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March 29, 2006

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Re: Interagency Guidance on Nontraditional Mortgage Products
OCC Docket No. 05-21
FRB Docket No. 0P-1246
OTS Docket No. 2005-56

Ladies and Gentlemen:

I write on behalf of low-income homeowners. I commend the agencies for their recognition that nontraditional mortgage products pose special risks, particularly for low-income borrowers, who may be steered into subprime products and who may not fully understand the risks associated with these nontraditional products. I thank the agencies for this opportunity to comment, and respectfully request that the agencies, given the serious risks posed to low income communities by these nontraditional products, consider binding, substantive regulation of these products.

Land of Lincoln Legal Assistance Foundation, Inc. is a federally funded legal services provider, serving low income individuals, families, and community groups in 65 counties in southern and central Illinois. I have worked in the East St. Louis office since 1994, primarily representing homeowners threatened with foreclosure. For five years, I also served as corporate counsel for the largest nonprofit provider of affordable homeownership opportunities in East St. Louis. I currently am the homeowner specialist for Land of Lincoln Legal Assistance, providing supervision of all homeownership cases we handle in our 65 counties. I served as a member of the Consumer Advisory Council of the Board of Governors of the Federal Reserve System from 2003-2005.

Nontraditional Mortgage Products Have Exploded in Recent Years

In the last five years, nontraditional mortgage products—especially interest-only loans—have moved from a marginal role in the mortgage market to a place of dominance. Interest-only loans now constitute 27% of loans nationwide and 30% of subprime loans.[1] In 2005, 63% of new mortgages were interest-only and adjustable-rate mortgages.[2] Over an 18-month period in 2004 and 2005, approximately one-third of homebuyers did not put any money down for their loan.[3] In the secondary market, 11 percent of all securitized subprime originations in 2004 were interest-only loans.[4] There is now a bewildering assortment of nontraditional mortgage products for consumers to choose among, including loans with flexible "pick-a-payment" options, no points up front, a fixed rate conversion option, or a short introductory period of a fixed rate followed by ARM terms. [5]

Consumers Cannot Adequately Protect Themselves

Consumers, particularly younger, poorer, less educated, and minority consumers, fare particularly badly when they try to understand even moderately complex products, like an adjustable rate mortgage.[6] African Americans and Hispanics are more likely than not to believe that lenders are required to give them the best possible rate.[7] Current disclosures do not give

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[1] Greg McBride, CFA, www.bankrate.com, Presentation to FRB Consumer Advisory Council (Oct. 26, 2005); *see also* Kirstin Downey, *Interest-Only: Borrower Beware:Popular but Risky Mortgage Draws Government Scrutiny*, Wash. Post, Dec. 21, 2005, at D1 (23% of borrowers in 2005 chose interest only mortgages, compared to 1% in 2000); Kenneth Harney, *Banks Warned They Must Scale Back on Payment-option Mortgage*, S. F. Chron., Dec. 11, 2005, at K12 (payment option mortgages account for roughly a third of new home loans issued by some major lenders in 2005).

[2] Michael Powell, *A Bane Amid the Housing Boom: Rising Foreclosures,* Washington Post, May 30, 2005.

[3] Edmund L. Andrews, *A Hands-Off Policy on Mortgage Loans*, New York Times, July 15, 2005.

[4] Inside B&C Lending, 2005.

[5]. *See, e.g.,* World Savings, Loan Features, available at http://www.worldsavings.com/servlet/wsavings/loans-new/popular-combinations.html.

[6] "Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages," p. 3, Consumer Federation of America press release, July 26, 2004, available at http://www.consumerfederation.org/releases.cfm#Consumer%20Literacy (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment).

