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May 7, 2007

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Board of Governors of the Federal
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Washington, DC 20219

Mary Rupp, Secretary for the Board
National Credit Union Administration
1775 Duke St.
Alexandria, VA 22314-3428

Re: **FDIC** Statement on Subprime Mortgage Lending, **FRB** Docket No. OP-1278, **OCC** Docket No. 2007-3005, **OTS** Docket No. 2007-09, **NCUA** ABA's Comments on the Proposed Statement on Subprime Mortgage Lending; 72 Federal Register 10533; March 8, 2007.

Ladies and Gentlemen:

The American Bankers Association ("ABA") appreciates the opportunity to comment on the Statement on Subprime Lending ("proposed Statement"), proposed by four Federal banking agencies and the National Credit Union Administration (collectively, the "Agencies"), to address emerging issues and questions relating to certain subprime mortgage lending practices. ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

Summary of ABA's Comments

ABA has long supported the industry's and the Agencies' efforts to protect borrowers against unfair and deceptive mortgage lending practices. We believe that banks and savings associations give the consumer the greatest opportunity not only to realize the American dream of homeownership, but also the best opportunity to sustain that home for many years. We believe that a consistent regulatory structure—both regarding standards and standards enforcement— should apply to all mortgage lenders and brokers and that lending principles based on sound underwriting standards should serve as the basis for all loans made to consumers.

Thus, ABA supports the Agencies' statement that loans targeted to subprime borrowers should not contain predatory features and should meet safe and sound underwriting standards, including an assessment of the borrower's ability to repay. We believe that such assessment has always been an essential ingredient of sound underwriting. ABA also supports the consumer protection principles of the proposed Statement, especially that lenders should ensure that disclosures of the material terms, costs and risks of loan products are made available to consumers. Finally, ABA recognizes that institutions need to ensure that they have adequate control systems to manage the operational and transactional risks of how they originate or purchase mortgage loans.

However, ABA has concerns about several parts of the proposed Statement. As discussed in greater detail below, the broad and imprecise definition of "subprime" used by the proposed Statement may create difficult compliance problems. Moreover, we have concerns about the inherently uneven application and enforcement of the proposed Statement, given that it applies only to insured depository institutions and their subsidiaries and affiliates. We believe that this uneven supervisory scheme will create additional consumer confusion and make the loan products of less regulated lenders and brokers appear to be "better" than our institutions' same or similar products, thus undermining the proposed consumer protections.

Specific Comments

ABA's comments on the Agencies' proposed Statement address six major topics: (1) the scope and applicability of the proposed Statement, (2) risk management practices, (3) consumer protection principles, (4) control systems of regulated financial institutions, (5) supervisory issues, and (6) answers to the four specific questions asked by the Agencies.

<u>1. Scope and applicability of the proposed Statement</u>

The Agencies need to clarify the scope of the proposed Statement. As drafted, the proposed Statement is unclear whether it applies to subprime lending *programs* or to individual subprime *loans*. This distinction, while seemingly technical, is not inconsequential. The resolution of this issue has potentially significant consequences for banks and their ability to meet the credit needs of their consumers.

The Agencies begin the proposed Statement by expressing concern about "emerging issues and questions relating to certain subprime mortgage lending practices" and then summarize these concerns as about "ARM products marketed to subprime borrowers" with certain characteristics. Thus, the scope of the proposed Statement appears to be limited to adjustable rate mortgages

(ARMs) marketed to subprime borrowers. However, other parts of the proposed Statement appear to apply to all mortgage loans to subprime borrowers.[1]

Judging from the context of the entire proposed Statement, it appears that the Agencies intend for the proposed Statement to apply to subprime lending programs. The proposed Statement incorporates the definition of "subprime" that is used in the 2001 Expanded Guidance for Subprime Lending Programs. That guidance states, in relevant part:

> The term "subprime" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:
>
> * Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
> * Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
> * Bankruptcy in the last 5 years;
> * Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
> * Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.
>
> This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, but should be viewed as a starting point from which the Agencies will expand examination efforts.

