CONSUMER MORTGAGE COALITION

March 27, 2006

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Re: Docket No. 05-21, 70 Fed. Reg. 77249 (Dec. 29, 2005)

Dear Sir or Madam:

The Consumer Mortgage Coalition (the "CMC"), a trade association of national residential mortgage lenders, servicers, and service-providers, appreciates the opportunity to submit these comments on the Interagency Guidance on Nontraditional Mortgage Products proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (the "Agencies"). The proposed Guidance would address underwriting standards, portfolio

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and risk-management practices, and consumer protection standards related to "nontraditional mortgage products," including interest-only and payment-option loans.

The CMC supports many aspects of the Guidance. We support the decision to provide this guidance on an interagency basis, although we believe that any new disclosure or other consumer-protection requirements should apply to all lenders, including those that are not affiliated with regulated entities, in order to be effective and as a matter of competitive equity. We support the issuance of these requirements as guidance rather than regulations and the decision to seek public comments, both of which should be helpful in ensuring that the Guidance meets its goals while minimizing the burden on industry and consumers.

As to the substance of the proposed Guidance, the CMC agrees with the Agencies that a loan with an aggressive short-term "teaser" rate should be underwritten at the fully-indexed rate, which reflects current industry practice, but are concerned that this concept should not be extended to require all loans to be underwritten at the long-term rate or assuming fully-amortized payments, regardless of the period to which the initial rate applies. We agree that the added risk that may be created by nontraditional features should be balanced by features that mitigate risk such as better debt-to-income and loan-to-value ratios. Such weighing of factors is already the practice of responsible lenders. We agree that "layering" of risks demands more conservative underwriting, although we note that not all loans with more than one risk factor truly involve "layered" risk.

At the same time, however, we are concerned that some aspects of the Guidance would have a negative effect on both regulated institutions and consumers. Among other things:

- The thrust of the Guidance is to impose suitability requirements analogous to requirements for broker-dealers for nontraditional mortgage products, in which lenders would be expected, for these products only, to undertake a comprehensive review of the borrower's financial situation and to refuse to make a loan to a consumer if the lender found that the loan was not in the consumer's best interest. Although we strongly support efforts to improve consumer understanding, once the consumer understands the available options, the consumer should be allowed to decide which product best meets his or her needs. The guidance should not require institutions to impose their opinions on consumers.

- Although we agree that consumer comprehension is essential, we do not believe that safety-and-soundness guidance for regulated institutions is the appropriate location for detailed disclosure requirements. If additional disclosures are to be required, they should apply to all lenders, not only institutions and their affiliates that are subject to examination by the Agencies, and they should protect all consumers. Moreover, the new proposed disclosures would be superimposed on the extensive existing framework of required consumer disclosures for mortgage products. These extensive disclosures, which would not be required for other products, would bias consumers against these products, even when they are advantageous for them. The disclosures could cause "information overload" that confuses rather than helps consumers.

- The Guidance departs from previous interagency guidance in the level of detail of the proposed requirements and the lack of consideration of best practices in portfolio management. We believe that the Guidance should be just that – suggestions that can be tailored to each lender's, and each borrower's, situation, rather than a series of rigid rules.

Background: Nontraditional Mortgage Products Can Reduce Risk to Consumers and Lenders

Although the proposed Guidance recognizes that nontraditional mortgage products can be beneficial to many consumers, the Agencies appear to assume that nontraditional mortgage products are inherently riskier than the alternatives that may be available to a consumer. We believe that nontraditional mortgage products, if properly managed, can reduce rather than increase the risks to the consumer.

All loans involve a balancing of risks and rewards to the consumer. For example, a consumer who chooses an adjustable-rate mortgage ("ARM") is making a tradeoff between the certainty of a fixed rate and, in most cases, the lower average rate and total cost of loan available with an ARM. Conversely, a consumer who chooses a fixed-rate loan usually makes higher initial payments in exchange for the security of a guaranteed rate.

