FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

April 7, 2008

Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Request for Comment on the Proposed Amendments to the Mortgage Provisions of Regulation Z (Docket No. R-1305)

Dear Mr. Chairman:

On behalf of the Federal Deposit Insurance Corporation, we commend the Board of Governors of the Federal Reserve System (FRB) for proposing amendments to Regulation Z, which implements the Truth in Lending Act (TILA) and Home Ownership and Equity Protection Act (HOEPA), to help address the numerous consumer protection concerns that have arisen in the context of residential mortgage lending. In recent years, a wide segment of the U.S. residential mortgage market experienced a systematic breakdown in lending standards—fed in large part by regulatory arbitrage between bank and nonbank originators. This breakdown in standards has harmed the nation as a whole, and has triggered a severe disruption in global credit markets. The uncertainty that now pervades the marketplace—which is directly attributable to weak underwriting practices—has seriously disrupted the functioning of the securitization markets and the availability of mortgage credit. Lax underwriting contributed to the housing market bubble, just as widespread foreclosures are now contributing to the market's precipitous decline, creating long-term adverse consequences for communities across the country.

These events demonstrate that credit provided on irresponsible or abusive terms does not benefit consumers, and does not provide a firm foundation for economic growth or stability. Restoring the mortgage credit markets to their proper functioning requires clear definition and enforcement of the principles of sound underwriting for mortgage loans. Thus, the FRB has an important opportunity with this rulemaking to establish strong, clear standards for responsible mortgage lending practices that will help prevent these problems from recurring. The FDIC appreciates the opportunity to provide the following comments on the proposed amendments:

1. Scope of the Proposed Rules

The FDIC agrees that the definition of a higher-priced mortgage loan should include transactions secured by the consumer's principal dwelling for which the annual percentage rate (APR) on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate lien loans. We think that the APR triggers are appropriate and the FRB should not consider raising them. However, the FDIC recommends that the FRB also incorporate an alternative fee trigger into the definition of a higher-priced mortgage loan, similar to the one currently applicable to HOEPA loans. The risk is great that creditors will circumvent the proposed APR restrictions by lowering interest rates below the APR trigger and instead charging consumers more and higher fees on their loans. This would significantly harm consumers.

As noted above, HOEPA loans as currently defined have not only an APR trigger but also an alternative points and fees trigger to help avoid circumvention. The points and fees trigger defines a HOEPA loan as one in which total points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or a set dollar amount ($561 for 2008).[1] Points and fees are defined to include all finance charges except interest, as well as non-finance charges, such as closing costs paid to the lender or an affiliated third party.[2] In fact, because HOEPA coverage is based not only on the APR but also on points and fees charged by the lender, some loans qualify only because of the fees charged. Thus, including a fee trigger for higher-priced loans will eliminate the ability of lenders to shift charges to fees not included in the calculation of the APR, thereby avoiding the APR trigger for higher-priced mortgage loans and circumventing the intended protections of the new rules.

In addition, the FDIC recommends that the prohibitions against extending credit without considering a borrower's ability to repay, stated income underwriting, and teaser rate underwriting should apply to negative or deferred amortization products such as the interest-only and payment-option adjustable rate mortgages (ARMs) described in the interagency nontraditional mortgage guidance, regardless of whether they would meet an interest rate or fee trigger.[3] These points are discussed in more detail below.

Finally, the FDIC recommends that the FRB consider extending the protections proposed in § 226.35(b) to reverse mortgages. The FRB excluded reverse mortgages from this proposal because it has not identified significant abuses in the reverse mortgage market.[4] However, there is evidence that significant abuses do exist in the reverse mortgage market and are on the rise.[5] Reverse mortgages are becoming increasingly popular with seniors, and unscrupulous lenders are taking advantage of that fact by promoting products that are not always in their best interest. This is reminiscent of the behavior of unprincipled subprime and nontraditional mortgage lenders as those products gained in popularity. Because reverse mortgages present some unique potential drawbacks for seniors, including high costs that are not clearly disclosed or understood, the FRB should address these problems sooner rather than later. If the FRB does not reconsider

---

[1] The exact dollar amount is adjusted annually, based on the Consumer Price Index.

[2] The fee-based trigger also includes amounts paid at closing for optional credit life, accident, health, or loss-of-income insurance, and for other debt-protection products written in connection with the credit transition.

[3] See *Interagency Guidance on Nontraditional Mortgage Product Risks (Nontraditional Mortgage Guidance)*, 71 Fed. Reg. 58609, 58617 (Oct. 4, 2006).