This definition is broad and, in many respects, vague. Moreover, the list of triggering conditions is not exhaustive. However, there was little problem in using this definition in the context of the 2001

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[1] For example, the proposed Statement states in its discussion of Consumer Protection Principles, "When applying these principles to ARMs marketed to subprime borrowers…." Moreover, it asks "Should the principles of this proposed Statement be applied beyond the subprime ARM market?" On the other hand, the proposed Statement seems to apply at times to each subprime borrower and at other times to each and every borrower, as seen by the following:

- The proposed Statement directs institutions to "refer to the Real Estate Guidelines, which provide underwriting standards for all real estate loans." [Emphasis added.]
- Under consumer protections, the proposed Statement provides "Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:..." without reference to subprime lending programs.
- In a number of places, the proposed Statement uses the terms "borrower" and "consumer" without qualifying them as either being subprime borrowers or consumers or that it is pursuant to a subprime marketing and lending program.

guidance because it was used in the evaluation of a number of loans to judge whether the bank had a "subprime lending program." The 2001 guidance stated:

> This expanded guidance applies specifically to those institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to 25% of tier 1 capital.... This guidance is meant to intensify examination scrutiny of institutions that systematically target the subprime market through programs that employ tailored marketing, underwriting standards, and risk selection.... For purposes of this guidance, subprime lending does not refer to individual subprime loans originated and managed, in the ordinary course of business, as exceptions to prime risk selection standards. The Agencies recognize that many prime loan portfolios will contain such accounts.

Thus, not every loan had to be analyzed and determined to be made with significantly higher risk of default; rather there just had to be a sufficient number of these loans with borrowers falling within the range of subprime characteristics to indicate a subprime marketing and lending program.

However, if the proposed Statement applies to all loans made to subprime borrowers, then this definition created to identify subprime lending programs becomes very problematic when used to identify each and every subprime borrower and thus each subprime loan. Compliance officers tell ABA that it is extremely difficult to use this definition on a borrower-by-borrower basis. First, the definition is not complete but only illustrative. Second, it is difficult to know what satisfies the criteria of a "relatively high default probability" or "otherwise limited ability to cover family living expenses." Even if workable tests could be established, each would have to be applied to every borrower and, if the borrower fit any one of them, the borrower would have to be classed as subprime.

The result is that compliance officers instead would simply have to require that their lenders treated all borrowers as subprime borrowers unless the borrower was clearly, demonstrably a prime borrower. This would be an overbroad and unfortunate result of applying to each borrower individually a definition meant to be fitted over a pool of borrowers to determine if the pool was the result of a subprime lending program. It could have the presumably unintended effect of curtailing credit options to creditworthy borrowers who otherwise would benefit from the flexibility afforded by the products covered by the proposed Statement.

ABA recommends that the Agencies carefully rewrite the proposed Statement with a clear initial statement that the scope and applicability of the proposed Statement is to ARM loans made as part of a subprime marketing and lending program. If the proposed Statement applies to every ARM loan to a subprime borrower, then ABA strongly recommends that the Agencies provide a specific definition of the characteristics that will define a subprime borrower that is not illustrative and open-ended but is determinable and bounded. ABA also strongly recommends that the Agencies eliminate any suggestions that the proposed Statement applies to any loans other than subprime ARMs.

2. Risk management practices

Predatory Lending Considerations. ABA agrees with the Agencies' restatement of risks from predatory lending practices in the marketing of subprime mortgage loans.

Underwriting Standards. ABA believes that insured banks and thrifts (and the affiliates and subsidiaries of either) are well aware of the strictures of the 1993 Real Estate Guidelines. However, we note that these do not apply to credit unions and so perhaps should not be included in a proposed Statement applying to credit unions without further disclaimer or explanation.

The proposed Statement reminds institutions that the Real Estate Guidelines require institutions to consider the borrower's ability to repay as a factor in prudently underwriting real estate loans. We note that under those safety and soundness guidelines, the borrower's ability to repay is just one of a number of factors in assessing a loan's soundness. However, the Agencies, in the 2006 Nontraditional Mortgage Guidance, go further and make the borrower's ability to repay a safety and soundness requirement for those specific forms of ARMs. In doing so, the Agencies specifically define the ability to repay with respect to nontraditional mortgages in order to address the impact of payment shock on an ARM borrower.