[7] *Mortgage Foreclosure Filings in Pennsylvania:A Study by The Reinvestment Fund for the Pennsylvania Department of Banking*, March 2005, at 74 *available at* http://www.trfund.com/policy/pa_foreclosures.htm, citing Fannie Mae's 2002 National Housing Survey.

consumers the basic information they need to be able to assess their interest rate exposure; there is no disclosure of the maximum payment. Given both the riskiness and the complexity of the products, however, it is implausible that consumers, regardless of the amount of education and disclosure given, could ever protect themselves adequately.[8]

Interest-only loans and adjustable rate mortgages generally are geared for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes and those with fluctuating incomes do not see substantial swings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan. While originators may adjust for this possibility by raising interest rates to cover future default or foreclosure, this process stands apart from underwriting that considers repayment ability.

Industry typically understands and prices the risk for itself.[9] The connection between high default and nontraditional mortgage products is evidenced by Standard & Poor's requiring, as of last August, increased credit enhancements for option-ARMs.[10] What industry does not do, however, is ensure that consumers understand the risk. The investors and originators know that it is likely that these products will lead to high foreclosure rates; consumers, who bear the brunt of the risk, who stand to lose their homes, their credit ratings, and their life savings, do not know.

Industry Has Not Put in Place Adequate Safeguards

Given the prevalence of "no-doc" and low-documentation loans in the subprime market, it is hard to see how the subprime market can properly identify risk at all.[11] This death of underwriting leads to high default and foreclosure rates.[12]

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[8] *See generally* William C. Apgar, Allegra Calder & Gary Fauth, *Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations* at 50-51 (Jt. Ctr. for Housing Studies, Harvard University, Mar. 2004) (discussing inability of even sophisticated consumers to understand mortgage products); Ronald H. Silverman, *Toward Curing Predatory Lending,* 122 Banking L.J. 483, 546 (2005) (borrowers, due to a variety of psychological effects, tend to underestimate the risk of foreclosure); A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. Marshall L. Rev 19, 42-47 (2004) (discussing limitation of financial literacy and disclosures due to cognitive biases).

[9] @ *See, e.g.,* Aames Mortgage Trust 2001-1 Mortgage Pass-Through Certificates, Series 2001-1, Aames Capital Corporation as Sponsor, Countrywide Home Loans, Inc. as Servicer, Prospectus Supplement to Prospectus dated March 13, 2001, S-10 (stating that no underwriting done on the fully indexed payment levels of the adjustable rate mortgages in the pool and there is likely to be a high rate of default after the initial teaser period).

[10] Remarks by Federal Reserve Governor Susan Schmidt Bies (Oct. 12, 2005), *available at* http://www.federalreserve.gov/BoardDocs/Speeches/2005/200510122/default.htm.

[11] Seventy percent of subprime loan pools rated by Standard and Poors in the first half of 2005 had less-than-full documentation. *See* Ruth Simon, James R. Hagerty & James T. Areddy, *Housing Bubble Doesn't Scare Off Foreigners*, Wall St. J., Aug. 24, 2005, at 1, 7.

[12] *See, e.g.*, Delinquency of Subprime Mortgages, Michelle A. Danis & Anthony Pennington-Cross, Working Paper 2005-022A, at 20, available at http://research.stlouisfed.org/wp/more/2005-022/ ("Loans with limited documentation also are delinquent and default more frequently than full documentation loans. The impact for loans with no documentation is even larger."); *cf.* Terwin Mortgage Trust Asset-Backed Certificates, Series

Delinquency rates for subprime ARMs demonstrate the huge risk posed by nontraditional products. At the end of 2005, 12.63% of subprime ARMs nationwide were past due, more than 4.5 times the rate for prime ARMs.[13] An increase in interest rates can only magnify this problem. Subprime ARMs also are much more likely than subprime fixed rate mortgages to go into default, magnifying the already high rate of default among ARMs.[14] Some local studies attribute a significant fraction of the increase in local foreclosure rates since the mid-1990s to subprime ARMs.[15] In addition, a subprime borrower who refinances a first lien with an adjustable rate loan instead of a fixed rate mortgage is 25% more likely to experience foreclosure than a borrower whose loan has an extended prepayment penalty.[16]

The Inter-Agency Proposed Guidance

The major benefit offered by the proposed Guidance is the implicit warning regarding these products that the Guidance has elicited. Everyone in the mortgage lending community should now be aware that these products differ in a material way from the more traditional, fully amortizing mortgage product. This should have the effect of making lenders, investors, as well as consumers, at least somewhat more cautious when dealing with these products.

