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Office of the Comptroller of the Currency
250 E Street, NW
Public Reference Room
Docket No. 05-21
Mail Stop 1-5
Washington, D.C. 20219

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

Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th and Constitution Ave., NW
Washington, D.C. 20551
Attn: Docket No. OP-1246

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

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the Proposed 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"). Our comments on the Proposed Guidance outline common concerns and suggestions of The Clearing House member banks.

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1 The members of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

The Clearing House recognizes that borrowers increasingly utilize the types of mortgage loans that are labeled "nontraditional" under the Proposed Guidance. However, these types of mortgage products are not new offerings. They have been provided for many years, and their recent increase in popularity reflects their benefit to both consumers and lenders. Moreover, by providing additional sources of home financing, they contribute to the expansion of the U.S. economy.

The payment flexibility afforded by nontraditional mortgages enables them to serve as valuable financial planning tools. Borrowers gain more resources to fund retirement accounts, invest in small business, or service debts (*e.g.*, credit cards) that do not receive favorable income tax treatment. The payment flexibility also makes home ownership more attainable for certain consumers, such as people with variable incomes. The benefit to borrowers is especially pronounced in the initial seven years of a mortgage during which time there is little or no amortization, regardless of the type of mortgage. Market data indicates that borrowers, on average, refinance or sell their homes every five to seven years.[2] Importantly, this corresponds to the period during which borrowers benefit from the lower rates that many nontraditional products carry before the rate is reset. This allows borrowers to make lower payments over that period of time and consequently realize a higher return on investment upon the sale of their homes.

Nontraditional products can also contribute to the safety and soundness of our member banks by mitigating the interest rate risks in their loan portfolios. For instance, in a rising interest rate environment, a portfolio of long-term, fixed-rate mortgages declines in value. Products, such as 5/1 or 7/1 interest-only loans, reduce the interest rate risk and stabilize the value of banks' loan portfolios. In such a rate environment, these products help prevent a decline

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[2] Todd Davenport, A Case for Interest-Only Mortgage Loans, *American Banker*, May 23, 2005; Jody Shenn, Mortgage Risk Debate Heating Up, *American Banker*, May 5, 2005.

in the spread between the short-term rates banks pay on deposits and the long-term rates they earn on outstanding mortgage loans.

We agree, of course, that underwriting of all loans should be done prudently, but overly conservative underwriting policies can be as destructive as overly liberal policies. It is essential that the Proposed Guidance not discourage products that will facilitate increased home ownership and liquidity without undue risk to the lenders or the borrowers. Consequently, The Clearing House believes that the Proposed Guidance should be structured to avoid discouraging, much less preventing, the use of nontraditional mortgage products in a safe and sound manner. The following recommendations are designed to effectuate that objective.

I. Overview: Scope and Applicability of Guidance

As a threshold matter, The Clearing House acknowledges that its member banks should maintain safe and sound underwriting standards for so called "nontraditional" products and adhere to fair marketing and disclosure practices -- as should be the case with every loan product. Almost every loan product is subject to abuse if not properly underwritten or marketed. Accordingly, The Clearing House supports the Agencies' initiative to issue guidance in this area.

Our member banks also agree that certain nontraditional products need to be underwritten with particular care and managed particularly well. A special level of concern applies to negative amortization loans. It seems prudent to limit negative amortization products to borrowers with higher levels of financial wherewithal and sophistication.

Our views on negative amortization loans do not apply to reverse mortgages, and we request the Agencies to acknowledge the difference between the two products. Although reverse mortgages may seem similar to negative amortization products in that the original balance is usually exceeded by the then current balance, reverse mortgages are specifically tailored for and only offered to borrowers that are 62 years or older and that live in the

mortgaged property. These loans are designed for the purpose of supplementing social security or to help borrowers meet unexpected medical expenses.[3]

Additionally, we are concerned that many of the proposed guidelines, especially those that deal with interest-only products, are too prescriptive and place restrictions on our member banks that would place them at a competitive disadvantage without providing a corresponding benefit. We recognize that regulated mortgage lenders such as banks are held to a higher standard than lenders who are not subject to comprehensive functional regulation. At the same time, however, we believe that the Proposed Guidance should more directly recognize that banks have substantial experience underwriting nontraditional products and have developed risk management procedures to ensure the soundness of their loan portfolios. Specifically, banks that take affirmative steps to manage the risks in their loan portfolios should, in appropriate situations, be allowed to depart from certain standards included in the guidelines. The particular standards at issue relate to borrower qualification standards, collateral dependent loans and reduced documentation.

