FannieMae

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April 8, 2008

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: <u>Docket No. R-1305—Proposed Amendments to Regulation Z</u>

Dear Ms. Johnson:

Fannie Mae appreciates this opportunity to comment on the proposal by the Board of Governors of the Federal Reserve System (Board) to amend its Truth-in-Lending Act regulation (Regulation Z). The Board indicates that one of its goals for the proposed amendments to Regulation Z is to "protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable homeownership." Fannie Mae was chartered by Congress to ensure a strong, liquid and stable secondary market for residential mortgages that promotes sustainable and affordable homeownership in all markets throughout the country. We support legislative and regulatory efforts that address abusive lending practices in the residential mortgage market, especially those directed at subprime borrowers, and that impose meaningful and material consequences for lenders that deceive and mislead borrowers. Thus, we support this effort by the Board to establish new regulatory protections for consumers.

The proposed rule could have a considerable effect on the residential mortgage market and all of its participants, from consumers considering the purchase of a new home to investors in mortgage-backed securities (MBS). As a secondary mortgage market participant bringing global capital to local residential mortgage markets, Fannie Mae offers several comments on the proposal, particularly the proposed rules that would define "higher-priced mortgage loans" and apply additional protections to these loans. Our comments are discussed below.

1. Benchmark to Define "Higher-priced Mortgage Loans"

The Board proposes a new section 226.35 of Regulation Z that would regulate the underwriting criteria and terms of "higher-priced mortgage loans." Under the proposal, creditors would be prohibited from—

- Engaging in a pattern or practice of making higher-priced mortgage loans based on underlying collateral without regard to a consumer's repayment ability;
- Making higher-priced mortgage loans without verifying consumers' income and assets that are relied on to make the loans and establishing escrow accounts for taxes and insurance for the loans;
- Imposing certain types of prepayment penalties on higher-priced mortgage loans; and
- Evading the restrictions on higher-priced mortgage loans by restructuring them as open-end lines of credit.

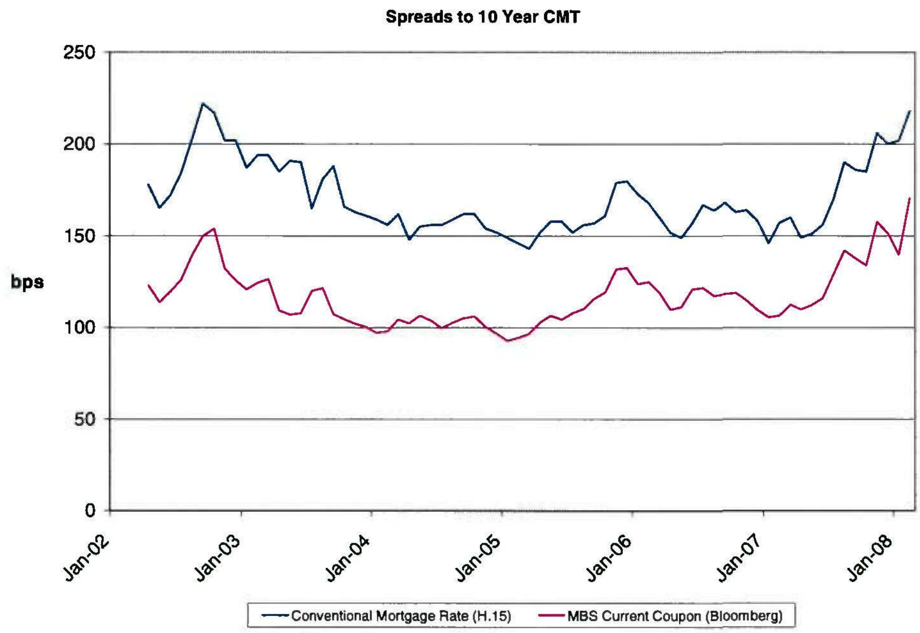
Higher-priced mortgage loans would be defined as those loans for which the annual percentage rate (APR) on the loan exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate lien loans. The comparable Treasury security would be determined based on the term of the loan to be made and whether it is fixed- or adjustable-rate and the length of any initial fixed-rate period. The Board proposed this comparison process in order to more closely align yields on Treasury securities with actual mortgage prices.

