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Via Federal Express Next Day Delivery

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

Re: Proposed Interagency Guidance on Nontraditional Mortgage Products 70 FR 77249 (December 29, 2005)

Dear Ms. Johnson:

Countrywide Financial Corporation, on behalf of its subsidiaries Countrywide Home Loans, Inc. and Countrywide Bank, N.A. ("Countrywide") is pleased to offer comments on the proposed Interagency Guidance on Nontraditional Mortgage Products ("the Proposal"). The Proposal clearly demonstrates substantial effort on the part of the federal banking regulators ("the Agencies") to provide direction on effectively assessing and managing the risks associated with "interest only" and "payment option" adjustable-rate mortgages ("ARMs"). Countrywide agrees that the risks associated with residential mortgage loans of all types need to be carefully assessed, monitored and managed. However, we do not believe that the risks associated with these particular loan products justify the specific and prescriptive guidance proposed by the Agencies.

Our comments on the Proposal are divided into three parts: general comments regarding the appropriateness of the proposed guidance; specific responses to questions raised by the Agencies in the Supplementary Information; and finally, specific comments on key sections of the Proposal.

I. General Comments

Existing safety and soundness guidance, applicable to all federally regulated banks, provides sufficient guidance on mitigating the risk associated with all types of mortgage lending, including the products addressed by the Proposal. No additional guidance is needed.

Existing law and regulation already provide a comprehensive framework for the risk management and underwriting principles articulated in the Proposal. Section 39 of the Federal Deposit Insurance Act, 12 USC Section 1831-p requires each federal banking agency to prescribe standards for various matters, including asset quality, internal controls, loan documentation and credit underwriting, as well as such other operational and managerial standards as the agency determines to be appropriate (collectively, the "FDICIA Standards"). Each of the Agencies has issued standards in the cited areas. The FDICIA Standards that relate to lending risk management and underwriting apply to all loans and not merely to the loan products characterized by the Agencies in the Proposal as "nontraditional." The FDICIA Standards have the added benefit of establishing a series of corrective actions that the Agencies can take in the event of noncompliance.

Given that an inter-agency framework already exists for managing real estate lending risk for banks in a safe and sound manner, and that the Agencies have already established a method for enforcing compliance with the standards, it appears that the "loan terms and underwriting standards" and "portfolio and risk management practices" sections of the Proposal are unnecessary.

Interest-only and payment option adjustable mortgages have been tested in previous economic cycles and are fundamentally sound loan products. In the absence of data indicating that existing underwriting standards and practices for these products do not adequately protect financial institutions, the Proposal's prescriptive approach appears excessive and will inhibit future innovation in the marketplace.

The Proposal defines as "nontraditional" interest-only mortgages and "payment option" ARMs even though lenders have successfully offered these products since the early 1980s, and through many different market cycles. The innovative primary mortgage market is continually developing loan products and features initially deemed "nontraditional" but which quickly become widely accepted as beneficial product offerings. The Proposal cites no empirical data to establish that interest only and payment option products have increased delinquency or foreclosure characteristics, or have caused increased loss to institutions that have originated or held such loans. In the absence of such data, we are concerned that certain aspects of the Proposal could unnecessarily have the effect of inhibiting innovation in the mortgage industry and reducing the affordability of housing.

As the Agencies have recognized in the Proposal, many of the risks associated with these products also exist in other ARM products which are currently managed effectively by prudent lenders under existing Agency standards. We believe that the additional risks associated with deferred principal amortization and the potential negative amortization can also be effectively managed by utilizing statistically based automated underwriting systems scorecards and by proper portfolio management employing risk adjusted and capital allocation approaches.

The Proposal does not recognize that interest-only and payment option ARM products are distinctly different from one another both in terms of function and underwriting standards.

The Proposal does not differentiate between interest-only and payment option ARMs with respect to underwriting and risk management standards even though these products are structured and designed to meet different borrower needs and preferences. Interest-only loans are clearly intended to be an affordability product, allowing borrowers to qualify with a lower non-amortizing payment. This lower payment is applicable for an extended term – Countrywide offers products with interest only terms ranging from 3 years to 15 years. Given typical loan durations, fixed term interest-only payment periods meet consumer needs while limiting the likelihood of exposure to unmanageable payment increases. Interest-only products do not result in an increase to the principal amount of the loan.