Many of our member banks offer mortgage products that may fall within the Proposed Guidance's rubric of "nontraditional", but do not implicate the concerns cited in the Proposed Guidance. We believe that at least exemptions are appropriate.

First, it seems unnecessary to apply the guidelines to loans to high-net-worth individuals. To that end, private banking nontraditional mortgage portfolios should be exempted from the guidelines, especially where the loan-to-value ratio ("LTV ratio") is conservative (*e.g.*, 80% or less), non-real estate collateral is pledged, or where nontraditional mortgage loans are underwritten using traditional mortgage loan standards.

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[3] *See* Reverse Mortgages for Seniors, *available at*: http://www.hud.gov/buying.rvrsmort.cfm; Facts for Consumers; Reverse Mortgages, *available at*: http://www.ftc.gov/bpc/conline/pubs/homes /rms.htm.

Second, so-called "jumbo mortgages" should be exempted from any new guidelines. The jumbo market is relatively small in comparison to the market for "conforming mortgages" that are eligible for purchase by Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Jumbo borrowers are also less susceptible to the risks of payment shock contemplated by the Proposed Guidance. Jumbo borrowers tend to be affluent and more financially sophisticated and, therefore, better suited to evaluate the appropriateness of nontraditional mortgages and the ways in which they can mitigate their risks. They also have greater capacity to avoid payment shock by prepaying their loans in order to avoid increased interest payments.[4]

Third, we believe that the new guidelines should not apply to home equity lines of credit ("HELOCs") and second-lien closed-end home equity loans ("HELs"). Otherwise, the Proposed Guidance would overlap with the guidance issued by the Agencies last year with respect to our member banks' home-equity programs.[5] Those guidelines apply to both HELOCs and HELs. The purpose of those guidelines is to promote sound risk management, much like the Proposed Guidance. Therefore, our proposed exemption for these loans would avoid duplicative guidelines.

In addition to avoiding redundancy, the risk of payment shock is significantly lower for home-equity loans because the principal amount of the loan is generally lower in comparison to first mortgages. In the event of a significant increase in interest rates, borrowers can more easily absorb higher monthly payments.

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[4] Interest Rate Differentials Between Jumbo and Conforming Mortgages, Congressional Budget Office, note 33 (May 2001) (*citing* Patrick Barta, "Jumbo Mortgages? Not A Huge Problem," *Wall Street Journal*, December 7, 2000, p. C-1).

[5] Interagency Credit Risk Management Guidance for Home Equity Lending, Docket No. SR 05-11 (May 16, 2005).

We also believe that the Agencies' consumer protection goals will not be most effectively realized through the Proposed Guidance. The guidelines will affect only a portion of the market -- federally regulated institutions and their affiliates. Other industry participants, such as state regulated entities and unregulated brokers and originators, will not be subject to the Agencies' guidelines.

Currently, there are comprehensive Federal laws and regulations that govern a broader spectrum of the residential mortgage lending industry, including non-functionally regulated lenders. Indeed, many provisions in the Proposed Guidance that relate to disclosure incorporate requirements that have traditionally been regulated through the Truth in Lending Act ("TILA"),[6] Regulation Z[7] and the Real Estate Settlement Procedure Act ("RESPA").[8] We suggest that the most appropriate method to ensure the effectiveness of consumer protection initiatives and to ensure that our member banks are not placed at a competitive disadvantage is through amendments to already existing Federal laws and regulations, as opposed to adopting the consumer protection Proposed Guidance. Our member banks welcome the opportunity to work with the Agencies in devising constructive regulations that will benefit all consumers through a more inclusive approach that will not hinder the competitive mortgage marketplace and will ensure that all consumers and lenders realize the intended benefits.