[4] 73 Fed. Reg. 1672, 1682 (Jan. 9, 2008).

[5] For example, on December 12, 2007, the Senate Special Committee on Aging held a hearing on reverse mortgages, during which Committee members and witnesses discussed the increase in abusive practices directed towards seniors, particularly with respect to advertising. Also, the AARP recently released a report on reverse mortgages, finding that loan costs are extremely high. *See* Donald L. Redfoot, Ken Scholen, and S. Kathi Brown, "Reverse Mortgages: Niche Product or Mainstream Solution?" Report on the 2006 AARP National Survey of Reverse Mortgage Shoppers. AARP Public Policy Institute, Washington, DC. December 2007.

including reverse mortgages in this proposal, then at the very least the FRB should quickly analyze the abuses associated with reverse mortgages and provide timely regulations and guidance so that it can curtail those abuses before they become widespread.

2. Ability to Repay

The FRB's rulemaking proposes prohibiting creditors from engaging in a "pattern or practice" of extending credit for higher-priced mortgage loans without regard to a borrower's ability to repay the loan. The FDIC strongly urges the FRB to eliminate the pattern or practice requirement of this provision and simply prohibit outright the practice of making higher-priced mortgage loans without taking into account consumers' ability to repay.[6] As indicated above, we recommend that the FRB extend this prohibition to include all nontraditional mortgages, even those that do not qualify as higher-priced mortgage loans.

The preamble to the FRB's proposal describes the significant injuries that unaffordable loans inflict on individual borrowers, neighborhoods, and all consumers who are in the market for a mortgage loan. The FRB concludes that "[t]here does not appear to be any benefit to consumers from loans that are clearly unaffordable at origination or immediately thereafter."[7] The FDIC strongly agrees with this point and believes this is exactly why the pattern or practice requirement should be dropped.

Moreover, the pattern or practice requirement inappropriately limits regulatory enforcement as well as civil liability. The FRB's existing commentary indicates that pattern or practice violations depend on the totality of the circumstances in each particular case.[8] Further, pattern and practice violations cannot be established by isolated or individual acts. Thus, proof of a pattern or practice violation requires a wide-ranging or institutionalized policy of making loans without considering a borrower's ability to repay. Meeting this high standard is difficult and costly for both regulatory agencies and consumers.[9] Though the FRB indicates that the pattern or practice requirement is intended to balance potential costs and benefits of the rule,[10] it clearly favors lenders by limiting the number of individual consumer lawsuits and the ability of regulators to pursue individual violations.

---

[6] Though the Truth in Lending Act (TILA), as amended by the Home Ownership and Equity Protection Act (HOEPA), currently prohibits lenders from engaging in a pattern or practice of extending HOEPA loans based on consumers' collateral without regard to their repayment ability, the FRB's rulemaking authority allows it to prohibit outright acts or practices that are unfair, deceptive, or designed to evade the provisions of HOEPA. *See* Section 129(h), 15 U.S.C. § 1639(h); Section 129(l)(2), 15 U.S.C. § 1639(l)(2).

[7] 73 Fed. Reg. at 1687.

[8] *See* Official Staff Interpretations of 12 C.F.R. § 226.34(a)(4).

[9] *See* National Consumer Law Center, Truth in Lending Manual § 9.5.2 (6th ed. 2007), observing that the requirement that a lender engage in a pattern or practice of making HOEPA loans without regard to the borrower's repayment ability "makes such cases difficult and expensive by extending the scope of relevant discovery in an individual case to include the lender's general underwriting practices, and, essentially, its entire loan portfolio." *Also see* Baher Azmy and David Reiss, *Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002*, 35 Rutgers L. J. 645, 695 n. 242 (2004), explaining that "[t]raditionally, the "pattern or practice" element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in a short period of time."

[10] 73 Fed. Reg. 1672, 1688 (Jan. 9, 2008).

A substantial proportion of subprime mortgage loans made during the past few years were underwritten without adequate consideration of the borrowers' ability to pay their mortgage and other housing-related expenses, such as real estate taxes and insurance. This has led to widespread turmoil in the residential mortgage markets and is resulting in significant losses to consumers, lenders, and the secondary market. Thus, we believe lenders should not make loans that they know or have reason to believe a borrower cannot repay. Indeed, recent guidance issued by the federal financial regulators instructs lenders to evaluate a borrower's "ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule."[11] By incorporating this guidance into its regulation, the FRB will be able to help level the playing field for bank and nonbank lenders.