As the preamble to the proposed Guidance states, nontraditional mortgage products offer payment flexibility. This flexibility gives the borrower more control over his or her monthly expenses, which can reduce rather than increase the risk of default. It should not be assumed that greater flexibility — *i.e.,* a lower minimum payment — implies a higher risk. On the contrary, the lower payment allows the borrower to stay current during period of temporary financial difficulty. It also allows borrowers who have uneven incomes to manage their cash flow.

Similarly, although nontraditional mortgage products may increase the risk to lenders in some ways, there are other ways that they can reduce it. Any product creates risk-management challenges. The interest-rate risk from long-term, fixed-rate mortgages has been perceived by the regulators as so severe that banks and thrifts have generally avoided holding them in portfolio for many years. Nontraditional mortgage products should not be singled out as necessarily riskier than other products; they simply present different types of risks.

The goal of the underwriting process is not to prevent all defaults, but to evaluate the risk and make mortgage credit available at a price that reasonably reflects risk. Features of the Guidance such as the requirement to underwrite at the fully-indexed, fully-amortized payment, regardless of whether that is reasonable given the particular product and the borrower's particular circumstances, could discourage lenders from using automated underwriting systems and other methodologies that reduce overall risk and benefit consumers while making the mortgage-lending process more efficient.

Discussion

Scope of the Guidance

A threshold question is the intended scope of the Guidance. There is no explicit definition of a "nontraditional mortgage product" in the proposal, although it does refer to "residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest." *See* 70 Fed. Reg. 77249, 77251-52.

The mortgage industry has extensive experience with many products that contain elements that would appear to be labeled "non-traditional" by this guidance. In fact, for example, lenders have been offering both interest-only HELOCs and equity loans with a balloon feature in volume for decades without encountering either the safety-and-soundness or the consumer problems noted in the proposed Guidance. In addition, the risk of "nontraditional" features of those products is already covered in the existing interagency Credit Risk Management Guidance for Home Equity Lending. Based on the discussion in the proposal of products such as interest-only loans and "option-payment" ARMs, it appears that the Agencies' intent is for the Guidance to apply to first-mortgage closed-end residential loans that permit a significant deferral of repayment of interest or principal in the early years of the loan, followed by potentially substantially higher payments. As in previous issuances such as the 1999 and 2001 guidance on subprime lending programs, the final Guidance should clearly identify the situations that it covers.

Consumer Protection Issues

The proposed Guidance includes very broad new requirements for disclosures to consumers who are shopping for a nontraditional mortgage product, as well as on monthly statements. Although CMC supports the concept of disclosures for *all* loans — not just nontraditional mortgage products — at an early stage of the mortgage process, we believe that it is inappropriate to include specific disclosure requirements in the Guidance. The Guidance should be just that – a series of suggested best practices that individual lenders can adapt to their particular circumstances, not a set of detailed, mandatory disclosures. The Guidance should discuss a range of solutions to the issues presented and not mandate one particular approach.

In addition, although the Guidance would not itself create a private right of action, there is a risk that state courts would look to it in interpreting state unfair and deceptive acts or practices ("UDAP") statutes that allow consumers to bring suit against state-chartered institutions. This is an additional reason that the Guidance should not include specific consumer-protection requirements.

Coverage of Only a Portion of Entire Industry

Because these disclosures would only apply to regulated lenders, they would leave consumers exposed to misleading claims by the minority of lightly regulated lenders that have been the main source of abuse, while putting regulated lenders at a competitive disadvantage compared to other lenders. The proposed Guidance does not ensure consistent disclosure across the industry.

In order to compete in the marketplace and serve their customers, banks need to be able to offer innovative products. If the government decides, as a matter of policy, that certain products are unsuitable, that decision should apply to all lenders and protect all consumers. This implies that any changes to existing disclosures should be made through amendments to Regulation Z, or, if that is not possible, amendments to the Truth in Lending Act ("TILA") or rulemaking by the Federal Trade Commission ("FTC") and the Agencies.

Overlaps or Contradicts TILA Requirements

The shopping disclosures would overlap, and in some respects conflict, with the extensive disclosures of ARMs already required under TILA. *See* Regulation Z, 12 C.F.R. § 226.19(b). For example, the Guidance suggests that:

> [P]roduct descriptions could specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.

