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Morgan Stanley

July 22, 2011

Via Electronic Submission at http://www.regulations.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Proposed Rule—Regulation Z; Truth in Lending, Docket No. R-1417, RIN No. 7100-AD75

Dear Ms. Johnson:

We are writing to the Board of Governors of the Federal Reserve System (the "Board") in connection with its proposed rule amending Regulation Z in accordance with amendments made to the Truth in Lending Act ("TILA") by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

First, Morgan Stanley Private Bank, National Association ("MSPBNA") suggests that the Board amend the list of examples of "other records a creditor may use to verify a borrower's income or assets" set forth at proposed 12 C.F.R. § 226.43(c)(4) to specify that "financial institution records" include records from the creditor, an affiliate of the creditor, or any other financial institution (including a securities broker dealer), and that a creditor may rely exclusively on such records in verifying a borrower's current or reasonably expected income or assets if the borrower has adequate verifiable assets (such as stocks, bonds, mutual funds, commodities, or other types of investment vehicles).

Second, MSPBNA urges the Board to expand the definition of qualified mortgage to be codified at 12 C.F.R. § 226.43(e)(2) to include interest-only residential mortgage loans for which the borrower has adequate verifiable assets as evidenced by financial institution records that equal at least 50% of the principal amount of such loan.

Last, MSPBNA supports the safe harbor approach with regard to qualified mortgages.

I. MSPBNA Background

MSPBNA is a national bank headquartered in Purchase, New York and regulated by the Office of the Comptroller of the Currency. MSPBNA is a subsidiary of Morgan Stanley ("MS"), a publicly-traded company, which offers a variety of services that are designed to assist clients with both sides of their balance sheet.

Among other things, MSPBNA originates residential mortgage loans to Morgan Stanley Smith Barney clients. MSPBNA strives to provide clients with flexibility in connection with the residential mortgage loans that it originates.

II. The Board's Proposed Rule

A. Verification of Income or Assets

Proposed 12 C.F.R. § 226.43(e)(2)(v) provides that a qualified mortgage is a covered transaction for which, among other things, a creditor must consider and verify the borrower's current or reasonably expected income or assets in determining the borrower's ability to repay. This requirement is further explained as follows, under proposed 12 C.F.R. § 226.43(c)(4):

> *Verification of income or assets.* A creditor must verify the amounts of income or assets it relies on to determine a consumer's ability to repay a covered transaction using third-party records[[1]] that provide reasonably reliable evidence of the consumer's income or assets. A creditor may verify the consumer's income using a tax-return transcript issued by the Internal Revenue Service (IRS). Examples of other records the creditor may use to verify the consumer's income or assets include:
>
> (i) Copies of tax returns the consumer filed with the Internal Revenue Service or a state taxing authority;
> (ii) IRS Form W-2s or similar IRS forms used for reporting wages or tax withholding;
> (iii) Payroll statements, including military Leave and Earning Statements;
> **(iv) Financial institution records;**
> (v) Records from the consumer's employer or a third-party that obtained information from the employer;
> (vi) Records from a federal, state, or local government agency stating the consumer's income from benefits or entitlements;
> (vii) Receipts from the consumer's use of check cashing services; and
> (viii) Receipts from the consumer's use of a funds transfer service.

Regulation Z; Truth in Lending, 76 *Fed. Reg.* 27390, 27483 (proposed May 11, 2011) (to be codified at 12 C.F.R. § 226.43(c)(4)) (emphasis added). MSPBNA appreciates this list of examples provided by the Board because it provides clear guidance to creditors regarding which records may be used to effectively and efficiently verify a borrower's current or reasonably expected income or assets in compliance with TILA § 129C(a)(4). MSPBNA urges the Board to clarify that "financial institution records" include records from the creditor, an affiliate of the creditor, or any other financial institution (including a securities broker dealer). In this regard,

[1] Notably, the definition of "third-party record" set forth at proposed 12 C.F.R. § 226.43(b)(13) already includes "[a] record the creditor maintains for an account of the consumer held by the creditor ..."

we note that in the supplementary information section of the proposed rule, the Board explains that it considers the list of examples to be illustrative, and not exhaustive. MSPBNA also requests the Board to clarify that a creditor may rely exclusively on financial institution records in verifying a borrower's current or reasonably expected income or assets if the borrower has adequate verifiable assets (such as stocks, bonds, mutual funds, commodities, or other types of investment vehicles).

Records from the creditor, an affiliate of the creditor, or any other financial institution (including a securities broker dealer) that provide evidence that the borrower has significant assets are "reasonably reliable" and, therefore, in line with the goal of TILA § 129C(a)(4) to safeguard against fraudulent reporting. By specifying that such records meet the requirement set forth under proposed 12 C.F.R. § 226.43(c)(4), and that creditors may rely exclusively on such assets when appropriate, creditors will have greater certainty to allow them to continue to offer valuable residential mortgage loan products to borrowers.

B. Inclusion of Certain Interest-Only Residential Mortgage Loans in Definition of Qualified Mortgage

MSPBNA proposes that the definition of qualified mortgage to be codified at 12 C.F.R. § 226.43(e)(2) be expanded to include interest-only residential mortgage loans[2] for which the borrower has adequate verifiable assets as evidenced by financial institution records that equal at least 50% of the principal amount of such loan.

