some obligation to locate the best available credit scenario for the borrower. While many honest correspondent/brokers may, in fact, search for the most favorable credit package for the borrower, all too often, the lender selection is based on the best fee package offered to the correspondent/brokers at the borrowers' expense. THE CORRESPONDENT/BROKER RELATIONSHIP AND THE FEES CHARGED BY SOME OF THESE INDIVIDUALS IS THE PRIMARY CULPRIT BEHIND THE REPORTED UNFAIR LENDING AND SHOULD BE THE FOCUS OF ANY REFORM EFFORTS. These fees frequently are all out of proportion to the service rendered. While a disclosure might help educate borrowers, we recommend a limiting cap be applied on ALL CORRESPONDENT/BROKER FEES and COMPENSATION (both front-end and back-end fees) to include origination fees, processing fees and yield spread differential. Normal and reasonable third party fees for appraisals, credit reports, title work, surveys, pest inspections should be excepted). Discounts to buy the rate down should be excepted only when it is demonstrated that the rate was reduced commensurate with the discount paid.

The size of the loan should determine the maximum fees that can be charged by the correspondent/brokers. We recommend a correspondent/broker fee (compensation) cap of 4% on loans up to $50,000; 3% for loans between $50,000 and $100,000; and 2% for loans over $100,000 with a minimum of $500 regardless of loan size. An additional 1% should be allowed

if the correspondent/broker supervises/disburses funds to construct a new home or provide major renovation. Correspondent/broker fees for loans refinancing within 36 months of the original loan with the same correspondent/broker or affiliate should be limited to the greater of $500 or 1%.

While the Office of Thrift Supervision could not directly limit correspondent/broker compensation, without a change in the law, limitations on such compensation could be applied to loans originated or purchased by a regulated thrift institution or its affiliate.

Prepayment penalties have some justification but too often serve as a consumer trap. Loans cost money to originate and if the rate falls immediately after an origination, the lender will not have an opportunity to recover its cost before the loan is refinanced. Frequently, however, the prepayment penalties do not serve as reasonable protection for the lender to recover origination cost, but a club used against an unsophisticated borrower. There are examples in the market place where correspondent/brokers have charged interest rates above the market and then offered the loan for sale to a financial institution at a premium. The prepayment penalty is then used to protect the premium paid by the financial institution to the correspondent/broker for the excessive interest rates. Limitations on excessive prepayment penalties would reduce the incentive to pay premiums for excessive interest rates. As reasonable protection for both borrower and lender, we recommend the maximum prepayment penalty for home loans to be 3% in the first year; 2% in the second year; and 1% in the third year and no prepayment penalty thereafter.

Loan originators who target marginal borrowers and charge high fees and rates will normally sell the loan to the customer based on the monthly loan payment. Since the inclusion of the escrow feature for the payment of taxes and insurance would increase the payment, the escrow is seldom required. In fact, frequently the cost of taxes and insurance is usually not even discussed. Regardless of the originators' escrow requirements, however, the property taxes and insurance must ultimately be paid and many customers are "flipped" or refinanced frequently just to make these annual payments.. Failure to pay taxes and insurance and the compound effect of several years of unpaid taxes is one of the major causes of delinquency and foreclosure.

To protect the borrowers and eliminate the low payment illusion, marginal borrowers (however a marginal borrower is defined) should be required to establish a escrow account for monthly budget purposes and the lender required to pay the taxes and insurance on behalf of the borrower.

Balloon payments are common with commercial bankers and some consumer lenders and result in additional fees and closing costs for the customer. The ability to periodically review the borrower's credit and demand repayment is an attractive feature for the lender but the same advantage can be accomplished with an option to call the loan rather than a balloon and avoid the refinance cost to the consumer. Should the regulators find it necessary to eliminate balloon loans to this type borrower, we urge you not to limit the ability to include call provisions in the note.