Now, in the proposed Statement, the Agencies enlarge the requirement that an institution assess the borrower's ability to repay as a separate and necessary factor in marketing and making subprime ARM loans. ABA notes that this analysis of a subprime borrower's ability to repay the debt is defined in the Nontraditional Mortgage Guidance as the ability to repay the debt at final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The Agencies defined "fully indexed" in footnote 5 of the Nontraditional Mortgage Guidance as equal to "the index rate prevailing at origination plus the margin that will apply after expiration of an introductory rate…" The Nontraditional Mortgage Guidance goes on to state that "In different interest rate scenarios, the fully-indexed rate for an ARM loan based on a lagging index…may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the consumer and determine repayment capacity." ABA believes that the Agencies need to clarify for the proposed Statement that the definition of the "ability to repay" a subprime ARM loan is the same definition that the Agencies created for the Nontraditional Mortgage Guidance's ARMs.

The proposed Statement goes further than any previous guidance or standards in seeming to add a requirement that any analysis of debt-to-income must include not only principal and interest but also real estate taxes and property insurance. While the proposed Statement notes that this is a widely accepted approach, we have heard from our members that it is not uniform. If applied to all borrowers, this may require considerable reprogramming of mortgage origination software and compliance programs. Assuming our understanding is correct that the proposed Statement is intended to apply solely to subprime ARM lending programs, **we recommend that this requirement be clearly limited to such programs.**

The proposed Statement notes that —

> [r]isk-layering features in a subprime mortgage loan program may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layered features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

ABA notes that the Agencies are limiting this to a requirement for policies on risk-layering in subprime ARM lending programs, given the scope of the proposed Statement. **ABA supports the requirement for such policies.**

3. Consumer Protection Principles

ABA supports the consumer protection principles of the proposed Statement, especially that lenders should ensure that disclosures of the material terms, costs and risks of loan products are made available to consumers. However, we note that the Agencies have now made the ability to repay a consumer protection standard rather than an underwriting standard, which appears to be the creation of a new policy by the Agencies in this proposed Statement.

The proposed Statement urges lenders to inform consumers of:

• Payment Shock. Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.
• Prepayment Penalties. The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.
• Balloon Payments. The existence of any balloon payment.
• Cost of Reduced Documentation Loans. Whether there is a pricing premium attached to a reduced documentation or stated income program.
• Responsibility for Taxes and Insurance. The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

Similar to the requirements of the Nontraditional Mortgage Guidance, disclosures of material terms, costs and risks of the product must be made "in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at the consummation of the loan." As we noted in our comments on the proposed Nontraditional Mortgage Guidance, disclosures at these early stages of contact with potential borrowers must be generic in nature. In fact, ABA asked that the Agencies provide some generic examples of such disclosures to aid in compliance and reduce the burden of every institution having to create its own. The Agencies did propose such illustrations in October of 2006, and the comment period closed in December 2006. ABA believes that those proposed consumer illustrations could be used in part to meet the disclosure responsibilities created in the proposed Statement, and **ABA recommends that the Agencies issue the proposed consumer illustrations.**

The Agencies urge lenders that use prepayment penalties to structure them so that they do not extend beyond the initial reset period and, further, to provide borrowers a sufficient window of time immediately prior to the reset date to refinance without penalty. ABA notes that prepayment penalties were originally crafted to partially offset the safety and soundness concerns of the Agencies over interest rate risk and earning asset prepayment risk. Regulatory shortening of prepayment periods of course will likely work at cross purposes to the Agencies' earlier concerns. Shorter prepayment penalty periods also will likely reduce interest rate reductions that are available to the borrower and that are predicated on the prepayment penalties. **Nonetheless, ABA understands the objective of shorter prepayment penalty periods in the context of subprime lending, and we do not object to the proposed Statement on this point.** Because the mortgage underwriting process proceeds so rapidly and because borrowers seeking to refinance may begin shopping and applying for a new loan even during the prepayment penalty time period of their existing loan (as long as the actual closing occurs after the prepayment penalty period has ended), **ABA suggests that a sufficient window for refinancing before reset need be no more than 60 days.**

Finally, ABA continues to be concerned by the Agencies' application of new consumer protection requirements only to insured financial institutions and their subsidiaries and affiliates and not to mortgage brokers and lenders that are not federally regulated. We address this issue below under the topic Supervisory Issues.

4. Control Systems

The proposed Statement, like the Nontraditional Mortgage Guidance, urges lenders to develop strong control systems to monitor whether actual practice is consistent with the institution's policies and procedures. These controls should cover both the institution's personnel and applicable third parties, such as mortgage brokers and correspondents. As we noted in our comments on the proposed Nontraditional Mortgage Guidance, this appears to increase the duties of lending institutions to monitor third parties and highlights the uneven supervisory scheme being implemented by the proposed Statement.

