H e m i s p h e r e   N a t i o n a l   B a n k

March 29, 2006

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop I-5
Washington, DC 20219
E-Mail Address: regs.comments@occ.treas.gov

Re: OCC Docket No. 05-21

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
E-Mail Address: regs.comments@federalreserve.gov

Re: FRB Docket No. OP-1246

Ladies and Gentlemen:

We appreciate the opportunity to comment on the proposed Interagency Guidance on Nontraditional Mortgage Products (the "Guidance"), which was jointly issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (collectively, the "Agencies") on December 20, 2005.

Overall, Hemisphere National Bank's (the "Bank's") reaction to the proposed Guidance is favorable. We believe that the proposal represents a balanced and appropriate supervisory response to significant issues raised by the growing popularity of interest-only mortgages and payment option adjustable rate mortgages. We commend the Agencies for their willingness to address what may be a controversial subject. At the same time, there are a few specific areas where we believe that final Guidance should be clarified. After providing some background information regarding the Bank, we provide our specific comments on the proposal.

1. Background

Hemisphere National Bank is a national bank with approximately $321 million of assets as of December 31, 2005. The Bank is a wholly-owned subsidiary of Privee Financial, Inc. and Privee LLC, both registered bank holding companies. An important part of the Bank's business consists of the origination of residential mortgage loans, most of which are sold to Freddie Mac and others in the secondary market. The Bank retains the servicing on the mortgage loans it originates. Virtually all of the Bank's mortgage loans are originated in the competitive Florida, California, New York, New Jersey and Connecticut markets. The Bank also engages in conventional deposit taking, commercial lending and related banking activities.

A significant portion of the Bank's residential mortgage lending consists of "stated income, stated assets" ("SISA") and "stated income, verified assets" ("SIVA") loans. The Bank has developed a highly sophisticated business model for the origination and servicing of these loans and our senior mortgage executives have many decades of experience with this type of lending. The Bank has found that these loans perform extraordinarily well. The record speaks for itself – in 2005, the Bank originated $266 million of residential mortgage loans and experienced only four 30-day delinquencies, two of which were directly linked to hardships caused by Hurricane Wilma. All four delinquencies were cured within a short number of days. To date, we have had no serious delinquencies, bankruptcies or foreclosures. In 2005, the Bank's average loan was for $350,000, our average loan-to-value ratio was 64%, and our borrowers had an average FICO score of 715. Our performance and the quality of our SISA and SIVA loans far surpass the U.S. mortgage industry's record for full documentation mortgage loan products. Thus, we are able to offer our comments on the proposed Guidance based on a wealth of successful experience with the origination and servicing of SISA and SIVA loans.

2. Use of the Term "Nontraditional Mortgage Loan"

The proposed Guidance refers to loan products that allow consumers to defer repayment of principal and/or interest (such as interest-only mortgages and payment option adjustable-rate mortgages) as "nontraditional mortgage loans." We recommend that the Agencies choose a more appropriate term for these mortgages, such as "deferred repayment mortgage loans."

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To our knowledge, the only parties that have prominently used the term "nontraditional mortgage loans" to refer to these products are the Agencies themselves. This term improperly suggests that these products are relatively new entrants in the residential mortgage market. In fact, as noted in the proposed Guidance, these loan products have been "available in similar forms for many years." Negative amortization loan products became widely available in the early 1980's and interest-only loan products became available decades earlier. Today, these products represent a large percentage of the mortgage loans made in the Nation, particularly in states such as California that have high property costs[1]. Labeling loans as "traditional" or "nontraditional" does not help a consumer understand the product's characteristics. In addition, the term "nontraditional" may be regarded by some as pejorative, which is inappropriate given the popularity of these products with borrowers across the country. We think that a more neutral, descriptive and accurate term is "deferred repayment mortgage loan."

3. Interest-Only Mortgages And Payment Option Adjustable Rate Mortgages

The proposed Guidance provides an analytical and thoughtful examination of the heightened risks associated with interest-only mortgages and payment option adjustable rate mortgages. While we may quibble with some individual elements of this discussion, overall we believe that the Agencies have gotten it right. For most consumers, these loan products are unduly risky, are not well understood, and therefore are inappropriate. We are concerned that the products being marketed to the mass audience will not withstand stress testing, and that any significant increase in interest rates and/or decrease in property values will have unfortunate financial consequences for depository institutions and consumers alike.