The benefits of the proposed Guidance, however, are limited. While the Guidance does have some mandatory requirements for those institutions covered by its terms (insured depository institutions), those requirements will have limited impact on the marketplace.

Not Enforceable By Consumers

The proposed Guidance is only that—a recommendation made by the agencies regulating some lenders. Failure to follow the Guidance does not lead to any enforceable sanctions. Even a consumer who has been directly harmed by an institution's failure to follow the explicit, modest requirements in the Guidance has no means of using it to obtain relief for that institution's failure.

Tmts 2004-11he, Terwin Advisors LLC, Seller, Merrill Lynch Mortgage Investors, Inc., Depositor, Prospectus Supplement dated Sept. 27, 2004, to Prospectus dated June 18, 2004, S-39 (stating that seller only knows the underwriting guidelines used for approximately 32% of the loan pool).

[13] Mortgage Bankers Association, National Delinquency Survey, Fourth Quarter 2005.

[14] Statistical evidence suggests that subprime ARMs are significantly more likely to result in foreclosure than subprime fixed rate mortgages. Roberto Quercia, et al. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, January 2005, at 28-29 (subprime refinance ARMs are 50% more likely than fixed rate loans to result in foreclosure), *available at* www.kenan-flagler.unc.edu/ assets/documents/foreclosurepaper.pdf.

[15] *See, e.g.,* Lynne Dearborn, *Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000,* July 2003, p. 23 (from 1996 to 2000, the proportion of foreclosure judgments attributable to adjustable rate mortgages rose from 11% to 30%; at the same time, the proportion of fixed-rate foreclosure judgements decreased almost 20%).

[16] Quercia, *supra* n. 12, at 29.

Leaves Out The Most Essential Lenders

The proposed Guidance only covers depository institutions; it does not cover affiliates of depository institutions, the vast array of lenders who are not depository institutions, and the secondary market. Thus, to the extent that it does establish standards that might be helpful in the mortgage industry, it still does not apply to many sectors. This approach merely gives a competitive edge to unregulated institutions, those most likely to make such loans. Only mandatory, universal limitations on non-traditional products will effect the market change that is needed.

Provides Inadequate Consumer Protections

The substantive requirements of the proposed Guidance do not adequately protect consumers. First it should be noted that the institutions covered by the Guidance have all said in a public meeting that the Guidance will not require that they change their procedures in a meaningful way regarding the provision of nontraditional mortgage products.[17] To the extent that depository institutions and their subsidiaries have been engaged in lending which was risky, these public admissions illustrate that the Guidance will not meaningfully change that scenario.

More importantly, while the Guidance does actually require a) specific underwriting requirements, and b) additional disclosures, these requirements do not adequately protect consumers.

Failure to Require Meaningful Underwriting

The proposed Guidance does require "fully indexed" underwriting. This means that if the mortgage product offers an initial teaser interest rate applicable to the mortgage products, that the lender must evaluate the borrower's ability to repay the loan based on what the payments will be if the teaser rate were not in effect. This underwriting requirement is certainly better than simply allowing the lender to evaluate the borrower's ability to make the initial payments, as some lenders do now. Unless, however, lenders underwrite for the *maximum* payment, and disclose that information to consumers, neither consumers nor the market are taking the risk of interest rate increases into account, creating a significant danger of economic instability.

Most of these mortgage products bear at least four separate triggers for increasing the borrower's minimum monthly payments. Minimum underwriting standards should require that borrowers are evaluated for their ability to pay the monthly payments after all applicable triggers are applied:

- *Teaser rate.* The teaser rate will no longer be applicable on some adjustable rate mortgages, so that the applicable interest rate will increase, even if the underlying index for the interest rate has not increased.