The Board articulates several principles that it is relying upon to guide its determination of the appropriate coverage of loans that would be subject to these new limitations. One principle is that the proposed limitations should apply as broadly as needed to protect consumers from actual or potential injury, but not so broadly that the costs, including the always-present risk of unintended consequences, would clearly outweigh the benefits. Applying this principle, the Board concludes that higher-priced mortgage loans should include subprime loans and exclude prime loans. It finds that prime loans should be excluded from these limitations because there is limited evidence that the problems the proposed rule is designed to address, such as lending without regard to a consumer's ability to repay, are present in the prime mortgage market. It also concludes that loan terms or lending practices that arise in the prime mortgage market are better addressed through means other than new regulations.

Fannie Mae agrees that the proposed limitations in section 226.35 should not apply to the prime mortgage market. However, the definition of higher-priced mortgage loan as currently proposed actually would result in a significant portion of the prime mortgage market becoming subject to the new limitations. For example, the yield on the 10-year Treasury note for March 14, 2008 (the Treasury security yield date that would be used today for the basis of comparison if the proposed rule was in effect) was 3.47 percent. The conventional mortgage rate as published by the Board in the H.15 statistical release for April 3, 2008 was 5.88 percent. Under the proposal, any first lien, 30-year fixed rate mortgage loan with application dates in April 2008 that has an APR of 6.47 percent or more would be a higher-priced mortgage loan. A mere 59 basis points separates the conventional mortgage rate and the higher-priced mortgage loan APR threshold. Moreover, the conventional mortgage rate does not include some typical fees and other charges that must be included in the APR. Thus, as proposed, the definition of higher-priced mortgage loan would not appear to meet the Board's objective of excluding the prime market from coverage under proposed section 226.35.

The reason such a large portion of the current prime mortgage market would be captured by the proposed rule is that the current spreads between the yield on Treasury securities and prevailing mortgage rates have widened over the last year. While spreads between the yields on Treasury securities and prevailing mortgage interest rates often remain fairly static, there are extended periods, particularly in times of market turmoil, when these spreads become volatile and widen dramatically. The following graph illustrates this by showing the spreads for 2002 through 2007 between the yield on the 10-year Treasury note and two benchmarks that are reflective of prime mortgage pricing, the conventional mortgage rate, as published in the Board's H.15 statistical release, and the current coupon rate for Fannie Mae

MBS with underlying loans consisting primarily of 30-year fixed rate mortgages, as published by Bloomberg.