70 Fed. Reg. at 77256. The TILA program disclosures, by contrast, give lenders the option, which most lenders choose, of providing a historical example rather than a "worst-case" one. *See* 12 C.F.R. § 226.19(b)(2)(viii)(A). We believe that the historical example is more useful to consumers than the worst-case scenario, which could cause consumers to avoid nontraditional mortgage products that could be beneficial to them, or to switch from a regulated lender to an unregulated one that was not subject to the Guidance.

In addition, the proposed advertising requirements would overlap with TILA's advertising rules. Regulation Z, which implements TILA, already prohibits practices such as advertising rates that are not available and showing only an initial (often first month's) low interest rate without showing the annual percentage rate over the life of the loan. *See* 12 C.F.R. § 226.24(a) and (b). In addition to the potential for duplication of or conflict with existing rules, some of the new requirements could trigger requirements to disclose additional information in the advertisement under TILA and Regulation Z. TILA's existing rules already appear to have the effect of suppressing competition and limiting the information available to consumers, by making it so difficult to show all the required data that creditors avoid displaying any numerical information in their advertising, depriving consumers of important information about their mortgage loan alternatives.

Finally, as noted in the proposed Guidance, existing agency regulations or interpretations already prohibit UDAPs or misleading advertising. *See* 70 Fed. Reg. at 77255 n.14. To the extent that a practice is not addressed under the existing Regulation Z rules, it will often be covered by the broad prohibitions against UDAPs contained in existing agency issuances.

Unworkable "Suitability" Standard

References to "responsible choices," consumers "prudently consider[ing] the costs, terms, features, and risks of" nontraditional mortgage products mortgages in shopping for a loan, and the like, suggest that the Agencies believe that lenders should take responsibility for steering consumers in the direction of what the lender believes is the most responsible or prudent choice for the consumer. In other words, the Guidance appears to suggest a suitability standard similar to what broker-dealers must abide by under the securities laws.

Although we agree that lenders should not mislead consumers and should provide full disclosure of the material terms of the transaction, we do not believe it would be feasible or good policy to impose on the lender the additional burden of investigating each consumer's specific circumstances – beyond repayment ability – and recommending what the lender thinks is the best product. In contrast to a broker-dealer, a lender is advancing funds to, rather than receiving funds from, the consumer, and has a significant incentive to avoid making a loan if the borrower's record does not demonstrate both the capacity and willingness to repay. In addition, a lender is prohibited under various federal laws from asking certain information that could be important in determining the most suitable product, such as information about childbearing plans, and is limited in obtaining information about the consumer's medical condition. *See* Regulation B, 12 C.F.R. § 202.5(d)(3); Fair Credit Reporting Act, 15 U.S.C. § 1681b(g)(3). After the lender provides the consumer with a range of reasonable product offerings, it should be ultimately up to the consumer to select the option that best meets his or her needs.

Information Overload

The many additional disclosures proposed in the Guidance are likely to exacerbate the existing problem of "information overload" in mortgage disclosures. As then-Acting Comptroller of the Currency Julie Williams noted in January 2005:

> I worry . . . that [the] approach [of mandating disclosures] is on the verge of breaking down, and if it's not re-focused, more prescriptive legislation and regulation could result. And it's reached that point not because consumers are getting too little information, but because they are getting *too much* information that's not what they're really after; and because the volume of information presented may not be *informing* consumers, but rather *obscuring* . . . what's most helpful to their understanding of financial choices.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before Women in Housing and Finance and The Exchequer Club, Washington, D.C., Jan. 12, 2005, at 2 (emphasis in original). Ms. Williams went on to characterize, as a "*critical element*" of the issuance of any regulation mandating disclosures, the need to "test . . . *how consumers interpret* particular disclosures and how to make disclosures *usable* to them." *Id.* at 5 (emphasis in original). As suggested by Ms. Williams, before any new disclosures are considered, they should be thoroughly tested in studies supervised by

marketing professionals. The current TILA ARM disclosures are the result of a long process, in which Congress first mandated extensive worst-case disclosures and then cut back on those requirements in the face of evidence that, in addition to being burdensome to the industry, they were too complicated to be of much value to consumers. The Agencies should not repeat the error of overwhelming consumers with information rather than providing simple and comprehensible disclosures. Moreover, singling out nontraditional mortgage products for special disclosures is likely to convey the impression that these are especially risky and undesirable, compared to other products that may, in fact, not serve consumer's needs as well.