We urge the Agencies to affirm that the guidelines will not be enforced as if they were new regulations. It is well settled that guidance issued by the Agencies cannot be the basis of a violation of law citation in a bank examination report. We urge the Agencies not only to reaffirm this position upon the issuance of any new guidelines, but to note that acting inconsistently with the Proposed Guidance does not create a presumption of an unsafe and

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[6] 12 U.S.C. § 3806 *et seq.*; 15 U.S.C. §§ 1604 and 1637(c)(5) (2006).

[7] 12 C.F.R. part 226 (2006).

[8] 12 U.S.C. § 2601 *et. seq.*; 42 U.S.C. § 3535(d) (2006).

unsound practice. As noted above, under certain facts and circumstances, departures from the guidelines would be entirely appropriate.

We also recommend that the Agencies provide a specific definition of the terms "nontraditional mortgages" and "collateral dependent loans," as those terms are used in the Proposed Guidance. We believe that these terms are subject to varying interpretations. For instance, in the Proposed Guidance, the Agencies describe collateral dependent loans as loans made to borrowers who "do not demonstrate a capacity to repay."[9] This description could be read to include reduced documentation or no documentation loans as a form of collateral dependent loan. In order to avoid confusion, we believe that these key terms should be defined with clarity and precision.

II. Loan Terms and Underwriting Standards

The Clearing House recognizes the need for banks prudently to underwrite residential mortgages. As such, banks should consider all relevant credit factors in accordance with applicable laws.[10] The Clearing House supports the view taken by the Agencies that banks should mitigate the portfolio risks of underwriting nontraditional mortgages. In many cases, borrowers who are approved for nontraditional mortgages should have compensating factors, such as lower DTI ratios or lower LTV ratios.

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[9] 70 Fed. Reg. 77253 (Dec. 29, 2005).

[10] *See* 12 C.F.R. Part 30 Appendix A (OCC); 12 C.F.R. Part 208 Appendix D-1 (Board); 12 C.F.R. Part 364 (Appendix A) (FDIC); 12 C.F.R. Part 570 Appendix A (OTC); and 12 U.S.C. § 1784 (NCAU).

There is, however, a crucial difference between sound underwriting and a requirement that lenders determine whether particular products are suitable for certain borrowers. Our member banks are concerned that provisions in the Proposed Guidance, such as the proposal that lenders consider future income, could be read to impose such a duty.[11]

The onus should not be placed on depository institutions to attempt to select the best product for a particular borrower. The primary purpose of lenders in the residential mortgage market is to assist consumers to purchase homes and consolidate debts. To that end, lenders have systems that determine whether borrowers qualify for certain products. If a borrower qualifies for multiple types of mortgage products, the borrower, not the lender, should select the type of loan that fits best.

A. Qualification Standards

We submit that the proposed methodology for determining a borrower's ability to repay a nontraditional mortgage is overly conservative and does not comport with current industry practices. Under the Proposed Guidance, an applicant's eligibility for a nontraditional mortgage would be based on the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.[12] To the extent that this methodology requires a depository institution to measure a borrower's long-term income potential, there is not only the absence of a reliable method, but the variables that are needed to calculate long-term income potential may be considered "prohibited bases" under the Equal

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[11] *See* 70 Fed. Reg. at 77251-52.

[12] *Id.* at 77252.

Credit Opportunity Act ("ECOA")[13] and Regulation B.[14] Additionally, it is very difficult to predict interest rate movements, particularly those that extend 20 or 30 years into the future.

Another concern is that the Proposed Guidance does not clearly indicate the rate that lenders should use to determine a borrower's eligibility for an interest-only loan. It is unclear whether lenders may use the initial rate, or a higher rate, based on the assumption that the rate will increase when it resets. The concern is magnified when one considers the effect the Agencies' guidance will have on the use of discount points that are used by consumers to lower mortgage interest rates. Of note, borrowers use discount points with fully amortizing fixed rate loans as well as ARMs and negative amortization loans. With ARMs, the discount points lower the interest rate during the initial period, before the rate is reset. If the Agencies will not permit lenders to underwrite loans at the rate that is in effect after taking the discount into account, then fewer consumers will qualify to obtain the funds needed to purchase new homes.