While we recognize the FRB's concern for potential civil liability that lenders may face if making unaffordable loans is prohibited outright, we believe those concerns can be substantially mitigated by clarifying in the final regulation that: (1) a subsequent default, in and of itself, could not constitute evidence of inability to repay; and (2) borrowers are presumed to have the ability to repay if their ratio of housing-related and all recurring monthly debt to income (DTI) is no more than 50 percent at mortgage origination. (See the discussion below regarding the use of a 50 percent, or alternative, DTI ratio to measure repayment ability in the context of mortgage lending.) We believe this approach would better balance the possible adverse consequences of such civil liability with the very real injury that will result from failing to establish an enforceable legal standard.

As noted above, we also recommend making the ability to repay requirement applicable to nontraditional mortgages. Nontraditional mortgage products, such as payment option ARMs and interest-only mortgages, carry inherent risks of payment shock and negative amortization. While some institutions have offered these products with appropriate risk management and sound portfolio performance, in recent years more lenders have offered nontraditional mortgages to a wider spectrum of borrowers without adequate risk management, including failure to determine whether borrowers can repay these mortgages assuming a fully amortizing repayment schedule. The combination of risk layering with the broader marketing of nontraditional mortgage loans significantly increases the risk for both consumers and lenders. Requiring lenders to consider repayment ability for nontraditional mortgages within Regulation Z would ameliorate this risk.

Therefore, the FDIC recommends that the FRB utilize its broad rulemaking authority under section 129(l)(2) of TILA to apply the ability to repay standard to both higher-priced mortgage loans and nontraditional mortgage loans without requiring that borrowers or regulators establish a "pattern or practice" of unaffordable lending.

3. Debt-to-Income Ratio

The FRB's proposal also makes a "pattern or practice" of failing to consider DTI a presumptive violation of the proposed prohibition against engaging in a pattern or practice of

---

[11] *See Statement on Subprime Mortgage Lending (Subprime Statement)*, 72 Fed. Reg. 37569, 37574 (July 10, 2007); *Interagency Guidance on Nontraditional Mortgage Product Risks (Nontraditional Mortgage Guidance)*, 71 Fed. Reg. 58609, 58617 (Oct. 4, 2006).

making higher-priced mortgage loans without regard to borrowers' repayment ability.[12] We commend the FRB for recognizing the importance of a borrower's DTI ratio, and we agree that consideration of a borrower's DTI ratio "generally is part of a responsible determination of repayment ability."[13] However, we believe that the FRB's proposal does not go far enough.

Specifically, we recommend that the FRB also eliminate the "pattern or practice" requirement in connection with consideration of a borrower's DTI ratio and instead require lenders to consider a borrower's DTI ratio when determining repayment ability for all higher-priced mortgage loans, as well as for nontraditional mortgage loans. The primary way lenders ascertain ability to repay is by determining if a borrower has sufficient income to meet his or her housing-related and other recurring monthly expenses.[14] Moreover, quantifying a borrower's repayment capacity by the DTI ratio is a widely accepted approach in the mortgage industry.

To that end, the FRB could set forth a presumption that borrowers have the ability to repay if their DTI ratio is no more than 50 percent at mortgage origination. A loan with a back-end DTI ratio above 50 percent is generally recognized within the industry as one that merits additional scrutiny. Such mortgages also are deemed unaffordable under a number of state laws,[15] and HOEPA currently prohibits prepayment penalties for covered loans where the borrower's DTI ratio at consummation exceeds 50 percent.[16] As an alternative DTI measure, the FRB could consider using the back-end DTI ratios specified under the mortgage loan programs of the government-sponsored enterprises (GSEs), the Federal Housing Administration (FHA) or the Department of Veterans Affairs.[17] In view of the common use of DTI ratios as a guide to affordability, it seems incongruous that there is not a DTI-based presumption of affordability in the FRB's proposed rule for higher-priced mortgage loans, as well as for nontraditional mortgages. We note that a presumption-based approach provides appropriate flexibility to allow higher DTI ratios in certain limited circumstances, such as where a borrower's disposable income after payment of back-end debt is substantial or where a borrower has significant capital assets or net worth. Conversely, a borrower might be able to show a violation with a lower DTI ratio where, for instance, the lender knew the borrower's income would be declining through an impending divorce or job change. At the same time, the presumption would provide greater

---

[12] 12 CFR § 226.34(a)(4); 73 Fed. Reg. at 1725.