If mortgage brokers were subject to the same level of regulation, supervision and enforcement as are insured depository institutions and their subsidiaries, ABA believes that this requirement would be unnecessary. However, the unevenness of the supervisory regimes results in an ever larger and more difficult monitoring responsibility being borne by our institutions.

Our institutions' compliance officers tell us that these additional controls and responsibilities simply mean that banks and thrifts will curtail their business with smaller-volume brokers, because the insured depository institutions cannot recover the costs of such monitoring from the small volume of originations and/or purchases that these brokers produce. The proposed Statement essentially tells insured financial institutions to stop doing business with any broker that they cannot so monitor. This could have the unintended consequence of promoting concentration in the loan origination market, hardly a development in the best interests of borrowers. The result, in the foreseeable future, will likely be a reduction in the viability of small mortgage brokers and consolidation of the origination business into fewer hands.

5. Supervisory Issues

There are two supervisory issues created by the proposed Statement that concern us. First, the Agencies should clarify the legal effect of the proposed Statement. This issue is more than theoretical, since, unlike previous real estate lending guidance, the proposed Statement now makes "approving loans based on the borrower's ability to repay" a consumer protection standard rather than a condition of safety and soundness. To the extent that the Agencies are using the proposed Statement not to clarify existing law, regulation and guidance but rather to enlarge them, the Agencies are raising the question as to what is guidance and, in particular, what is this proposed Statement?[2]

Second, and of greater concern, the proposed Statement appears likely to lead to greater consumer confusion in the subprime lending market. The proposed Statement is limited to insured financial

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[2] We assume that the proposed Statement would be a "guidance document" as that term is used in Executive Order 12866, as recently revised by Executive Order 13422. Should the Agencies intend a different result, we urge you to explain why a "statement" or similar document is outside the scope of Executive Order 12866.

institutions and their affiliates and subsidiaries. While this may make sense for safety and soundness regulation, it does not make sense in the context of consumer protection. The application of this proposed Statement only to banks, savings associations, credit unions and their affiliated lenders means that other lenders will not have to comply with the consumer protection standards unless their primary regulator changes the applicable law. As a result, consumers may mistakenly assume that a loan product that has conspicuous consumer warnings is riskier than the identical product offered by a lender that is not required to provide comparable disclosures. The proposed Statement of the Agencies actually may push consumers into the hands of the lesser regulated and supervised lenders and brokers.

We made similar observations about the Nontraditional Mortgage Guidance last year, and, looking at cable television and Internet advertising over the past months, our concerns have been borne out. We continue to see advertisements for "savings of hundreds of dollars per month on your mortgage" from mortgage brokers and from lenders not affiliated with insured financial institutions, claims that can be made either due to different disclosure standards on, or to the higher regulatory scrutiny of, insured depository institutions. We believe the Federal Reserve Board has the legal authority to apply these consumer protections across the mortgage industry.[3] Failing to do so does a disservice to consumers and to the insured financial institutions regulated by the Agencies. **ABA recommends that the consumer protections in the proposed Statement be removed and be made part of a joint rulemaking under the Federal Trade Commission Act by the Federal Trade Commission and the Agencies or part of a rulemaking by the Federal Reserve Board under its authority pursuant to the Home Owner Equity Protection Act (HOEPA) to end unfair or deceptive mortgage practices.**

6. Questions from the Agencies

Question 1. The proposed qualification standards are likely to result in fewer borrowers qualifying for the type of subprime loans addressed in this Statement, with no guarantee that such borrowers will qualify for alternative loans in the same amount. Do such loans always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances are they appropriate?

Answer: As an initial matter, ABA is concerned about the use of the word "appropriate" as a lending standard. It smacks of the imposition of a "suitability" standard that is fraught with conceptual difficulties and raises questions concerning whether a lender is in a fiduciary position with regard to its loan customers. This issue arose recently in the proposed Nontraditional Mortgage Guidance, and the Agencies, in their preamble to the final Guidance, stated—

> The Agencies disagree with the commenters who expressed concern that the guidance appears to establish a suitability standard, under which lenders would be required to assist borrowers in choosing products that are suitable to their needs and circumstances. It was not the Agencies' intent to impose such a standard, nor is there any language in the guidance that does so. In any event, the Agencies have revised certain statements in the proposed guidance that could have been interpreted to suggest a requirement to ensure that borrowers select products appropriate to their circumstances.