In many circumstances, using the fully indexed rate to determine whether an applicant qualifies for a loan simply does not reflect market realities and creates unduly conservative underwriting criteria. For instance, the average consumer who has a mortgage with an interest-only feature will never make a payment at the fully indexed rate, because market data indicates that consumers, on average, sell their homes or refinances into a different product approximately every five or seven years. Therefore, certain products, especially those with long interest-only periods (*e.g.,* 10 years), should be underwritten based on the effective rate during the interest-only period. The Clearing House agrees that certain mortgage products that offer short-term "teaser rates" should be underwritten at the fully indexed rate, but this practice should not extend to all nontraditional mortgage products.

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[13] 15 U.S.C. § 1601 *et seq.* (2006).

We also believe that the Proposed Guidance overstates the risks posed by mortgages with interest-only features and that these mortgages need not be underwritten using the fully amortized payment. Interest-only mortgages do not create any negative amortization, and it is unclear that these mortgages present a materially greater risk of default than ordinary ARMs. Based on current underwriting standards, a borrower that cannot qualify to refinance a mortgage with an interest-only feature once amortization begins will be equally likely to default on an ARM whose interest rate has been rising during the same time period. Because mortgages with interest-only features do not create the types of risks that are inherent in negative amortization loans, lenders should not be required to consider the fully amortized payment when evaluating an applicant's eligibility for such loans. In fact, we submit that ARMs with extended initial periods or interest-only periods, such as 3 or more years, should not be subject to the more stringent underwriting provisions that the Proposed Guidance suggests is appropriate for nontraditional products.

Under the comprehensive qualification standards contemplated by the Proposed Guidance, it appears that lenders must assume that borrowers will make only minimum payments on an interest-only loan until amortization begins. Under this methodology, interest-only products will underwrite more stringently than traditional fully amortizing loans. We believe that such a methodology is overly conservative and may even counteract the Agencies' goal to protect borrowers from payment shock. If lenders must assume that amortization will occur only once the interest rate is reset, then conservative interest-only products, with longer interest-only periods (*e.g.,* 10 years), will be harder to qualify for than products that have shorter interest-only periods. This will likely induce borrowers to select less conservative interest-only products where the risk for payment shock is greater because of the shorter initial interest-only period.

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[14] 12 C.F.R. part 202 (2006). Situations where a lender would implicate ECOA considerations is one where the borrower is over 55 years old and may not survive to make the last payment on a 30-year loan, or where the applicant lives in an area where employment is rising.

Therefore, we respectfully request that the Agencies allow lenders to assume that principal payments will be made during the entire life of the loan, as is the case with traditional fully amortizing loans.

Requiring lenders to underwrite nontraditional mortgages at the fully indexed rate, assuming full amortization, will not eliminate nontraditional mortgage offerings that do not meet this criterion. Rather, consumers will turn to alternative lenders, primarily unregulated mortgage companies, that are not bound by such underwriting standards. This will only exacerbate the volatility in real estate markets and might even destabilize some regional markets where consumers rely more heavily on nontraditional products, such as mortgages with interest-only features. Therefore, the consumer protections goals of the Agencies will not be realized.

B. Collateral Dependent Loans

Our member banks generally agree that it is unsafe and unsound to extend a mortgage to a borrower whose capacity to repay the loan is dependent on whether the borrower can sell or refinance the property once amortization begins. Nevertheless, we point out that private banking divisions that underwrite nontraditional loans commonly augment the underlying collateral with securities or other readily marketable collateral. We believe that, in private banking activities with high-net-worth customers, reliance on collateral, other than the home that is mortgaged, should not be deemed unsafe or unsound, and therefore, should not be subject to the special standards applicable to a nontraditional mortgage loan.

C. Risk Layering

We appreciate the Agencies' concern with the impact that risk-layering practices may have on consumers and on banks' loan portfolios. Generally, it is not prudent for lenders to put borrowers in situations of maximum-layered risk. From a practical perspective, however, neither the use of reduced documentation, nor the extension of a simultaneous second-lien loan, automatically means that a loan is more risky. In such situations, our member banks consider mitigants that support their underwriting decisions, such as lower LTVs or higher credit scores. Therefore, we respectfully submit that any guidance related to risk layering should not impose an absolute prohibition against such practices.