Unduly Burdensome Monthly Statement Requirements

The proposed Guidance would require extensive disclosures on the monthly statement for payment-option ARMs. Currently, federal law does not mandate disclosures related to the terms of the loan on monthly statements for closed-end loans.

Like many of the other provisions of the Guidance, this is a burden that would be imposed on the subset of mortgage lenders that are regulated by the agencies. Because of space limitations and the need to comply with a variety of state-law requirements, redesigning a monthly statement to comply with these new rules would present formidable systems problems for many loan servicers. While CMC members and other mortgage servicers have devoted a great deal of energy to making their monthly statements as clear and understandable as possible, regulated institutions and their affiliates should not be subject to a new set of requirements that does not apply to their competitors.

Self-Testing Programs

The proposed Guidance suggests that lenders use mystery shopping and call monitoring to ensure that line employees are "communicating appropriate information." 70 Fed. Reg. at 77257. While lenders should consider these approaches as part of an overall compliance program, singling out nontraditional mortgage products for this special treatment is unwarranted for at least two reasons.

First, lenders should have as much flexibility as possible in designing their compliance programs. For example, call monitoring may be appropriate in a call center but not in a retail branch that is open to the public, in which consumers as well as employees could perceive it as an invasion of privacy. Second, requiring use of these methods for nontraditional mortgage products but not for other products with similar risk profiles would tend to discourage lenders from offering the nontraditional product, reducing its availability.

Brokers and Correspondents

The Guidance would require lenders to monitor the marketing activities of brokers and correspondents. Although the CMC agrees that a lender should not encourage or acquiesce in deceptive or abusive practices by brokers and correspondents, it is not realistic to expect wholesale lenders to be able to monitor marketing practices of their

retail counterparties. The wholesale players in the mortgage market generally have little or no information, other than copies of the disclosures, that would allow them to understand how retail brokers and correspondents marketed a loan that the lender purchased. Moreover, the monitoring requirement is not, on its face, limited to the originator or first purchaser but could apply to subsequent purchasers and investors, including securitizers, who are not equipped for this complex task.

Congress recognized this difficulty and generally limited the responsibility of assignees under TILA to violations apparent on the face of the documents. *See* 15 U.S.C. § 1641(a). Moreover, Regulation Z's advertising requirements apply to the "advertisement" rather than to the creditor on the note, and the FTC has generally proceeded against the entity that placed an advertisement that allegedly violated these requirements rather than against the creditor, which is often unaware that an advertisement was even placed. *See* 12 C.F.R. § 226.24. In appearing to mandate a direct role for lenders in ensuring that brokers and correspondents comply with the law, the Guidance would deviate from this pattern.

Suggested Alternative Approach

As an alternative to including detailed consumer-protection requirements in the Guidance, CMC recommends the following:

- To the extent that additional consumer disclosures are deemed necessary, they should be required of all lenders, through amendments to Regulation Z or through coordinated action also involving the FTC and Department of Housing and Urban Development.

- As part of the process of revising Regulation Z, the Agencies should consider revising the "CHARM" booklet to address the benefits and risks of nontraditional mortgage products. They could also create an online calculator allowing consumers to compare the costs of different mortgage programs, including nontraditional mortgage products, under different interest-rate and prepayment scenarios.

Safety and Soundness Issues

Underwriting to the Fully-Indexed, Fully-Amortized Payment

The proposed Guidance is extremely prescriptive on safety-and-soundness issues compared to other Guidance. The most significant example of such "rule-like" provisions is the proposed requirement to underwrite to the fully-indexed rate and fully-amortized payment.