In contrast, payment option ARMs are designed to provide borrowers additional payment flexibility over the life of the loan. These products offer options to homeowners with fluctuating incomes including the self-employed and borrowers whose incomes are bonus-driven. The product allows homeowners to access equity in the short term without incurring refinancing fees. Unlike the interest only product, however, the borrower is qualified using a fully amortizing payment at the fully indexed rate (or a predetermined interest rate, whichever is greater). While this product has the potential to increase the principal loan amount, the borrower is qualified from the start to make a payment that is greater than the amount that would allow the loan to negatively amortize.

By applying the same standards to these very different products, the Proposal will have the effect of unnecessarily limiting the availability of products that have benefited many borrowers. If the Agencies believe guidance is needed to address these products, it must recognize the distinctions and tailor guidance accordingly.

Issuing the proposed guidance would create a dual market for these products: one governed by the detailed risk management, underwriting and consumer disclosure standards of the Agencies, and the other driven by the dictates of the secondary mortgage market.

This dual market will inhibit product innovation and flexibility in the federally regulated sector, as these institutions will become constrained by prescriptive, product-related guidance while the non-regulated sector will be able to respond more quickly to market risks and opportunities. The Proposal would require lenders to apply inflexible rules in determining when certain features can be offered with these products, e.g., reduced documentation. We note that if these restrictions are mandated based on prime lending standards, it will limit the ability of federally regulated entities to offer these as prime products and more significantly, will almost eliminate the ability to offer them as subprime products. The result will be a subprime market once again dominated by nonregulated lenders. The reality is that credit and market risk are inextricably linked together in any individual mortgage loan. Lenders must be allowed to manage the interplay of credit and market risk without the artificial restrictions drawn by the Agencies.

We believe withdrawal of the Proposal is the best approach to prevent the evolution of a dual market. However, should the Agencies move forward with the Proposal, we would recommend that the risk management and underwriting portions of the Proposal be revised to contain explicit acknowledgement that the risk profile of a lender who effectively transfers the economic risks of a loan to the secondary market is lower than that of a portfolio lender. The Proposal does not currently contain any recognition of this crucial consideration. In addition, the Proposal fails to recognize that evaluating risk outside the context of return violates the fundamental precepts of sound investing. We believe that such modifications to the Proposal would mitigate, although not completely eliminate the creation of the dual market discussed in this letter.

From the consumer protection perspective, the dual market is particularly problematic as only mortgage applicants of regulated institutions and their affiliates would benefit from the enhanced disclosures required by the Proposal. Disclosures between the two markets would not be comparable, making it difficult for consumers to comparison shop.

For maximum effect, consumer protection disclosures and other measures should be made available to all borrowers, not merely to those borrowers who, by happenstance, are dealing with a lender regulated by one of the Agencies. There are many mortgage companies and lenders originating the products contemplated by the Proposal that are not affiliated with a financial institution. Absent further action on the part of a number of state agencies, federally regulated entities will be held to one set of disclosure standards and other mortgage lenders will be held to another. If the Agencies conclude that additional disclosures are warranted, the Board of Governors of the Federal Reserve System ("Board") should amend Regulation Z and make the requirements applicable to all mortgage lenders.

II. **Questions posed by the Agencies**

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, we believe it is impractical to apply the same guidance to these two very different products. Interest-only loans are designed to be an affordability product, allowing borrowers to qualify at the "minimum" or lower non-amortizing interest only payment for a fixed and extended term. We believe that it is appropriate to qualify borrowers based on the interest only payment.