We urge the Agencies to continue to allow lenders to establish risk selection standards with the flexibility afforded by existing rules and guidelines. Under current rules, lenders can measure the risk of default based on various credit measures, such as credit/repayment history or debt-to-income levels. Although credit scores can be used as an alternative measure of the risk of default, we submit that a particular credit score should not predetermine that a loan is subprime or that certain loan features are inappropriate. We specifically stress that a credit score that distinguishes prime from subprime should not be the same for mortgage loans, whether or not traditional, and unsecured consumer loans.

The Clearing House does not agree with the notion set forth in the Proposed Guidance that it is always improper to underwrite interest-only loans with high LTV ratios, coupled with minimal borrower equity.[15] From a safety and soundness perspective, when banks offer such products, they often also use risk mitigants, such as pool insurance and securization.[16] Indeed, in previous guidelines, the Agencies recognized that pool insurance can be a sufficient credit enhancement that removes a high LTV designation where: (i) the policy is issued by an

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[15] 70 Fed. Reg. at 77253.

[16] Financial Institutions Letter-45-2005 (May 16, 2005) *available at* http://www.fdic.gov/news.press/2005/pr4405a.html

acceptable mortgage insurance company; (ii) it reduces the LTV for each loan to less than 90 percent; and (iii) it is effective over the life of each loan in the pool.[17]

From the consumer's perspective, interest-only loans allow consumers to realize significant cost savings without adding any more risk than would otherwise exist under a fully amortizing, fixed-rate loan. For instance, a borrower who qualifies for a fully amortizing fixed-rate loan, for more than 80% of the purchase price, must obtain private mortgage insurance ("PMI") at a significant cost that is not tax deductible. Alternatively, the borrower can obtain a HELOC behind a first interest only mortgage. This allows the borrower to avoid the cost of purchasing PMI and to recognize tax deductions for the interest paid on the HELOC. Of note, under both scenarios, the borrower's equity, or conversely, the amount of the borrower's risk exposure, remains the same. At the same time, pool insurance and securitization are available to lenders in order to mitigate the credit risk of such loans.

We are also concerned that the proposals regarding risk layering are too restrictive and could foreclose lenders' ability to serve certain segments of the market. In fulfilling responsibilities under the Community Reinvestment Act, insured depository institutions provide credit products to segments of the population that have previously been underserved in order to promote responsible home ownership. Banks often need to use risk layering features to make credit products available to those segments of the market. These features can be utilized without deploying those nontraditional mortgage products, such as negative amortization mortgages, that should be directed only to sophisticated borrowers.

D. Reduced Documentation

The growth of reduced documentation products has been driven by an increase in consumers' demand to process and close transactions expeditiously. We urge the Agencies to

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[17] *Id.*

recognize that various documentation practices contain varying levels of risk. Generally, mortgage loan documentation types range from "fully" documented to "no" documentation, with numerous variations in between (*e.g.,* stated income/verified assets, no income/verified assets, stated income/stated assets).

The riskiness of a loan cannot be evaluated solely on the level of documentation, but only on the basis of all the relevant considerations. Indeed, when borrowers request an eligibility decision based on reduced documentation, our member banks utilize more sophisticated underwriting models. These models are often supplemented with various credit enhancements, such as PMI and mortgage pool insurance, to mitigate the risk of reduced documentation products. Other common credit enhancing tools include the use of spread accounts, reserve accounts, or requiring overcollateralization for reduced documentation loans. For these reasons, it would be inappropriate to issue guidelines that automatically apply similar and more stringent underwriting guidelines for all types of reduced documentation loans.

III. Portfolio and Risk Management Practices

The Clearing House shares the Agencies' concern that negative amortization mortgage products present risks that necessitate conservative underwriting policies. In addition, even with such policies, the appropriate risk management analysis must be applied in terms of appropriate capital levels and reserves for loan losses, as well as close monitoring of portfolio concentrations. As discussed above, however, these specified considerations do not apply to all mortgage products deemed nontraditional.