The proposed regulation would place the determination of suitability on the lender. If a suitability standard is imposed, any foreclosure would automatically become a legal challenge since the foreclosure is superficial evidence the borrower could not pay and, therefore, the loan should not have been made. Lenders will react to this with caution and restrict credit to avoid lawsuits. This will result in increased borrowing cost for marginal borrowers whose only option will be a finance company.

Mandatory arbitration is used by lenders to prevent the predatory practices of the legal profession. Lenders are constantly harassed with spurious claims that are expensive to defend. Plaintiff lawyers realize that lawsuits even with no legal basis will cost a lender in the range of $20,000 each to defend with no risk to the lawyer or his client and expose the lenders net worth for punitive damages from a jury that may not understand the legal issues but act entirely on emotion. The high-cost lending issue is being used by the plaintiff bar in concert with consumer groups to restrict the use of a fair and independent arbitrator to inexpensively and quickly dispose of issues and complaints without excessive legal fees.

The financial institution I serve is engaged in various types of home loan lending. Borrowers who qualify for and meet secondary loan documentation standards are processed, closed and delivered to a government-sponsored secondary market agency. Loans that do not qualify for the secondary market are credit scored based on a Fair Isaac credit score product. (This product is marketed by the major credit bureaus under several names to include Fair Isaac, Empirica or Beacon.) Using the score, the lender determines the maximum loan to value ratio and the interest rate. The institution began using the Fair Isaac Delphi scoring system in 1991 and switched to the current Fair Isaac scoring system in 1994. During this period, we acquired extensive experience and history using this credit scoring system. From 1991 through 1995, no loan applicant was excluded on the basis of credit. The lender compensated for the additional risk of lending to lower credits by increasing the rate to cover the higher cost of servicing and the cost of foreclosures and losses. Experience with this liberal policy of accepting all loans, regardless of credit score, was extremely poor and resulted in more delinquency and foreclosure than the institution could reasonably service.

In June of 1994, a retrospective analysis was performed on the institution's scored non-conforming loan portfolio. Borrowers with Fair Isaac credit scores of 550 and below represented only 17% of the total number of loans and substantially less in dollar volume but accounted for 52% of the serious delinquencies and foreclosures. This was totally unacceptable. Borrowers with scores between 550 and 570 represented 7.77% of total loans and 15.31% of the serious delinquencies and foreclosures. Clearly, this also was a very risk prone group. As a result of the evaluation, the lending policy was revised to eliminate loans to borrowers with credit score below 570 or, alternatively, the maximum loan-to-value ratio was reduced to 55%.

Subsequent to the credit score analysis, the institution has maintained a record of credit score in the loan data base. The following is a summary of the portfolio loans originated since December 31, 1995 by a Fair Isaac credit score. This portfolio is obviously large enough to validate the accuracy of the scoring system.

		Delinquency							
		30 Days		60 Days		90 Days		Total	
Credit Score Range	# of Loans in the Portfolio	# of Loans	%	# of Loans	%	# of Loans	%	# of Loans	%
No Score	563	22	3.12%	7	1.55%	31	5.30%	60	9.98%
Below 550	459	27	4.43%	11	1.87%	27	6.44%	65	12.74%
550+	273	18	9.38%	6	1.40%	20	6.53%	44	17.31%
570+	113	7	8.50%	1	0.08%	4	3.00%	12	11.58%
580+	407	18	4.55%	5	1.67%	19	6.53%	42	12.75%
610+	869	22	2.03%	9	0.76%	25	3.07%	56	5.85%
640+	1253	30	2.60%	9	0.99%	33	3.25%	72	6.83%
660+	2036	29	1.11%	9	0.35%	25	1.62%	63	3.08%
690+	1571	9	0.60%	6	0.32%	11	0.60%	26	1.51%
710+	1677	13	1.20%	4	0.19%	3	0.21%	20	1.61%
730+	1974	3	0.13%	1	0.07%	7	0.33%	11	0.53%
760+	1847	2	0.06%	2	0.21%	8	0.38%	12	0.65%
790+	896	3	0.55%	1	0.02%	1	0.05%	5	0.62%
Total	13938	204	1.12%	71	0.38%	214	1.23%	489	3.51%