The CMC would not oppose a requirement that loans with an aggressive short-term "teaser rate" should be underwritten based on the rate in effect when the discounted rate expires, which is standard industry practice. But the Guidance would apparently require basing criteria such as the debt-to-income ratio on the fully-indexed rate and fully-amortized payment even when those terms do not apply until far into the future.

Such a requirement could have unintended consequences. For example, the effective maximum debt-to-income ratio for some nontraditional mortgage products would be drastically reduced in comparison to the ratio for other types of ARMs. This effect would be compounded because points paid to buy down the ARM interest rate generally apply only to the initial rate, resulting in an even greater increase in the payment after the initial period. Assuming that traditional products such as 3/1 or 5/1 ARMs are not covered by the guidance, requiring this type of "worst-case" underwriting would put nontraditional mortgage products at a significant competitive disadvantage. Current maximum debt-to-income ratios and other requirements, such as cash reserves, are set conservatively in relation to the borrower's current status, at a level designed to protect against the possibility of future temporary reductions in income or increases in other expenses.

Loan-Level Stress Test

The proposal to require underwriting to the fully-indexed rate and fully-amortized payment would, in effect, require that lenders apply a "stress test" to each individual loan, rather than to their entire portfolio. This "loan-level" stress test is unprecedented and, if taken literally, would drastically reduce the availability of nontraditional mortgage products. If the same approach were applied to traditional lending, it would also significantly reduce the amount of credit available. For example, no lender would make a 30-year fixed-rate loan to a 45-year-old couple if it had to establish that the borrowers would still be both alive and able to make the full payment at age 75. Lenders can prudently make long-term fixed loans, as they can prudently offer nontraditional mortgage products, because they have sophisticated models that allow them to manage their financial risk on a portfolio basis. Using these models, they can take into account the probability that the vast majority of loans will be paid off before the end of the term – thirty-year mortgages have an average duration of seven to ten years, despite the nominal loan term of thirty years. As the Agencies are aware, in nontraditional loans as in other mortgage loans, borrowers have the option of paying off the loan at any time, and they do so for a variety of reasons, including sale of the residence, cashing-out equity, or moving from a variable to a fixed rate.

In addition, mandating underwriting based on the fully-indexed rate and fully-amortized payment would effectively require more conservative underwriting for less risky loans. Lenders generally regard an interest-only feature as reducing the credit risk, much as the length of time that the interest rate is fixed in a hybrid ARM decreases the risk, because it lessens the impact of monthly mortgage payments on the borrower's cash flow if his or her income is reduced or other expenses increase. Under the proposal, however, a 10/1 hybrid ARM in which the loan does not begin amortizing until after the ten-year fixed period would require more conservative underwriting than a less risky 3/1 ARM with amortization beginning after three years.

Valid stress-testing, which lenders should and do conduct for their entire portfolio, makes reasonable worst-case assumptions for default and runoff rates. The Guidance should clarify that the need to consider the borrower's ability to absorb higher payments does not require unrealistic assumptions about the whole portfolio, and, in particular, lenders can consider reasonable, although still worst-case, default rates and assume that many loans will be paid off before amortization begins.

Lower-Documentation Loans and Risk-Layering

Although we agree with the general concept that there should be balancing factors when a lender accepts a lesser level of documentation, we are concerned that some of the examples could be misunderstood by examiners. For example, the preamble to the proposed Guidance refers to "over-reliance on credit scores as a substitute for income verification in the underwriting process" as risk increases. 70 Fed. Reg. at 77252. This could be interpreted as an absolute ban on placing significant emphasis on credit scores in higher-risk loans, regardless of other features of the loan or the borrower. Examiners should be directed to evaluate the whole range of a lender's criteria in determining whether a specific program feature such as a relaxed documentation requirement is justified under the circumstances.

We support the indication in the "risk-layering" section that "[m]itigating factors might include higher credit scores, lower LTV and DTI ratios, credit enhancements, and mortgage insurance," but are concerned that it could be read to bar lenders from making, for example, nontraditional low-documentation loans above a certain loan-to-value ratio, regardless of the specific circumstances.