[17] Consumer Federation of America Meeting on Nontraditional Mortgage Products, January 26, 2006.

- *Adjustable rate.* The interest rates on most of these mortgage products are adjustable. The ability of a borrower to repay an adjustable rate mortgage should be evaluated based on what the payments will be under the worst possible scenario—which means that the interest rate will increase at the fastest allowable rate under the mortgage.
- *Negative amortization.* The minimum payments for some products, for some periods of time on the mortgage, can be less than the amount of interest that is due. This means that the balance on these mortgages are likely to increase over time, rather than decrease, which in turn can lead to higher assessments of interest on the outstanding balance, and higher payments at later times during the mortgage.
- *Postponed principal payments.* Some of the mortgage products require that the loans become amortizing at some point during the loan term—significantly increasing the minimum monthly payment from either interest only, or in some cases, some amount less than interest, to an amount necessary to amortize the mortgage over a specific term. As noted above, some lenders only underwrite for the teaser rate and no lenders consider the maximum payment under the loan.

Purported Justification of "Stated Income" Loans

The proposed Guidance asks for comments on when it is permissible for loans not to require verification of income.[18] In our opinion, the answer is "never." Everyone can supply either wage forms or tax returns. Stated income loans are really only a means for people who are telling mortgage companies that their income is something different from what they are telling the IRS. At the same time, stated income loans are the tool to put many less-sophisticated borrowers into loans they cannot afford. Stated income loans should never be permitted. Reduced requirements to verify income should be allowed, with independent verification. Underwriting standards should always require that income be verified and that it be adequate for: current loan payments; the increase in loan payments that could occur if all events which increase loan payments coincide; other known debt; other home-ownership related expenses (taxes and insurance); and reasonable living expenses (that is, that there be adequate residual income left over after the above expenses are met). The facile use of credit scores as a proxy for affordability deprives the consumer of this full analysis.

Lending without regard to repayment ability is only permitted by lenders because they can collect on the collateral—someone's home. Because lenders can protect themselves from losses, through collateralization, securitization and other means, there is little market incentive to ensure the affordability of the loans. Moreover, before the loan enters foreclosure, the equity can be further stripped through refinancings, increasing the collateral for the lender and removing any cushion for the borrower. This imbalance demands equity.

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[18] Seventy percent of loan pools rated by Standard and Poor's have less-than-full documentation. *See* Ruth Simon et. al*, Housing Bubble Doesn't Scare Off Foreigners*, Wall Street Journal (Aug. 24, 2005), at 1, 7.

Insufficient Enhancement of Disclosures

The proposed Guidance recommends that improved disclosures be provided regarding the risks borrowers may face with the changing nature and amounts of payments. This is good, but not sufficient. Disclosures should be required which show both when and what the greatest potential monthly loan payment would be in order to avoid default on the mortgage—in other words, the maximum-minimum monthly payments, and the soonest possible date these payments may be required.

While this information will help certain borrowers better evaluate the risks of a loan, disclosures will never be sufficient to protect homeowners from underwriting failures by originators. Consumers often apply for fixed rate loans and believe they have a fixed rate loan, only to discover upon the first payment adjustment that the loan was an ARM. Even consumers who knowingly obtain variable rate loans are not told the single most important piece of information that they need in order to evaluate the riskiness of the loan—the maximum potential payment. Most consumers minimize the interest rate risk by underestimating the amount by which payments are likely to increase.

Only substantive regulation can balance the scale.

Conclusion

I thank the agencies for this opportunity to submit comments on the interagency guidance and congratulate them again on their efforts to address the potential risk posed by these products. I hope that the agencies will consider enforceable substantive regulation requiring meaningful underwriting guidelines that will protect consumers as well as the legitimate safety and soundness concerns of regulators and investors.

Sincerely,

Diane E. Thompson