The Bank makes a small number of agency-qualified interest-only loans each year, but does not offer negative amortization loans (which we believe are too risky for our institution at this time). Based on our experience that deferred repayment loan products can be soundly underwritten and offered to suitable borrowers, we believe that the final Guidance should not restrict depository institutions from offering those products to the small subset of consumers who can truly understand and afford them. Many consumers who meet the traditional qualifications of a financially sophisticated high net worth customer will be well suited for these types of products. Those consumers are better able to understand the relative benefits and risks of the products and have the financial strength to withstand the changes in rates, property values and economic conditions that may occur during the term of their loans. The final Guidance should make clear that

[1] A *Los Angeles Times* article dated April 11, 2005 reported that interest-only loans were used in about a third of home purchase transactions nationally, and 48% of home purchase transactions in California, in 2004.

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depository institutions continue to have the flexibility to offer these products without restriction to such consumers.

4. **Reduced Documentation Loans**

The proposed Guidance does not characterize reduced documentation loans as unsuitable mortgage products, but rather states that deferred repayment mortgage products that are combined with risk-layering features such as a simultaneous second-lien loan pose increased risk. The proposed Guidance proceeds to discuss the nature of this risk and describes the risk mitigation practices that depository institutions should follow with respect to reduced documentation programs. While the Bank does not quarrel with the proposed Guidance's treatment of deferred repayment loan products that are risk layered, we feel most strongly that this treatment must be explicitly limited to deferred repayment mortgage loan products. To this end, the final Guidance should make clear that the cautions discussed in respect to reduced documentation loans do not apply to reduced documentation loans that do not constitute unsuitable or risky mortgage loan products. We offer the following in support of our position:

Clearly there is significant risk in lending practices that expose borrowers to products that lack suitability given their financial resources. On the other hand, lending practices that may put the lender at some financial risk as a result of inaccurate representations by the borrower can be, and have historically been, mitigated by lender due diligence processes. The guidance is correct to single out interest only, option arm, and negative amortization practices as those posing the highest risk to both consumers and to financial institutions.

Moreover, banks have developed systems to analyze and underwrite credit for reduced documentation mortgage loans very successfully, and there is an extensive track record to prove this. The Bank's mortgage executives, for example, have over 21 years experience offering SISA/SIVA products, and the loan loss rates over that period of time have ranged from 1-5bps. For more than a decade through a variety of housing and interest rate markets, banks have successfully insulated themselves from the potential risks of SISA/SIVA mortgage products.

However, banks have historically been less able to insulate themselves from losses associated with high loan to value loans. Moreover, there is not enough of a track record to opine as to the default probability of new products such as option ARMS and interest only loans. Common sense dictates, however, that it is difficult for highly leveraged borrowers to mitigate future negative variations in interest rates or declines in housing prices. Only lower LTV products and/or fixed rate products would mitigate that risk.

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Therefore, reduced documentation loans that are not incorporated into deferred repayment mortgage loan products are, by definition, not risk-layered and therefore do not present the same high risks that are referenced in the proposed Guidance. As discussed in Part 1 of this letter, while a significant portion of the Bank's residential mortgage lending consists of SISA and SIVA loans, these loans perform extraordinarily well – in fact, far better than full documentation mortgage loans. Once again, this is consistent with the experience of mortgage executives at other banking institutions, who have had the opportunity to observe the performance of these loans under a wide range of economic conditions and interest rate environments.

The key to our record of performance is the sophistication of our underwriting model, combined with our high FICO scores (in 2005, an average of 715) and low loan-to-value ratios (in 2005, an average of 64%). In underwriting applications for SISA and SIVA loans, for example, the Bank uses credit scores from multiple sources, uses third party data bases to identify and root out fraudulent applications, subjects each appraisal to a strong appraisal review process, and employs a judgmental underwriting system in addition to its credit scoring model. Both the Bank and other depository institutions should have the flexibility to offer, without limitation, reduced documentation products that are not incorporated into deferred repayment mortgage loan products and that are of such quality.