By contrast, the payment option product is designed to give consumers maximum repayment flexibility so they can better manage their own financial circumstances. As noted above, borrowers are qualified based on a fully amortizing payment at the fully indexed rate rather than the lower minimum payment. We believe that requiring lenders to utilize the minimum payment and to assume principal increase to the maximum amount of negative amortization at the recast date would significantly reduce the number of borrowers who could qualify based on this hypothetical loan-to-value ratio. These are borrowers that could otherwise qualify and make the payments. Underwriting should be based on factors known with certainty at the time it is performed. Similarly, future increases in income or home appreciation price, both potential offsets to payment shock, should likewise not be considered in the underwriting decision.

We believe that a more appropriate way to manage both potential negative amortization exposure and to insulate the borrower from payment shock is to limit the amount of negative amortization potential and to provide for an extended initial recast date. Countrywide limits negative amortization potential to 115 percent of the original principal balance. We have also extended the recast date for amortization from 5 to 10 years – longer than the average time many people stay in the same home or in the same loan.

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.

Reduced documentation is a feature available with many currently offered mortgage programs – both prime and subprime -- and provides borrowers with expedited underwriting and loan closing and the ability to qualify borrowers that have income that may be difficult to document. Prudent lenders recognize the additional credit risk inherent with this feature and offer it only with counterbalancing pricing and underwriting requirements, such as higher credit scores and lower loan-to-value or debt-to-income ratios. Our internal empirical analysis has validated the predictive nature of these compensating factors.

Stated income programs that Countrywide has experience with include "SIVA," or stated income/verified assets and "SISA," or stated income/stated assets. While asset verification provides an additional risk offset not provided with stated assets, we have found that both programs with the counterbalancing requirements have demonstrated solid performance.

The Proposal states that "[a]s the level of credit risk increases, the Agencies expect that an institution will apply more comprehensive verification and documentation procedures to verify a borrower's income and debt reduction capacity" and that "[r]educed documentation, such as stated income, should be accepted only if there are other mitigating factors such as lower LTV and other more conservative underwriting standards." This seems to ignore industry accepted use of statistically-based underwriting systems or "scorecards" that make use of multivariate techniques to manage multiple risk factors. As the Agencies are aware, these scorecards have proven to make more consistent, objective and accurate loan decisions in terms of eventual credit performance than human underwriters. We believe that such scorecards constitute "best practice technology" and should be fully utilized in order to make effective decisions on products with potential risk layering features such as reduced documentation. Any guidance on managing this risk should acknowledge that such systems are effective when properly utilized.

Should the Proposal 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?

Prudent underwriting guidance generally does not contemplate qualifying a borrower on the basis of estimated future income or other unknown events in the borrower's life that may impact the ability to repay. There is no current method for reliably making such an estimate and in the absence of an accepted convention or a statutory or regulatory requirement specifying a methodology for such a calculation, such an approach would introduce unnecessary complexity and potential inconsistency across products and borrowers. Factors such as assumed future income growth, projected home price appreciation and projected interest rates are well-suited for portfolio stress tests, and should be risk management analysis for projecting the potential performance of a product, particularly in the absence of historical experience. However, these assumptions do not work at the loan level. In the absence of clear requirements for such a projection, taking assumed future facts into consideration in the repayment analysis could potentially subject a lender to allegations of predatory lending if the assumptions fail to materialize.

III. Specific Comments

Loan Terms and Underwriting Standards

Qualification Standards
The Proposal would require lenders to underwrite borrowers for all "nontraditional" mortgages based on "their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule." We reiterate that underwriting should be based on factors known with certainty at the time it is performed and should be consistent with the purpose of the product. As noted previously, underwriting based on a fully amortized payment at the fully indexed rate is standard practice for the payment option ARM, but it is not consistent with the function or the structure of the interest-only product. Interest-only loans are affordability products. Requiring lenders to qualify borrowers utilizing the fully indexed rate for a fully amortizing payment due at final maturity would tend to defeat the intended function of the loan and would significantly reduce the number of borrowers that could qualify for this product – borrowers that we know could both qualify and make payments. Future increases in income or home appreciation price, both potential offsets to payment shock, should not be considered in the underwriting decision.

On a separate note, most home equity lines of credit (HELOC) are "interest-only" products. We encourage the Agencies to make clear that, however the Proposal comes out, that the guidance is limited to closed-end products only and does not have wider application. Specifically, the Proposal should not be seen as superceding or amending the recent guidance on home equity lending.