Using the credit score analysis, it was also determined that the loan could be consistently graded based on a combination of the credit score and LTV. The following is an analysis of 16,506 loans scored and graded from our files using the grade grid described below:

		LOANS DELINQUENT							
		30 DAY		60 DAY		90 DAY +		TOTAL	
Grade Based On The Grid Below	Total # of Loans Scored & Graded in the Portfolio	#	%	#	%	#	%	#	%
A	10,709	63	.59	18	.16	86	.80	167	1.55
B	2,154	42	1.95	15	.70	54	2.51	111	5.16
C	3,643	96	2.64	40	1.10	179	4.91	315	8.65
Total	16,506	201	1.22	73	.45	319	1.93	593	3.60

Grade Grid

If credit score is greater than 700, the loan is classified as an A regardless of LTV.
If credit score is between 610 and 690 and LTV is 68% or less. The loan is classified as an A.
If the credit score is less than 550, the loan is classified as C.
If credit score is less than 680 and LTV is greater than 55%, the loan is classified C.
All other loans classified B.

The Fair Isaac score system is used by all of the major credit bureaus and is generally accepted in the industry. Use of some combination of the Fair Isaac credit score and loan-to-value ratio would allow a consistent definition of the loan grade or risk profile across the industry.

The Home Ownership and Equity Protection Act of 1994 (HOEPA) is in effect a usury bill. Compliance with the disclosures, including the appropriate timing of disclosure delivery is difficult, so prudent lenders will tend to avoid the ceilings set by the law and it, therefore, serves essentially as a cap on interest rates and loan charges. Each time you reduce the "usury" cap, you will eliminate credit to certain borrowers. Unfortunately, it is an economic certainty that a substantial number of the high risk profile borrowers that will be eliminated from credit by such limitations because of an insufficient risk reward ratio are also low income borrowers with few other sources of credit.

There are two life insurance products that are typically sold with home loans. Credit life insurance is a group policy that does not require individual underwriting to obtain. The policy can be sold to anyone regardless of health conditions, and, consequently, losses under credit life group policies are unusually high. The resulting premiums and commissions are also high when compared to other types of life insurance. Most state insurance laws limit credit life group products to a 5-year term; and, as a result, this type of life insurance does not fit well with long-term mortgage loans. Some lenders provide for long-term amortization but balloon the home loan at 5 years for the sole purpose of selling this high commission life insurance product. This practice should be discouraged and group credit life only permitted on loans that fully amortize within the 5-year term.

The other life insurance product sold with long-term mortgage loans is mortgage protection insurance. Each policy is individually underwritten based on the applicant's age, health and other health habits (smoking/non-smoking). The cost for this insurance is competitive with other forms of life insurance and the commissions are low. No premium is paid for this insurance as part of loan closing and it is not part of the loan settlement cost. If the insurance application is approved, (almost always after the loan closes), the monthly premiums are added to the regular payment and accumulated in escrow for disbursement to the insurance company. The insured may cancel the policy at any time and no return premium calculation is necessary since the premium is not paid in advance. This type life insurance is very consumer friendly and competitively priced. Any law or regulation should consider that two different types of credit insurance exist and make certain that the less expensive mortgage protection product is not discouraged.

An example of an unintended discouragement for the mortgage protection insurance is the Truth-in-Lending (TIL) law, which appears to treat both types of credit insurance the same. Most lenders have adopted the model disclosure form that requires the borrower to indicate an insurance preference. Many customers believe they have insurance coverage when they check the TIL selection box. Advance disclosure (prior to underwriting and policy issuance) of the mortgage protection insurance has been confusing to the consumer and the source of frequent lawsuits. Since the mortgage protection product is not a part of the loan settlement process it clearly should not be included in truth-in-lending or in any future regulation/law considered. The regulations should clearly exempt mortgage protection insurance sold outside of the settlement process. I recommend revision to TIL regulation Section 226.4 Paragraph 4(b)(7) and (8) Explanation 2. The first sentence should be revised to state: Insurance sold after consummation <u>or not included as a part of the settlement process</u> in closed-end credit.......