It is important to note that reduced documentation loans are important and necessary in order to meet the needs of a growing number of consumers. The residential mortgage market has changed dramatically over the past 20 years. The Nation has far more consumers who are self-employed or otherwise have less conventional income streams and assets. As a result, the Bank has found that there are many consumers who are financially strong and willing to pay their loans on time, but are unable to produce the financial documentation required by traditional underwriting standards. The Bank is able to perform specialized underwriting to meet the needs of these consumers, and the Bank is able to verify taxable income where it is necessary to do so. Reduced documentation loans made by the Bank and others to these consumers are purchased by Freddie Mac, Fannie Mae and others in the secondary mortgage market. In short, reduced documentation loans are now part of the mainstream and should not be regarded as exotic. To continue to meet the legitimate mortgage needs of a growing number of consumers, the Bank and other depository institutions require the ability to offer their reduced documentation products. Where those reduced documentation characteristics are not incorporated into deferred repayment mortgage loan products, depository institutions should not be hampered by the restrictions that will be set forth in the final Guidance.

Finally, reduced documentation products are necessary in order to meet the credit needs of low and moderate income communities. We cannot ignore the fact that many of the consumers who obtain reduced documentation loans are small business owners and their

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employees. It is not usual for these consumers to work two, three or more jobs, as do their family members. They frequently change jobs multiple times each year. These individuals often live in low and moderate income communities, many residing in inner city neighborhoods. Many of these consumers are also members of protected classes. Small business owners and their employees with such characteristics frequently have complex financial situations and cannot qualify for full documentation mortgage products. However, they can qualify for reduced documentation loans. By providing reduced documentation loans to small business owners and their employees, the Bank and other depository institutions are able to meet the credit needs of the low and moderate income communities in which those individuals live and work. Where the reduced documentation loans are not incorporated into unsuitable mortgage products, depository institutions should not be precluded from meeting the credit needs of these individuals and their communities by the restrictions that will be set forth in the final Guidance.

In summary, we feel strongly that reduced documentation loans are legitimate products that meet the needs of a growing number of U.S. consumers, including those in low and moderate income communities. When these loans are underwritten properly, they are made with low risk. The Bank and other depository institutions must have the continued ability to offer these loans to deserving consumers. Accordingly, we request that the final Guidance make clear that its discussion of the risks of reduced documentation loans and the related risk mitigation steps are explicitly limited to unsuitable deferred repayment mortgage products and do not apply to reduced documentation loans that do not qualify as nontraditional mortgage products.

5. Regulation of Mortgage Bankers and Mortgage Brokers

The majority of U.S. residential mortgage loans are made by non-depository institution mortgage bankers that will not be subject to the final Guidance. A large, and growing, percentage of mortgage loans are originated through mortgage brokers, who also will not be subject to the final Guidance. We recognize that the Agencies must discharge their statutory responsibilities by causing depository institutions to offer deferred repayment mortgage loans in a safe and sound manner, regardless of the practices of unregulated mortgage bankers and mortgage brokers. Nevertheless, in preparing the final Guidance we ask the Agencies to be mindful that the Bank and other depository institutions compete directly with these unregulated entities. As discussed above, the Bank offers a legitimate, valuable and sustainable loan product that provides financing to deserving consumers who cannot qualify for full documentation products, thereby strengthening the communities in which they live. If the final Guidance is excessively broad in scope, neither the Bank nor other depository institutions will be able to meet this credit need, and many of these consumers instead will obtain predatory loans from unscrupulous lenders that are not regulated. We implore the Agencies to protect these consumers by

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issuing a final Guidance which does not impose restrictions on SISA and SIVA loans that unless these are packaged with deferred repayment mortgage loans.

* * *

Once again, we are grateful for the opportunity to comment on the proposed Guidance. We hope that our comments are useful and will be given serious consideration in preparing the final Guidance.

Sincerely,

Walter R. Cook
Chairman and CEO

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