Implicit Recourse

The proposed Guidance includes a reference to the requirement in the Agencies' risk-based capital guidelines that certain repurchases of defaulted mortgages be treated as "implicit recourse," requiring "that risk-based capital be maintained against the entire portfolio or securitization." *See* 70 Fed. Reg. at 77254. As drafted, the language could be read as providing for stricter capital treatment of "implicit recourse" with respect to pools and securitizations backed by nontraditional mortgage products than for other loans. We do not believe that this is the Agencies' intent. The agencies could clarify this point by redrafting that language as follows:

> While sale of loans to third parties can transfer a portion of the portfolio's credit risk, an institution continues to be exposed to reputation risk that arises when the credit losses on sold loans or securitization transactions exceed expected losses. In order to protect its reputation in the market, an institution may determine that it is necessary to repurchase defaulted mortgages. It should be noted that, as provided in the Agencies' risk-based capital guidelines, "[r]ecourse may . . . exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold." Institutions should consult those guidelines for a detailed explanation of the capital treatment of "implicit recourse" when they provide support to collateralization pools. ~~the repurchase of mortgage loans beyond the selling institution's contractual obligations is, in the Agencies' view, implicit recourse. Under the Agencies'~~

~~risk-based capital standards, repurchasing mortgage loans from a sold portfolio or from a securitization in this manner would require that risk-based capital be maintained against the entire portfolio or securitization.~~

Answers to Specific Questions

Although we have addressed our primary concerns with the proposed Guidance in the discussion above, we are also answering the specific questions raised in the request for comments.

(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 noted above, an appropriate stress test would not assume that every single borrower would make only minimum payments over the life of the loan, but would make appropriate assumptions about the worst-case proportion of borrowers who would actually experience payment shock. For example, a lender should be able to make reasonable, although conservative, assumptions about how many borrowers with a payment-option loan: (1) will not have opted to amortize their loan; (2) will still be borrowers when the higher, amortized payments apply and (3) will not then be able to afford those payments. Payment shock will not be an issue if the borrower pays off the loan during the initial period, which is often the case, and lenders should be allowed to recognize runoff rates.

(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.

This question appears to assume (as does the proposed Guidance) that combining a nontraditional mortgage product with other "nontraditional" features such as "stated income" automatically involves "layering" of risk rather than an assessment of separate risks. In fact, the use of "stated income" in combination with a nontraditional mortgage product such as an interest-only or payment option ARM is a good example of why this might not be true. "Stated income" is often used to spare self-employed borrowers from onerous documentation requirements, in situations whether other factors, such as credit score and initial equity, indicate low risk. A lower payment during the early years of the loan, a common feature of nontraditional mortgage products, allows a self-employed borrower to devote resources to building the business rather than to paying down a mortgage and makes it easier to cope with an uneven cash flow. Thus, in this example, a

nontraditional mortgage may be less risky for a "stated income" borrower than a traditional ARM or a fixed-rate loan.

The recent *Ameriquest* settlement specifically authorizes stated-income loans to any borrower, including non-prime borrowers, subject to specific disclosures and other protections. Although we oppose any blanket limitation on stated-income loans, the agencies could consider noting that lenders should understand the borrower's reasons for selecting a stated-income or other low-documentation loan. For example, a borrower with a W-2 and easily verified income who is still motivated to pay a higher rate for a stated-income loan may raise suspicions that he or she does not really earn the claimed salary.

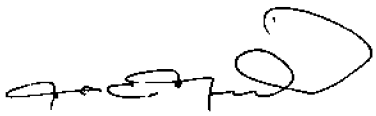
(3) Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?

Requiring lenders to consider repayment ability far into the future for nontraditional mortgage products would be a departure from current practice for other loans, and is unnecessary for proper risk management. As noted above, if the same approach were applied to the traditional 30-year, fixed-rate loan, many current borrowers could not qualify, despite the continued very low default rate on such loans.

* * *

We appreciate the opportunity to present our views. Please do not hesitate to call (202) 544-3550 with any questions.

Sincerely,



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