The Home Ownership and Equity Protection Act of 1994 limited the total points and fees payable by the consumer to 8% or $400. Included in the 8% is ANY FEE or CHARGE retained by the lender (or an affiliate) regardless of reason. Many lenders want to provide convenient one-stop services at attractive prices for the consumer. Example: Title insurance, appraisals, and closing services in many cases may be provided at less expense by the lender. The 1994 law had the chilling effect of reducing the competitive pricing provided by lenders and the convenience of lender provided companion services. Borrowers are forced to rely on more expensive and slower third party service providers because lenders want to avoid inclusion of these services in the 8% fee limit. Any changes in the law or regulation should exempt title insurance, appraisals and other regular and reasonable settlement services provided by the lender.

Notifying applicants for high cost loans of the availability of home loan counseling is a waste of time and another useless disclosure in a file already full of useless and meaningless disclosures. Also a substantial number of "high cost" loans originate through brokers/correspondents that would not be reached with the regulation.

Certain state laws allow for late charges, other states permit an acceleration of interest. A few have a combination with some limit. To accelerate the interest rates post-default seems inappropriate when a late charge is already provided. Lenders should have the election of a 5% maximum late charge or an acceleration of post-default interest rates but not both.

Limitation on refinancing may not be appropriate. This eliminates some of the consumer options and if there is a limit on broker/correspondent fees for refinancing within a short period it would serve to discourage bad practices without damage to the consumer.

RECOMMENDATIONS

1. Eliminate the reference to sub-prime and use the term non-conforming with a specific grade.

2. Require lenders to include a Fair Isaac score in the loan record.

3. Establish a standard grading system using a combination of the Fair Isaac score and loan-to-value ratio, grade the loan A, B, C, Below C.

4. Limit broker/correspondent fee income on any loan acquired by a federally insured institution to a reasonable amount. For example:

   4% on loans up to $50,000 with a minimum of $500 allowed
   3% on loans between $50,000 up to $100,000
   2% on loans over $100,000
   An additional 1% allowed if the broker/correspondent supervises/disburses funds to construct a new home or provide major renovation.

   Limit fees to the greater of $500 or 1% if the loan is refinanced by the same broker/correspondent within 36 months of the original loan.

5. Limit prepayment penalties to:
   3% in the first year
   2% in the second year
   1% in the third year
   0 after 3 years

6. Require an escrow for taxes and insurance on any loan graded C or below.

7. Eliminate the balloon product in less than 7 years but allow for a call provision at the lender's option.

8. Do not include a suitability provision in any regulation or law.

9. Continue to allow arbitration as an inexpensive way to quickly settle disputes.

10. Be careful about reducing the HOEPA limits.

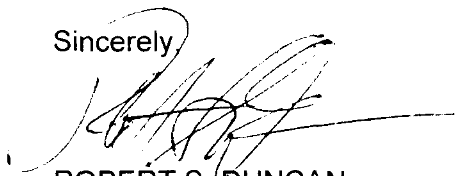
11. Eliminate the sale of group credit life on long-term home loans but encourage the sale of mortgage protection life. Correct the truth-in-lending (TIL) regulations to make it clear that mortgage protection insurance is a product sold outside of the settlement process and should not appear on the TIL.

12. Do not require applicants to be advised of the availability of home loan counseling. This is a worthless disclosure.

13. Allow for an increase in the rate of interest after default or a 5% late charge but not both.

14. Sophisticated borrowers should not be included in usury regulations or law. HOEPA and other regulations should exempt any loan over $100,000.

Sincerely,



ROBERT S. DUNCAN
FORMER CEO
MAGNOLIA FEDERAL BANK

RSD/db