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March 29, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Attn: Public Information Room
Mailstop 1-5
Washington, DC 20219
Attn.: Docket No. 05-21

Robert E. Feldman
Executive Secretary
Attention: Comments
FDIC
550 17th Street, NW
Washington, DC 20429

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn.: Docket No. 2005-56

Re: Interagency Guidance on Nontraditional Mortgage Products

To Whom It May Concern:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments on the proposed Interagency Guidance on Nontraditional Mortgage Products.

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[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

Background

The banking regulators released proposed guidance to clarify how institutions can offer nontraditional loan products in a safe and sound manner and in a way that clearly discloses the potential risks that borrowers may assume. The proposed guidance could require banks that offer nontraditional loan products such as interest only and payment option adjustable rate mortgages to adjust loan terms and underwriting standards, as well as increase portfolio and risk management practices and consumer disclosures.

The banking agencies state that many of the risks associated with nontraditional loans exist in other adjustable rate mortgage products, but they are particularly concerned about nontraditional products due to the lack of principle amortization and potential accumulation of negative amortization. The banking agencies are concerned that these products and practices are being offered to a wider spectrum of borrowers; including some who may not otherwise qualify for traditional fixed rate or other adjustable mortgages and who may not fully understand their risks. These products accounted for less than 5% of all mortgage products in 2002 and 25% in 2005.

Examples of nontraditional mortgages include:

- Interest only loans that allow the borrower to pay lower initial monthly payments and in return no principle is paid the first few years. At the end of the period, the payment is raised to the fully amortizing level.

- Payment option adjustable rate mortgages that allow the borrower to choose from a variety of payment options. In addition to amortizing and interest only payment options, these option ARMs contain a minimum payment option, based on a "teaser" rate which doesn't cover the interest owed and can result in negative amortization. The borrower could end up owing more than originally borrowed. Borrowers could also experience payment shock when the initial "teaser" rate period is over. In some cases, payments could double after the promotional period.

Summary of ICBA Position

Nontraditional loan products make up only a relatively small amount of mortgage originations for many community banks but they view them as a useful financing option for certain borrowers. Some lenders have offered what are currently considered "nontraditional" products in a safe and sound manner for decades, demonstrating that there is a need for these types of loans. However, community bankers are very concerned about the proliferation and risks associated with nontraditional mortgage loans industry-wide. Bankers caution that the growth of these products, especially those that are underwritten hastily or poorly, can adversely affect the borrower, the lender, and the entire industry.

Community banks tell ICBA that they utilize very stringent underwriting standards for nontraditional loans and apply prudent risk management strategies. Community bankers believe that the proposed stress testing and segmenting as a risk

management practices are particularly burdensome for those institutions with a de minimus level of nontraditional mortgages. ICBA suggests a threshold level of nontraditional mortgage loans in the portfolio be met before a bank is required to stress test or segment.

General Comments

John M. Reich, Director of the Office of Thrift Supervision, in a recent speech to community bankers, said that "there is a market for these products in situations where the loan product is properly structured, fully disclosed, appropriately marketed, well underwritten, and safely managed." While possibly not appropriate for all borrowers, Reich pointed out that qualified candidates should not be deprived of homeownership opportunities by declaring this product off limits.[2] ICBA agrees. ICBA would also like to note that many institutions have offered nontraditional loans for decades in a safe and sound manner. These institutions have solid underwriting and risk management policies that are appropriate for these loans.

Generally, ICBA members say that they have not seen a large increase in demand by their customers in nontraditional loans in recent years. Many community banks do not offer nontraditional loans products and when they do, nontraditional loans generally comprise 5%-10% or less of originations. Community banks tend to lend conservatively and this is reflected in their usage of nontraditional products—nontraditional loans are not for the majority of borrowers, but there is a relatively small segment of borrowers that can benefit from nontraditional loans and should have those products available to them.