[13] 73 Fed. Reg. at 1689.

[14] The *Subprime Statement* specifies that institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the loan according to its terms.

[15] As of February 2008, 11 states had specified that a DTI ratio of more than 50 percent rendered a loan unaffordable. *See* National Conference of State Legislatures http://www.ncsl.org/programs/banking/predlend_intro.htm#Laws, accessed on March 17, 2008.

[16] Section 129(c) of TILA, 15 U.S.C. § 1639(c).

[17] For example, the GSEs and FHA have established back-end DTI ratios ranging from 36 percent to 45 percent for various loan programs. A back-end DTI ratio is calculated by adding monthly housing-related expenses to the total of other monthly obligations and dividing it by monthly gross income. The maximum back-end DTI ratio for Freddie Mac is 45 percent. *See,* Freddie Mac Single-Family Seller/Servicer Guide, ch. A34.9(d). Fannie Mae's "benchmark debt-to-income ratio is 36 percent of the borrower's stable monthly income," however, it "may occasionally specify a maximum allowable debt-to-income ratio for a particular mortgage product." Fannie Mae Selling Guide, Part X, 703. Moreover, Fannie Mae recognizes that a DTI of 45 percent or greater "significantly increases risk." *Id.* at 302.08. The back-end ratio for mortgages insured by the Federal Housing Administration cannot exceed 43 percent unless the lender explains in writing why the mortgage presents an acceptable risk. *See* HUD Mortgagee Letter 2005-16 & HUD Handbook 4155.1, REV-5, Paragraph 2-12 and 2-13.

clarity for both borrowers and lenders in meeting the ability to repay standard to help address the FRB's concerns about litigation risk.

The FDIC also recommends requiring disclosure of the DTI ratio to borrowers if it is greater than 50 percent. The inclusion of this information in loan disclosure documents would not only benefit consumers by helping them determine the affordability of loan products, but would facilitate investors' ability to conduct due diligence and identify riskier loans, which would help restore credibility and discipline in the secondary market.

4. "Stated Income" Loans

The FDIC recommends that the FRB prohibit "stated income" underwriting outright for higher-priced first- and second-lien mortgage loans, as well as nontraditional mortgage loans such as interest-only loans and payment-option ARMs. The proposed rule currently requires creditors to verify income or assets before making higher-priced mortgage loans. However, the rule provides a safe harbor for creditors who fail to verify income or assets before extending credit if they can show that the amount of income or assets relied on was not materially greater than what the creditor could have documented at consummation. We strongly recommend that the FRB eliminate this safe harbor. Verifying a borrower's income and assets is a fundamental principle of sound mortgage loan underwriting that protects borrowers, neighborhoods, investors, and the financial system as a whole. The proposal does not explain why the safe harbor is necessary or what potential problem it is designed to remedy. We believe the safe harbor is unnecessary, particularly given the flexibility that the FRB has built into the verification requirements. In our view, the safe harbor creates a loophole that will undermine the effectiveness of the stated income prohibition.

Information about income is critical for establishing a reasonable basis that a borrower has sufficient capacity to repay the loan, particularly in the case of subprime and nontraditional loans. The more risk a loan presents, based on its features or the borrower's credit characteristics, the more important it becomes to verify the borrower's repayment capacity. Furthermore, as the FRB points out, consumers typically "pay more for [stated income] loans than they otherwise would" if they had simply provided documentation verifying their income.[18] And brokers and other participants in the mortgage origination process have failed to inform many consumers of that cheaper alternative, even though most borrowers can readily document their income through W-2 statements, pay stubs, bank statements, or tax returns.

Both the *Subprime Statement* and the *Nontraditional Mortgage Guidance* caution lenders against making "stated income" loans. However, these guidelines set forth a minimum standard and permit exceptions when "there are mitigating factors that clearly minimize the need for direct verification of repayment capacity."[19] We believe the FRB should eliminate the proposed safe harbor and stand firm in requiring lenders to adequately verify borrowers' income and assets. Requiring borrowers to document their income will make it far less likely that consumers will receive loans that they cannot afford to repay. Documentation also will provide the markets with greater confidence in the quality of pools of higher-priced and nontraditional mortgage

---

[18] 73 Fed. Reg. at 1691.
[19] 71 Fed. Reg. at 58614; 72 Fed. Reg. at 37573.

loans and their projected income streams. Thus, both consumers and the economy as a whole will benefit.