A. Concentrations

The proposal to base concentration limits on loan types is problematic. There are today no generally accepted limits based on the type of products offered (*e.g.*, interest-only, reduced documentation, second lien, etc.). Rather, concentration limits are set exclusively by

each lender, based upon its internal risk assessment. These assessments include the level of geographic dispersion, which, if broad, allows a bank to maintain a diversified portfolio and mitigate collateral risk. Our member banks' continuing efforts to strengthen their credit quality standards has resulted in improved "FICO" distributions and strong LTV ratio cushions. Although some banks may not have formal concentration limits in place, proper portfolio management monitoring and reporting is in place to avoid issues associated with excessive concentrations.

We believe that adopting additional concentration limits of the types outlined in the Proposed Guidance could adversely impact programs designed to serve segments of the market that have been historically underserved. Often, borrowers that purchase residential properties located in traditionally underserved areas possess multiple risk attributes. Requiring concentration limits could also implicate fair lending issues by forcing banks to restrict access to credit for certain segments of the borrowing community.

B. Controls

The Clearing House banks generally agree with the concepts outlined in the Proposed Guidance with respect to a bank's quality control, compliance and audit procedures. The Clearing House is concerned, however, that the Proposed Guidance, as written, is overly prescriptive. We respectfully suggest that it should be more principles-based. Moreover, any additional audit and control requirements should reflect industry practices that monitor and control retail credit risk on a portfolio basis, not just on a loan by loan basis. For example, lenders engage in stress testing and monitor risk concentrations by reviewing segments of their portfolios, not by assessing individual borrowers and their future income potential. The ability to originate and manage consumer credit on a portfolio basis is essential to the continued development of the wide-spread, low-cost, consumer credit market that exists in the United States today.

C. Third-Party Originators

We do not question that, in originating loans via third-parties, a lender has the responsibility to monitor the activities of the third-party originator ("TPO"). Currently, the residential mortgage lending industry has numerous generally accepted requirements and controls for approving and monitoring TPOs. These include, but are not limited to: appropriate licensing; minimum experience requirements; minimum net worth requirements; public records searches; watch and exclude lists; fraud product screening; and regular quality control reviews where compliance data is tested.

The Proposed Guidance suggests that lenders should perform additional due diligence reviews on TPOs, especially as they relate to the TPOs' up-front marketing practices (*e.g.,* advertising). We urge the Agencies to reconsider imposing additional requirements. The market in which our member banks participate already contains safeguards that adequately protect lenders and consumers against the risk mentioned in the Proposed Guidance. Representations and warranties that typically appear in agreements with TPOs incentivize them to comply with applicable rules and protect the lenders from non-compliance with marketing or disclosure requirements. Moreover, it is not feasible for our member banks to monitor the marketing practices of all their correspondents. Most major lenders, including our member banks, purchase loans from thousands of correspondents and bulk sellers, who in turn may purchase loans from other correspondents. It would be impossible for our member banks to monitor the marketing practices of all their correspondents without significantly increasing the cost and time required to purchase loans from TPOs.

The problem is exacerbated when one considers provisions in the Proposed Guidance that could be read to impose similar due diligence requirements on securitizers. We respectfully request that securitizers not be required to ensure that all loans in their pools comply with the requirements of the Proposed Guidance. Securitizers have even less practical capacity

than their correspondents to control the marketing and disclosure practices of the originators of loans in their pools.

Currently, all mortgage brokers and correspondents must comply with TILA, and state-chartered entities must also comply with state advertising requirements. The foundation of TILA is that evidence of violations must appear "on the face" of the documentation when purchasing in the secondary market. In contrast, to comply with the Proposed Guidance, lenders would need manually to review documents beyond the loan files they purchase from TPOs. This would put an insurmountable burden on loan purchasers.

We would like to reiterate that amending TILA and Regulation Z is the best mechanism to achieve the most meaningful consumer protection. Any guidelines issued by the Agencies will only affect a portion of the market. Market participants that are not regulated by the Agencies will not be required to modify their practices. Consumers will most likely migrate to other lenders that continue to offer nontraditional products, and, in the process, put our member banks at a competitive disadvantage.

D. Secondary Market Activity

Lenders' effective use of the secondary marketplace as a risk management tool is evidenced by the robust liquidity of the U.S. mortgage market today. Unfortunately, the Proposed Guidance neglects to recognize the extent to which many lenders use the secondary markets to manage the credit risk in their loan portfolios. Indeed, many lenders' risk models are based on the fact that a majority of loans will be sold in the secondary marketplace shortly after origination. Often, lenders may underwrite loans that seem risky for the lender's portfolio but meet the secondary purchaser's risk tolerance.