Collateral-Dependent Loans
Countrywide agrees that underwriting an individual borrower's loans, relying solely on the borrower's ability to sell or refinance the transaction once the amortization period commences is not prudent. However, given the realities of the consumer mortgage market in which borrowers no longer retain their loans for extended periods, such assumptions are appropriate in designing

loan programs when counterbalanced by other mitigating factors. We also note that the use of multivariate scoring models in the underwriting process further lessens collateral dependence.

Simultaneous Second-Lien Loans
The Proposal states that "[l]oans with minimal owner equity should generally not have a payment structure that allows for delayed or negative amortization," but it provides no guidance on what would be deemed "minimal" for this purpose. This restriction would apply to both interest only and option ARM products in terms of defining both allowable loan-to-value ratios for the primary loan, and combined loan-to-value ratios for secondary financing. The term "minimal" will be subject to varying interpretations by regulators, lenders and advocacy groups creating inconsistency in its application. Rather than setting an arbitrary standard, we believe that lenders should be allowed to address collateral risk in this instance by including equity as part of the layered risk assessment done when both setting product guidelines and in developing models.

Portfolio and Risk Management Practices

Policies and Concentrations
The Proposal would require institutions to set strict subjective volume and portfolio limits by loan type. Countrywide believes that setting explicit growth and volume limits leads to poor investment decisions and operational impracticalities. It also ignores active risk-adjusted return and capital allocation models.

Developing product standards taking credit risk solely into account without consideration of interest rate risk could lead to undesirable effects on the portfolio in the long-term. Imposition of strict limits on interest only and payment option products would ignore the impact of economic and market conditions which require some degree of flexibility to rebalance portfolios to maximize risk-adjusted returns. For example, imposing a cap on the percentage of payment option and interest only mortgages in the portfolio could lead to unintended consequences for the portfolio by encouraging the retention of assets that may actually have risk-adjusted returns lower than those of the product being capped. Moreover, substitute products could have inferior interest rate characteristics, hence exposing the portfolio to greater market and interest rate risk and potentially higher costs to manage those exposures. Finally, imposing strict limits on specific product types is not practical in that it can introduce significant operational burdens on the origination process.

In order to ensure adequate portfolio diversification, a better approach would be to measure and monitor portfolio economic capital on an active basis. Best practice models take into account loan-level probabilities of default and even loss given default which are built upon specific loan attributes such as credit score, loan-to-value, documentation type and other factors. By taking all of these factors into account as well as geography, a portfolio can be effectively managed from a diversification standpoint better than by using subjective limits imposed on selected criteria. The benefits of such portfolio models have been shown in many academic studies and these also serve the twin benefit of being used in setting risk-based capital according to Basel II standards.

Third-Party Originations

Monitoring of third party originations is a recommended practice across the product spectrum. We require our third part originators to be properly licensed and to make representations and warranties as to the compliance and underwriting quality of the loans sold to us. However, in requiring institutions to ensure that unaffiliated parties follow marketing standards imposed by the Proposal forces lenders to have awareness and control over third-party practices that is not realistic or practical.

Secondary Market Activity

We believe this section of the Proposal is unnecessary. The Agencies' risk based capital guidelines already clearly articulate that secondary market activities involving implicit recourse arrangements do not effectively transfer the economic risks of assets, including loans, off an institution's balance sheet. Addressing this aspect in the Proposal implies that the principles of implicit recourse are applied differently to these types of loans than to other mortgage loan programs. We recommend eliminating this section from the Proposal.

Consumer Protection Issues

Communications with Consumers

We strongly urge that the Board adopt regulations to implement those provisions of the Proposal relating to communications with consumers rather than setting forth these precepts in the form of informal guidance. The proposed guidance is applicable only to those institutions regulated by the Agencies. Thus, the compliance costs and burdens are placed solely on those institutions while large segments of the lending industry will continue to comply with existing rules and regulations that are applicable to "creditors" generally and that do not contain the additional disclosure principles outlined in the Proposal. In addition, the risks of the failure to comply with the guidance, as discussed below, are placed solely on the institutions regulated by the Agencies.