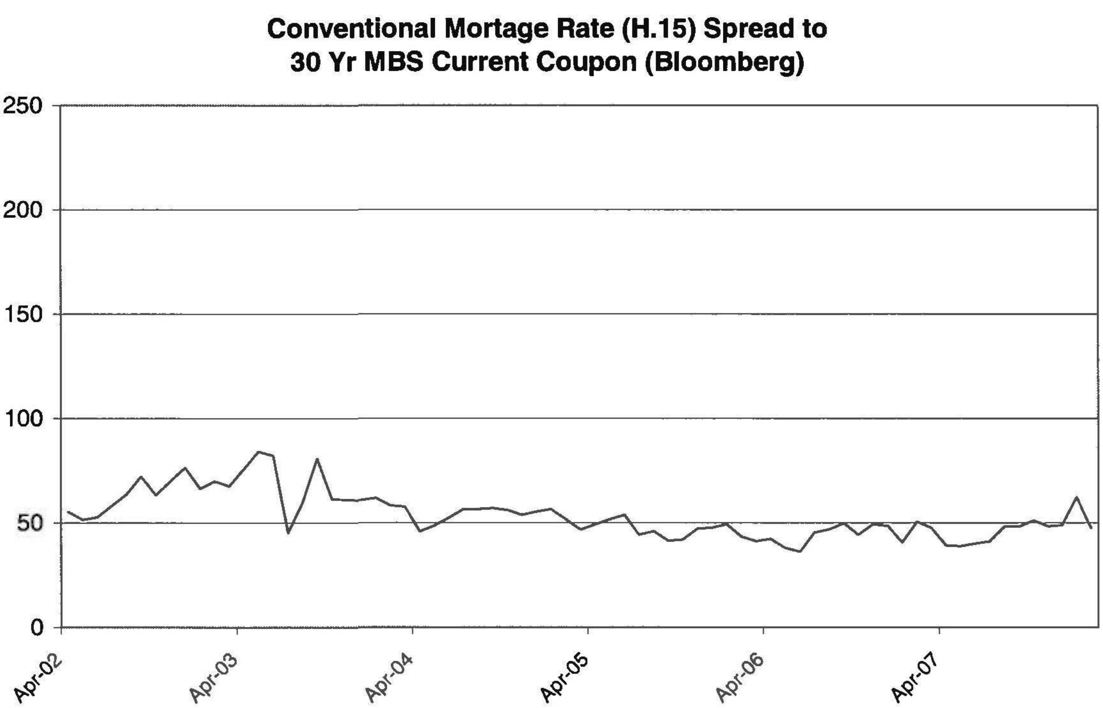


Given the tendency for the volatility in, and the widening of, the spread between the yield on Treasury securities and prevailing mortgage rates, Fannie Mae recommends that the Board replace the yield on Treasury securities with a benchmark that is more reflective of prevailing interest rates for prime mortgage loans. We believe such a benchmark would more effectively meet the Board's objective of ensuring that the new limitations apply to subprime mortgage loans, but not to prime mortgage loans. We also believe that use of such a benchmark would meet the other objectives for coverage that the Board identifies in the preamble to the proposed rule. Alternatively, the Board could increase significantly the APR margin of three percent (and five percent for second lien loans) that was proposed.

The Board could define higher-priced mortgage loans as loans with APRs that exceed the higher of the current coupon yield for Fannie Mae MBS or Freddie Mac participation certificates (PC) with comparable underlying loans plus a certain margin. Like yields on Treasury securities, prices and the resulting yields for Fannie Mae MBS and Freddie Mac PCs are set through a competitive marketplace. The Government Sponsored Enterprise mortgage-related securities (GSE securities) market is the largest and most highly liquid market for mortgage assets. Thus, the yields for GSE securities could not easily be manipulated by a single or group of market participants.

Unlike yields on Treasury securities, where investor demand and external market forces can cause significant volatility, yields for GSE securities are often referenced for the pricing of prime mortgage loans. The coupon yield reflects the price a GSE security can be sold in the market. Primary market lenders that are seeking to sell loans into the secondary market will look to the yield in the GSE securities market as a benchmark in deciding what interest rates they will use to originate mortgages.

Moreover, unlike Treasury securities, there has not been a dramatic widening of spreads between the yield on GSE securities and other indices of mortgage prices during times of turmoil when investors are purchasing Treasury securities and driving down Treasury yields. The following chart shows the spread between the 30-year Fannie Mae MBS yield and the conventional mortgage rate published by the Board between 2002 and 2007.



Thus, using the yield on GSE securities as a benchmark would not likely result in periods when portions of the prime market would be considered higher-priced mortgage loans.[1]

Another objective of the Board in setting the scope of the proposed rule is that lenders should have a reasonable degree of certainty during the application process whether a particular mortgage will be a higher-priced mortgage loan. The proposed rule already provides that the Treasury securities yields that would be used are these as of the 15th of the month preceding the month in which the application is received. The Board could adopt this same requirement for the GSE securities yields. Of course, since GSE securities yields are updated regularly, the Board also could select yields on a more frequent basis to account for sudden and dramatic shifts in interest rates.

Yet another objective of the Board in setting the coverage of section 226.35 is that the rule should make it as simple as reasonably possible to identify higher-priced mortgage loans. As discussed above, the Board proposes a fairly complex system whereby lenders would select the appropriate Treasury security to be used in determining whether a loan is a higher-priced mortgage loan based on its term and whether it is adjustable-rate or fixed-rate and the length of any initial fixed-rate period. Yields on GSE securities with underlying loans made up predominantly of 30-year and 15-year mortgages are currently published by Bloomberg and easily could be incorporated into the Board's H.15 statistical release. In fact, much of the information included in that release already comes from sources outside of the Federal Reserve System. GSE securities yields are not currently published by the Board for those with underlying adjustable rate mortgages. Nevertheless, such rates easily could be determined as of the 15th of each month and also published by the Board on the H.15 statistical release. Thus,