We also strongly urge the Agencies to reconsider their assessment of the implicit recourse risk that exists in the secondary marketplace for both traditional and nontraditional

mortgage products. Absent some contractual obligation, banks rarely provide support to poorly performing pools. The Proposed Guidance incorrectly assumes that banks will rescue pools for the sole purpose of maintaining a good reputation in the secondary marketplace.

Based on the fact that banks rarely repurchase loans from underperforming pools absent some contractual obligation, we respectfully disagree with the suggestion that the potential for recourse is greater for pools of nontraditional products. It is important to note that only sophisticated investors purchase mortgage-backed securities, and they typically do so on a fully disclosed basis. These investors are made aware, and have the ability to understand, the risks that exist in pools containing nontraditional mortgage products. Therefore, we do not believe that depository institutions or their affiliates would feel pressured to rescue such pools in the event that defaults exceed investors' expectations.

E. Stress Testing & Management Information and Reporting

We respectfully submit that the Agencies permit our member banks to exercise their judgment in creating and applying stress testing models. Although our member banks' stress testing models do not include all the factors mentioned in the Proposed Guidance, they adequately identify, monitor and manage portfolio risks. Consideration should also be given to the fact that creating stress-testing models is a subjective process that requires the exercise of judgment. Moreover, we request that the Agencies acknowledge that the sophistication of a lender's management information and reporting systems should be commensurate with the size and risk of the lender's portfolio.

F. Capital and Allowances for Loans and Lease Losses

We believe that requiring lenders to consider particular product features when establishing a reserve methodology conflicts with existing accounting policies and industry

standards.[18] Our member banks continuously review the adequacy of their capital and loss reserves and are guided by their vast experience in the industry and an extensive body of existing rules and guidelines. To the extent that an institution's portfolio is exposed to additional risk, lenders are well suited to use their judgment to establish additional reserves.

IV. Consumer Protection Issues

We agree that lenders should provide consumers with clear and concise information about the relative benefits and risks of loan products. As the types of mortgage offerings continues to expand, the industry must find new ways to provide consumers with timely, clear and concise information that is relevant to their decision-making process. To that end, our member banks believe they are at the forefront in the effort to improve consumer protection best practices.

That being said, we are concerned that the Proposed Guidance requires lenders to attach a warning label on particular mortgage products. This may unnecessarily confuse borrowers and cause them to overlook the benefits of certain nontraditional products. Ultimately, it is the borrower's responsibility to weigh the benefits and risks associated with various loan products and choose the appropriate product.

As we discuss above, there are already comprehensive Federal laws and regulations related to consumer protection issues that govern all participants in the residential mortgage lending industry, including TILA, Regulation Z and RESPA. Therefore, to ensure the effectiveness of consumer protection initiatives and to ensure that our member banks are not placed at a competitive disadvantage, we suggest that the proper method to enhance disclosure requirements is through amendments to already existing Federal laws and regulations. For

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[18] *See* FASB Staff Position SOP No. 94-6-1, Terms of Loan Products That May Give Rise to a Concentration of Credit Risk (suggesting that any such concentrations should be dealt with by disclosure rather than through the reserve).

instance, the Agencies' proposal that consumers receive certain information when they are shopping for a mortgage and the proposal regarding advertising requirements both overlap with the ARM product description required under TILA and Regulation Z.

Particularly problematic is the Agencies' proposal that certain advertising material contain specific terms that trigger additional requirements under TILA. For instance, under the Proposed Guidance, where lenders disclose the benefits of nontraditional mortgages, they must also disclose the amount of payments and the timing of those payments.[19] Under TILA, if such disclosures are made, then additional, more comprehensive disclosures must also be provided. The Proposed Guidance should be modified so as not to require the use of TILA trigger terms in advertising. Alternatively, those requirements should be taken out of any guidelines issued by the Agencies and instead incorporated as amendments to Regulation Z.