Community banks believe as long as these products are properly structured and underwritten conservatively, nontraditional mortgage products can be a good option for well qualified borrowers who understand the loan and are not risky to the borrower or lender in all cases. On the occasions that borrowers express interest in these loans, most community banks tell ICBA that they underwrite the loans to very conservative standards.

The proposed guidance would apply to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. ICBA applauds the regulators for including this statement to clarify that the proposed guidance applies as broadly as possible to the industry. We would like the regulators to encourage state mortgage regulators to adopt similar guidance to ensure there is a level playing field in the mortgage industry.

Loan Terms and Underwriting

The agencies warn that underwriting for nontraditional loans should consider the impact of a substantial increase in payment on the borrower's ability to repay. Banks should have sound qualifying standards in place that recognize the potential impact of

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[2] Remarks of John M. Reich, Director, Office of Thrift Supervision, to the Independent Community Bankers of America, March 8, 2006, page 6.

payment shock. ICBA agrees. The low level of usage of nontraditional products by community banks demonstrates their conservative approach to these products. When they do offer them, community banks compensate the risk of nontraditional loans with more stringent underwriting, requiring higher credit scores, income, savings, and lower loan to value ratios.

The agencies suggest that banks qualify borrowers for the fully indexed rate after the introductory period based on the full amount of the loan, including balances through negative amortization. This practice is consistent with most current underwriting standards that community banks employ. In most cases, this is a good way to mitigate the additional risk. A good underwriter will always take this information under consideration when approving a nontraditional mortgage loan.

Further, the banking agencies want banks to use caution when allowing borrowers to provide reduced documentation, particularly unverified income. If borrowers are allowed to provide reduced documentation, community banks will often require additional, more stringent standards in other areas, like high credit scores, lower ratios and job longevity. Community bankers believe that reduced documentation is acceptable when borrowers have these risk mitigating factors and will require any borrower with a reduced documentation loan to exhibit those characteristics. Stated income programs are typically used for self-employed borrowers who have the gross income to support the new, higher payment.

Simultaneous second mortgages reduce borrower equity and increase credit risk. The agencies note that typically as LTVs rise, defaults also increase and that a borrower with little to no equity has little incentive to work with the lender to bring the loan current. Community banks tell ICBA that when they make loans with "layered risk," they will compensate that risk with additional underwriting requirements. Typical standards include higher credit scores, higher interest rates, and stricter debt to income ratios.

Risk Management

The agencies believe that risks with negative amortization and interest only loans can be managed as long as borrowers are qualified so that they can withstand the payment shock, hold sufficient equity in the loan, the institution structures its products to minimize negative amortization and payment shock, and higher risk elements are not layered with other risks.

ICBA agrees with the agencies and community banks believe that they manage their risk prudently. Most community banks develop and follow good underwriting policies, which is a sound business practice to protect the borrowers as well as the bank. Furthermore, community banks argue that they already have written underwriting policies in place that give loan decision makers guidelines for acceptable and prudent risk. Lenders that are actively offering nontraditional products should have specific underwriting policies that address maximum loan to value ratios, credit scores, and debt ratios.

The agencies believe nontraditional mortgages should receive higher levels of monitoring and loss mitigation. According to the guidance, a bank should stress test its portfolio and should also analyze key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the bank's immediate control. Through stress testing, a bank should be able to identify, monitor and manage risk, as well as develop appropriate cost-effective loss mitigation strategies.

Stress testing is the most burdensome aspect of the proposed guidance for community banks. Setting up a system to run the suggested analysis is time consuming, expensive and in many cases, would require hiring additional staff. For community banks that originate a small percentage of these loans, the costs of developing the capability of stress testing may well outweigh the earnings potential on the loans. Thus, they may discontinue offering the loans, which would be a disservice to consumers.

Stress testing is a reasonable option for many of the larger lenders with higher volume of nontraditional loans. ICBA suggests a threshold level of nontraditional mortgage loans in the portfolio be met before a bank is required to undertake stress testing. If a bank has a certain percentage of nontraditional loans under the level, perhaps less than 10% of its portfolio originations, then it should not be required to perform stress testing. ICBA does not believe that an institution with such a de minimus percentage of nontraditional loans would be exposed to significant risk by the loans, particularly in light of the conservative manner in which community banks offer and underwrite the loans. Community banks generally know these customers and their repayment ability very well.