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[1] Another possible alternative benchmark would be the interest rate swap rate. While this rate is more reflective of mortgage pricing than Treasury securities, the spread between the interest rate swap rates and the conventional mortgage rate tends to be larger and more variable than the spreads to GSE securities yields. For example, the spread between conventional mortgage rates published by the Board and 30-year Fannie Mae MBS current coupon yield published by Bloomberg between April 2002 and February 2008 ranged from 36 basis points to 84 basis points. In the same period, the spread between conventional mortgage rates and 10 year swap rates published by the Board ranged from 96 basis points to 165 basis points.

while choosing GSE securities yields as the benchmark may require the publication of new data, once the systems are created to publish the data, use of the GSE securities yields would be as easy to use as the Board's current proposal.

2. Consideration of Expected Income

In Section 226.34(a)(3), the Board would require that lenders making loans subject to the Home Owners' Equity Protection Act (HOEPA loans) and higher-priced mortgage loans take into account a consumer's "current or reasonably expected income" when considering the consumer's ability to repay a HOEPA loan or higher-priced mortgage loan. If lenders must take into account reasonably expected future income, we are concerned that lenders could interpret the rule to exclude creditworthy consumers whose future income is derived from seasonal or irregular income, such as tip income. Therefore, Fannie Mae recommends that the Board clarify that seasonal and irregular income would meet the reasonable expectation of income standard in the proposed rule. Fannie Mae believes this clarification will help ensure that the reasonableness test does not inadvertently hinder credit access for the creditworthy underserved mortgage consumer.

3. Crediting Consumer Payments

Section 226.36(d)(1)(i) would require that a mortgage servicer credit a payment to a consumer's loan account as of the date of receipt unless the delay in crediting will not result in a charge to the consumer or the reporting of negative information to a consumer reporting agency (subject to an exception in paragraph (d)(2) of the proposed section). We would like to offer the following point to avoid any ambiguity in the application of this provision.

The vast majority of residential mortgage loans in the United States are serviced on a monthly interest accrual basis. As a consequence, mortgage payments received on a date other than the due date set forth in the related mortgage note (usually the 1st of the month) are credited to a consumer's loan account as if such payments were received on that due date, subject only to the imposition of a late fee if the consumer's payment is received on or after the date on which late fees accrues (usually the 15th of the month). Thus, if a mortgage loan provides that monthly payments are due on the first of each month, the borrower can make payments as of the fourteenth day of the month and will not only avoid a late fee, but also pay only thirty days interest with respect to that payment. This is a common course of practice in the mortgage industry and Fannie Mae relies on this course of practice with respect to its issuance of mortgage-backed securities, which also accrue interest on a monthly basis.

It does not appear that the Board intends section 226.36(d)(1)(i) to prevent the crediting of consumers' payments on a monthly interest accrual basis. However, we are concerned that the rule, as proposed, does not contemplate this practice because it requires crediting as of the date of receipt, even if the servicer actually credits the payment to the due date. Furthermore, the exception in the proposal for applying the rule only when consumers are charged or negative information is provided to a consumer reporting agency appears only to apply when there is a "delay in crediting." Thus, it is ambiguous whether the exception would apply to the crediting of a payment to an earlier date.

Prohibiting the use of the monthly interest accrual would have significant negative consequences for borrowers who frequently make their monthly payments a few days after the due dates set forth on their mortgage notes, resulting in the payment of additional interest over the life of the loan. It would also have significant negative consequences for Fannie Mae, which would then be faced with the daunting task of accounting for daily interest accrual mortgages differently than it accounts for the related monthly accrual mortgage-backed securities.

Accordingly, we recommend that either (i) this provision be revised to state that no late fee may be charged by a servicer if the related payment is actually received by the servicer before the date on which such late fee accrues or (ii) the Board explain that this provision applies only to the calculation and imposition of late fees and does not otherwise affect the calculation of payment of accrued interest on the mortgage loan.

Fannie Mae appreciates this opportunity to comment on the Board's proposal.

Sincerely,

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