If the FRB does not eliminate the safe harbor, the FDIC recommends requiring disclosures for stated income loans regarding the availability of lower cost fully-documented loans. This disclosure would help give consumers enough information to choose the most appropriate loan product for their needs and would facilitate investors' ability to conduct due diligence and identify riskier loans, which would help restore credibility and discipline in the secondary market.

5. Underwriting for Interest-Only Loans and Payment-Option ARMs

In addition to the preceding recommendations, the FDIC proposes that the FRB prohibit underwriting based only on the initial "teaser rate" for all mortgages described in the *Nontraditional Mortgage Guidance*, such as interest-only mortgage loans and payment-option ARMs. Over the past few years, lenders have offered an increasing variety of mortgage products—including interest-only loans and payment-option ARMs—to a broader spectrum of borrowers. A substantial number of these loans were underwritten without adequate consideration of the borrowers' ability to repay over the entire term of the loan. Instead, borrowers were qualified at low introductory or teaser rates. Such loans have proven to be unstable long-term financing structures for homeownership, particularly for new or unsophisticated homeowners.

So-called "teaser rate" underwriting is a pervasive and dangerous practice. In effect, it is tantamount to not considering affordability. Many consumers do not understand the payment shock features of their ARMs. Qualifying borrowers based on a low introductory payment rather than a fully indexed, fully amortizing repayment schedule is almost invariably a fatal underwriting flaw that is harmful to both consumers and lenders. Indeed, as previously mentioned, both the *Subprime Statement* and the *Nontraditional Mortgage Guidance* instruct lenders to evaluate a borrower's "ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule."[20] Thus, the FRB should exercise its rulemaking authority and prohibit "teaser rate" underwriting outright for interest-only loans and payment-option ARMs.

6. Prepayment Penalties

The FDIC believes that the FRB should consider banning prepayment penalties outright for higher cost loans. Prepayment penalties can cause substantial financial injury as borrowers are faced with the difficult choice of either: (1) paying a large penalty to refinance their loan; or (2) continuing with a loan they cannot afford and, by doing so, stripping their home of equity or losing their home through foreclosure. As the FRB observed, "[t]he injuries prepayment penalties may cause consumers are particularly concerning because of serious questions as to whether borrowers knowingly accept the risk of such injuries."[21] These risks are particularly devastating to borrowers trapped in mortgages that are, or shortly will be, unaffordable because

---

[20] *Id.*

[21] 73 Fed. Reg. at 1694

they can significantly hinder efforts to refinance or otherwise structure loan work outs. As a practical matter, many subprime borrowers are not offered the choice of a loan without prepayment penalties. Moreover, unlike the prime market, most subprime loans include a prepayment penalty. For example, whereas about 70 percent of the balance of subprime loans over the past four years included a prepayment penalty, prepayment penalties are comparatively rare (about 3 percent) among prime mortgage loans.[22] Therefore, banning these penalties will ensure that consumers—particularly subprime consumers—will be able to refinance or sell their homes within a reasonable amount of time.

If the FRB does not prohibit prepayment penalties outright, it should at least reduce the amount of time that prepayment penalties are permitted for higher-priced mortgage loans from five years, as is currently proposed, to two years. The proposal explains that a five-year period "would prevent creditors from 'trapping' consumers in a loan for an exceedingly long period."[23] We believe that five years *is* an exceedingly long period.

One of the reasons that the agencies issued the *Subprime Statement* was their concern about the growing popularity of ARM products that had low initial payments based on an introductory rate, which expired after a short period of time and adjusted to a variable rate for the remainder of the loan.[24] Many lenders aggressively marketed these loans as "credit repair" products. They assured consumers that they would qualify for a lower-priced product at the time that the introductory rate expired—often in two years. Prepayment penalties that extend beyond that timeframe have made such representations illusory. Borrowers who have demonstrated a positive payment history and could qualify for a lower interest rate are not likely to be able to refinance their loans due to the sheer cost of prepayment penalties, which often can amount to six months' worth of interest. In addition, many fixed subprime loans currently have prepayment penalties with terms of 25 to 36 months.[25] Therefore, we recommend alternatively that the FRB limit prepayment penalties for higher-priced mortgage loans to two years or less.