The guidance also suggests banks segment their nontraditional loan portfolio into pools with similar credit risk characteristics like collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Further, segments should also distinguish between differing payment and portfolio characteristics such as borrowers who habitually make only minimum payments, mortgages with existing balances above original balances due to negative amortization, and mortgages subject to sizable payment shock.

ICBA views this as prudent risk management for institutions that are very active in nontraditional lending. However, for community banks that do a low volume of nontraditional loans, the process would be particularly burdensome. Their volume is relatively small and from one geographic area. Community banks are very familiar with the customers that take these loans and their local housing market. In the view of community banks, for lenders that only hold a small percentage of these loans, the burden of this requirement far outweighs any improvements in risk management. While this may be necessary for larger lenders, ICBA suggests another threshold level for these reports. If a bank has a certain percentage of nontraditional loans are under the level, perhaps less than 10% of their portfolio, then it should not have to produce this analysis.

The guidance also calls for banks to retain higher capital amounts and to establish an appropriate allowance for loan losses to offset the increased risk for nontraditional mortgages. Community banks already hold capital at levels above minimum standards and should not need to raise additional capital automatically because the offer nontraditional loans. Regulators should consider the bank's allowance for loan losses and current capital levels along with risk management practices. Higher capital requirements might be needed for institutions with high volumes of nontraditional mortgages, and especially for those institutions with loans that have not been underwritten to sufficiently consider repricing risk. However, the banking agencies should look to each individual institution's volume of nontraditional loans, underwriting, risk management and current capital and reserve levels when considering whether increases are needed.

Consumer Protection and Education

The guidance states that in promotional materials and advertising, banks should provide clear and balanced information about the relative benefits and risks of these products to help consumers select product and payment options. The proposal suggests "at the time of application" may not be early enough. The materials should clearly describe when structural payment changes will occur and what the new payment will be or how it will be calculated (i.e. payment shock). The consumer should also be alerted to any prepayment penalty and the possibility of negative amortization.

The success of community banks depends on good relationships with their borrowers and maintaining a good relationship in the community. Thus it is very important for them to offer a borrower the right loan for their situation. Community banks tell ICBA that before the borrower applies for a nontraditional loan, the bank's loan officer will typically ensure the borrower fully understands the positives and negatives of a nontraditional loan. After this unofficial counseling session, the customer will often choose a traditional loan product over the nontraditional one. Generally, those borrowers that do decide to go forward with a nontraditional mortgage have researched the loan and the loan officer feels comfortable with their decision to proceed.

Community banks are very concerned that some lenders, particularly those that aggressively market nontraditional products, approve borrowers too easily in order to "close the deal" and do not try to educate the borrower. ICBA believes education is a key ingredient when marketing these loans. "What's my payment" should not be the only decision driver, so all lenders should provide enough information so the borrower can make a responsible payment choice. ICBA fully supports all types of lenders completing this task.

As always, adding disclosures to the mortgage lending process is burdensome to the bank and the borrower. Many borrowers are overwhelmed with the amount of disclosures in the mortgage process and they may overlook the additional disclosure. However, ICBA believes prudent disclosures for nontraditional loans products are necessary.

Conclusion

Nontraditional mortgage products can be suitable for certain borrowers. Most community banks either do not offer nontraditional mortgages or they constitute only a small percentage of their originations. Community banks are concerned about the recent proliferation of nontraditional loans. Nontraditional loans must be properly underwritten and their inherent risks properly managed. Consumers need clear, effective disclosures specific to the risk of these products.

Thank you for the opportunity to comment. If you should have any questions please contact the undersigned at 202-659-8111 or by email at ann.grochala@icba.org.

Sincerely,

Ann M. Grochala
Director, Lending and Accounting Policy