MSPBNA believes that such an expansion of the definition of qualified mortgage would be consistent with the intent underlying Section 1412 of the Dodd-Frank Act. Specifically, borrowers with verifiable assets that equal at least 50% of the principal amount of the interest-only residential mortgage loan will almost certainly have sufficient resources—and, therefore, a reasonable ability—to repay the loan. Indeed, MS's documented performance figures show that such loans have half (or less) the default rate of loans where the borrower has assets that equal less than 50% of the loan amount.

Additionally, this amendment will preserve access to an important type of credit for sophisticated borrowers, allowing them to better allocate their investment portfolio. Specifically, with an interest-only residential mortgage loan, such borrowers can: (i) smooth out irregular compensation (such as that associated with commission based compensation, bonus compensation, or self employed borrowers), (ii) free up the principal portion of their monthly loan payment and apply it to stocks, bonds, mutual funds, commodities, or other types of investment vehicles, and (iii) reduce the effective term or amount of future interest payments by making principal payments at their convenience until the point when the principal and interest amortization schedule becomes effective.

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[2] "Interest-only" has the same meaning as in 12 C.F.R. § 226.18(s)(7)(iv)—that is, "under the terms of the legal obligation, one or more of the periodic payments may be applied solely to accrued interest and not to loan principal; an 'interest-only loan' is a loan that permits interest-only payments."

Finally, interest-only residential mortgage loans are permitted under the general ability to repay standard, provided that they meet specified underwriting requirements (e.g., the creditor must use the payment amount required to amortize the loan by its final maturity). MSPBNA believes that such loans, under the conditions described above, should not be excluded from the definition of qualified mortgage for the same reasons that they are permitted under the general ability to repay standard.

C. Definition of Qualified Mortgage – Safe Harbor

The proposed rule sets forth two alternative definitions of qualified mortgage. MSPBNA recommends that the Board adopt "Alternative 1" (i.e., the safe harbor approach), which defines qualified mortgage as follows:

> A qualified mortgage is a covered transaction—
> (i) That provides for regular periodic payments that do not—
>   (A) Result in an increase of the principal balance;
>   (B) Allow the consumer to defer repayment of principal, except as provided in paragraph (f) of this section; or
>   (C) Result in a balloon payment, as defined in § 226.18(s)(5)(i), except as provided in paragraph (f) of this section;
> (ii) For which the loan term does not exceed 30 years;
> (iii) For which the total points and fees payable in connection with the loan do not exceed the amounts specified in paragraph (e)(3) of this section;
> (iv) For which the creditor underwrites the loan, taking into account any mortgage-related obligations, using—
>   (A) The maximum interest rate that may apply during the first five years after consummation; and
>   (B) Periodic payments of principal and interest that will repay either—
>   (1) The outstanding principal balance over the remaining term of the loan as of the date the interest rate adjusts to the maximum interest rate set forth in paragraph (e)(2)(iv)(A) of this section; or
>   (2) The loan amount over the loan term.
> (v) For which the creditor considers and verifies the consumer's current or reasonably expected income or assets to determine the consumer's repayment ability, as required by paragraphs (c)(2)(i), (c)(3), and (c)(4) of this section.

Regulation Z; Truth in Lending, 76 *Fed. Reg.* 27390, 27484 (proposed May 11, 2011) (to be codified at 12 C.F.R. § 226.43(e)(2)). Under the safe harbor approach, a qualified mortgage will be considered to comply with the ability to repay requirement set forth under section 1411 of the Dodd-Frank Act.[3]

[3] Section 1411 of the Dodd-Frank Act explains that the ability to repay test requires creditors to make "a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the [borrower] has a reasonable ability to repay the loan ..."

Alternative 1 is preferred because, as recognized by the Board in the supplementary information section of the proposed rule, it provides creditors that make qualified mortgages with more certainty and protection from liability in connection with the ability to repay requirement. In light of the substantial potential liability for noncompliance, a clear safe harbor will be critical to creditors and assignees (including purchasers of whole loan pools and residential mortgage backed securities investors). Additionally, borrowers benefit from the safe harbor approach in the form of increased access to credit, reduced loan fees and interest rates, and less-risky loan features. This is in line with Congress' goal in creating section 1411 of the Dodd-Frank Act—that is, to protect, limit, and regulate the terms of residential mortgage loan credit and the practices related to such credit, *while ensuring that responsible, affordable mortgage credit remains available to consumers*. *See* Dodd-Frank Act, H.R. 4173, 111th Cong. § 1402 (2010).

"Alternative 2" provides that a qualified mortgage is *presumed* to comply with the ability to repay requirement. Under this approach, a borrower can rebut the presumption of compliance afforded to the creditor with evidence that the creditor did not meet the ability to repay requirement. It can be expected that many borrowers subject to foreclosure will assert the creditor's failure to comply with the ability to repay requirement as a defense to foreclosure. Obviously, this affects creditors' willingness to make qualified mortgages (or any mortgages, for that matter). In such an event, creditors are expected to opt for overly strict credit standards which could have a chilling effect on the origination of residential mortgage loans (notably, at a time when the housing market is extremely fragile), or could price in the increased risk to the loan products, which would make credit less affordable for consumers.

We thank you in advance for your consideration of our comment. Please contact me at (914) 225-8429 or Julie.Hobbs@mssb.com should you have any questions or comments.

Very truly yours,

Julie Hobbs
Executive Director, Legal and Compliance