The Clearing House banks are also concerned with the Agencies' proposal that monthly statements for payment option ARMs include detailed information about a borrower's payment options.[20] This would be very expensive to implement and the quantity of information on each monthly statement may confuse the borrower. There are better approaches to provide borrowers with payment option information. Loan servicers can provide payment option information on their websites, with a reference to the website link on the monthly payment statement. Alternatively, payment option information can be provided to borrowers periodically, as a separate mailing, or as a separate page enclosed with the monthly statement. Another alternative is to allow our member banks to provide borrowers with general payment option information that does not specifically describe each borrower's mortgage features.

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[19] 70 Fed. Reg. at 77256.

[20] 70 Fed. Reg at 77256.

Additionally, we respectfully request that the Agencies grant a 24-month transition period for our member banks to adapt their systems and forms to any new monthly statement requirements.

V. Specific Questions Raised by the Agencies

As requested in Section III of the Proposed Guidance, we submit the following responses to the three specific questions raised by the Agencies. These responses supplement the relevant discussions that appear in the other sections of this Comment Letter and should be read in conjunction with those discussions. For ease of reference, each response is preceded by the question that it addresses.

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?

As stated in Section II.A of this Comment Letter, under the proposed comprehensive debt service qualification standards, interest-only products will be underwritten more stringently than traditional fully amortizing loans. We believe that such a methodology is overly conservative and may even counteract the Agencies' goal to protect borrowers from payment shock. If lenders must assume that amortization will occur only once the interest rate is reset, then conservative interest-only products, with longer interest-only periods (*e.g.*, 10 years), will be harder to qualify for than products that have shorter interest-only periods. This will induce borrowers to select less conservative interest-only products where the risk for payment shock is greater because of the shorter initial interest-only period. Moreover, it is likely that unregulated mortgage companies that are not bound by such underwriting standards will continue to aggressively market interest-only products, putting our member banks at a competitive disadvantage.

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.

As discussed in Section II.D of this Comment Letter, the riskiness of a loan cannot be evaluated solely on the level of documentation, but only on the basis of all the relevant considerations. Likewise, the appropriateness of low or no documentation loans cannot be reduced to a single or multiple specific standards, but must take into account the combination of all the relevant factors. At the same time, a reduced documentation loan often introduces an element of risk, and, accordingly, when borrowers request an eligibility decision based on reduced documentation, our member banks utilize more sophisticated underwriting models or various credit enhancements, or both. These credit enhancements, such as PMI and mortgage pool insurance, serve to mitigate the risk of reduced documentation products. Other common credit enhancing tools include the use of spread accounts, reserve accounts, or requiring overcollateralization for reduced documentation loans. For these reasons, it would be inappropriate to issue guidelines that automatically apply similar and more stringent underwriting guidelines for all types of reduced documentation loans.

With specific reference to the "stated income" feature, it is often used when the borrower's line of work does not produce regular paychecks in the normal sense, such as seasonality. It is also usual when a borrower has a high net worth, a high FICO score, or where the borrower pledges marketable securities as additional collateral. Some lenders also verify the reasonableness of the stated income through online resources that track employee compensation data. Under certain "stated income" verification methods (*e.g.,* stated income/verified assets),

lenders continue to use traditional methods to verify a borrower's assets, such as requiring the borrower to provide a copy of the two most recent bank statements.

With respect to subprime borrowers, reduced documentation loans can be appropriate in circumstances where there is as a relatively low LTV ratio or where the lender uses mortgage pool insurance.

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 rate for adjustable rate mortgage products?

As stated in Section II.A of this Comment Letter, it is not feasible for lenders to base qualification decisions on future events, such as income growth or future interest rates. There is not only the absence of a reliable method to determine a borrower's long-term income growth, but the variables that are needed to calculate long-term income potential may be considered "prohibited bases" under the ECOA and Regulation B. Additionally, the realities of interest rate movements make it extremely difficult to predict interest rate movements, particularly those 20 or 30 years into the future. Indeed, the recent phenomenon of a flattening and inverted yield curve, partly caused by the increased participation of foreign institutions and hedge funds in the U.S. bond market, makes predicting interest rate movements even more difficult.

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Thank you for considering the views expressed in this letter. If the Agencies would like additional information regarding this letter, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Very truly yours,