Further, if prepayment penalties are not banned altogether, the FDIC recommends that the FRB prohibit them for higher-priced mortgage loans at least 180 days before the reset date, rather than 60 days as currently proposed. This longer period provides a more realistic timeframe than 60 days, particularly for subprime borrowers, because it affords consumers more time to refinance into a mortgage product that meets their financial needs. Unlike the prime market where interest rates are widely published, interest rates in the subprime market are nontransparent, making it more difficult and time-consuming for consumers to determine the costs of refinancing. Finding competitively priced refinancing is particularly challenging when housing prices are decreasing or mortgages are less available. In recognition of that fact, HOPE NOW Alliance members have agreed to contact at-risk borrowers 120 days prior to the initial ARM reset for all 2/28 and 3/27 products.

---

[22] FDIC calculations using the Loan Performance Securities Database. Data for prime loans represent nonagency originations.
[23] *Id*
[24] 72 Fed. Reg. at 37569.
[25] FDIC calculations using the Loan Performance Securities Database.

7. Yield Spread Premiums (YSPs)

The FDIC recommends that the FRB prohibit the use of YSPs to compensate mortgage brokers. The current proposal merely provides for additional disclosures and the consumer's written consent to the maximum amount of compensation that he or she will pay the broker. We do not believe that such disclosures will be effective. Disclosures alone will not address the fundamental problem with YSPs, which is that they provide an inappropriate financial incentive for mortgage brokers to steer consumers to unaffordable loans. The FRB describes a yield spread premium as "the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender."[26] We think a ban on YSPs, as the FRB has defined them, would eliminate compensation based on increasing the cost of credit and make the amount of the compensation more transparent to consumers.

The inherent conflicts presented by a broker compensation system that rewards increasing the cost to the borrower have been debated for years. To be sure, mortgage brokers can provide valuable services and should receive fair compensation. However, there are ample alternative means of compensation available, such as flat fees or fees based on the total principal amount of the mortgage, which would not present skewed incentives to increase borrower costs and which would be much more transparent and understandable to borrowers. The same can be said for commissions paid to loan officers. Borrowers should continue to have the option to finance the broker's compensation. However, a ban on YSPs will ensure that broker compensation will not be based on steering the consumer to a loan that is more expensive than one for which he or she would otherwise qualify. Thus, the FRB should ban any amount of compensation based on increasing the cost of credit, including compensation that is tied to the APR, or that is not a flat or point-based fee.

8. Advertising

While the FDIC generally supports the advertising provisions proposed by the FRB, we recommend that the FRB restrict use of the term "fixed," or similar terms, in marketing information for adjustable rate or hybrid mortgage products. The term "fixed" has long been used to describe traditional mortgage products with no payment shock features. Using the term to describe adjustable rate products, which have "fixed" rates for only a few years, or interest-only products, which may have "fixed" rates but also the potential for significant payment shock, can be inherently misleading.

9. Escrows

The FDIC strongly supports the FRB's proposal to require escrows for real estate taxes and insurance and believes it would be appropriate to extend the time period to opt out beyond the 12-month period currently proposed. Real estate taxes and insurance are required expenses that lenders should always consider in evaluating a borrower's capacity to repay a mortgage loan. The failure to pay taxes and insurance is a form of default that can lead to foreclosure, causing substantial financial injury to borrowers. Requiring escrows ensures that borrowers will

---

[26] 73 Fed. Reg. at 1698.

have sufficient funds set aside to meet their obligations and avoid the potentially dire consequences for failing to pay their taxes and insurance in a timely manner. The requirement also benefits the economy overall, as fewer foreclosure actions will result if borrowers are able to afford all housing-related expenses, not just principal and interest. We applaud the FRB for making this proposal.

10. State Law

The FDIC also agrees that the proposed rules should not preempt state laws unless they are inconsistent. Many states have proven to be innovative laboratories for the development of consumer protections in recent years. They have been especially active in efforts to address predatory mortgage lending, loan flipping, prepayment penalties, the fiduciary obligations of mortgage brokers, and many other areas. States should not be prevented from providing their citizens with strong consumer protections, and we applaud the FRB for allowing them to continue to do so.

We appreciate the opportunity to comment and encourage the FRB to consider the FDIC's recommendations, which will help eliminate the mortgage lending practices that have hurt so many consumers and led to deterioration and uncertainty in our financial markets. We commend you for your leadership in moving decisively to apply common sense rules of underwriting to all mortgage originators, as well as your advocacy for market innovations to serve the mortgage credit needs of low and moderate income communities. We believe that these simple, basic rules will allow substantial flexibility and latitude to provide affordable mortgage options to lower income populations within a prudential framework that will assure their long term affordability.

Sincerely,

Sheila C. Bair

cc: Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
Washington, D.C. 20551