If the Agencies believe additional disclosures are warranted for these products, then we believe that all creditors, as defined by Regulation Z, should be subject to the same clear and precise disclosure requirements relating to these products. The development of these mortgage products parallels the development of adjustable rate mortgages in the 1980s. At that time, the individual Agencies adopted their own regulations to address concerns about the proper disclosure of information relating to adjustable rate mortgages. Because of the confusing array of different disclosures and limitations on what loans institutions could or could not purchase, the Board, upon the recommendation of the Federal Financial Institutions Examination Council, implemented revisions to Regulation Z to standardize disclosures given in connection with those products and to make those requirements applicable to lenders generally.

We urge the Agencies to review the history of the ARMs' amendments to Regulation Z to provide information about variable-rate features of closed-end adjustable-rate mortgages. At that time, the Agencies stated their belief that

> this regulatory structure [of different disclosure requirements imposed by various federal agencies], which requires different

> disclosures by different lenders delivered at different times, is causing problems for both consumers and mortgage lenders. The ability of consumers to understand and make important decisions about ARMs before entering into these transactions may be hampered by their receipt of differing information about ARM programs depending on what type of lender they have approached. This problem is exacerbated by the variety of ARM products now being offered as well as the complexity of some of these programs.

52 Fed. Reg. 48665 (December 24, 1987).[1] The concerns expressed by the Board seem no less applicable to the information relating to the more recent developments in mortgage products. If, for no other reason than insuring the adequacy of disclosures to consumers for shopping purposes, we believe the Board should adopt regulatory amendments to Regulation Z rather than the informal guidance of the Proposal.

The Proposal sets forth standards that are vague and subject to varying interpretations and implementation. The proposed guidance suggests that institutions "highlight key information so that it will be noticed" or "provide clear and comparably prominent information [relating to lower initial payments]." These standards seem to beg a number of questions including; what would constitute key information? What constitutes adequate "highlighting" of information? What constitutes "clear and comparably prominent?" Again, we are concerned that failure to adequately define these standards may subject institutions to varying interpretations by regulators, competitors and advocacy groups creating inconsistency in its application. Such inconsistency could subject institutions to challenge under section 5 of the Federal Trade Commission Act based on the argument that failure to meet the Agencies standards constituted an unfair and deceptive act or practice.

We urge the Agencies to revisit some of the issues raised in response to the 2004 proposed revisions defining the standard for "clear and conspicuous disclosures" for various federal regulations. The Board ultimately withdrew the proposed revisions partly in response to industry concerns about litigation risks as a result of "vague standards subject to differing interpretations." 69 Fed. Reg. 35542 (2004).

We urge the Board, in consultation with the Agencies, to develop specific disclosure requirements pursuant to its authority under section 105 of the Truth in Lending Act. Implementation of clear and certain disclosure requirements will insure that institutions are not subjected to a multiplicity of lawsuits that would most certainly ensue if vague or uncertain requirements are merely suggested through guidance. While the Agencies guidance may not have the force of law, it will certainly set a standard by which institutions will be judged and held accountable. We would certainly expect that the Agencies "will seek to consistently

[1] See also Memorandum "Disclosures for Adjustable Rate Mortgages Under Regulation Z", from Division of Consumer and Community Affairs to Board of Governors, dated December 16, 1987, at p. 7 ("consumers receive different information about ARMs at different times depending on the type of lender they approach. . . . nonuniformity in federal disclosure requirements inhibits the ability of consumers to compare various ARM products.)

implement the guidance." 70 Fed. Reg. at 77251. There is no guarantee, however, that the enforcement by private litigants or state regulators will be similarly consistent.

We thank the Board for considering our comments, and we would be pleased to discuss them in greater detail if you desire. This letter has also been sent by separate cover to Office of the Comptroller of the Currency. If you have any questions, please feel free to contact me.

Sincerely,

Mary Jane M. Seebach

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