[3] This point is underscored in a letter from 10 Senators to Chairman Bernanke on the Home Ownership and Equity Protection Act of 1994 ("HOEPA") and subprime lending, dated April 23, 2007.

We found this clarification in the final Nontraditional Mortgage Guidance very helpful, and we encourage the Agencies to include a similar clarification in the final Statement. The Agencies should focus on the question of whether a product or practice is unfair or deceptive, the legal standard found in the FTC Act and in the HOEPA provisions, and continue to eschew considerations of whether a product is "appropriate" or "suitable."

As to the substance of Question 1, we believe that there are times when a borrower may reasonably conclude that a hybrid ARM loan best meets his or her needs. Thus, we urge the Agencies, when drafting the final Statement, to provide flexibility for lenders to continue offering hybrid ARMs to creditworthy individuals.

Question 2. Will the proposed Statement unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock? The Agencies also are specifically interested in the availability of mortgage products that would not present the risk of payment shock.

Answer: Application of the standards in the proposed Statement likely would preclude lenders from making some of the loans that have been made over the past couple of years. Thus, for that group of existing subprime borrowers who are facing payment shock as a result of interest rate resets, a rigid application of the Statement could well leave them with no option other than default and foreclosure. For this reason, we believe it would be appropriate for lenders to have the flexibility to address extenuating circumstances by continuing to offer a full range of products, including hybrid ARMs, even if such a refinancing would not meet the new standards of the proposed Statement.

Clearly, it is in everyone's best interest for a borrower to be able to repay a loan at its fully-indexed rate over the fully-amortized life of the loan. However, some current borrowers may find themselves in a squeeze of having taken out a loan that is affordable only until the interest rate resets. A lender should not be precluded by the Statement from offering products that can decrease the likelihood of default.

The Agencies clearly recognize the need for flexibility, as evidenced by their statement in the recently-issued "Statement on Working with Mortgage Borrowers"[4] that –

> The agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties.

The circumstances in which such flexibility would be called for likely will vary significantly from one borrower to the next. Thus, it is difficult to articulate a uniform standard for when exceptions to the Statement may be made. However, we believe it is important that lenders be permitted to make exceptions to the Statement on a case-by-case basis. We know that a number of banks are attempting to aid struggling subprime ARM holders in finding a viable mortgage, and will continue to do so. The determination of the safety and soundness of these loans should be viewed within the context of the borrower.

[4] Joint Release of the Agencies and the U. S. Department of Housing and Urban Development, dated April 17, 2007.

Question 3. Should the principles of this proposed Statement be applied beyond the subprime ARM market?

Answer: We know of no apparent general consumer concerns in the prime mortgage market. Certainly, we believe that consumers should be given disclosures that protect them from unfair and deceptive practices. These protections already exist, though enforcement may be uneven outside of the jurisdiction of the banking Agencies. Rather than apply the principals outside of the subprime ARM market, we have urged and continue to urge the Agencies to clearly set out that the proposed Statement is in fact limited to marketing and lending programs targeting ARMs to subprime borrowers.

Question 4. We seek comment on the practice of institutions that limit prepayment penalties to the initial fixed rate period. Additionally, we seek comment on how this practice, if adopted, would assist consumers and impact institutions, by providing borrowers with a timely opportunity to determine appropriate actions relating to their mortgages. We also seek comment on whether an institution's limiting of the expiration of prepayment penalties such that they occur within the final 90 days of the fixed rate period is a practice that would help meet borrower needs.

Answer: As noted above, ABA believes that a 60-day period before reset expiration of any prepayment penalty should be a sufficient window for the closing of a mortgage refinancing.

Conclusion

ABA supports the proposed Statement and the Agencies' efforts to protect borrowers against unfair and deceptive mortgage lending practices. We believe that the consumer protection standards embodied in the proposed Statement, particularly that lenders should ensure that disclosures of the material terms, costs and risks of loan products are made available to consumers, will help alleviate prospective issues within the subprime mortgage lending industry. However, the proposed Statement's scope and applicability should be clearly limited to marketing and lending programs for ARMs targeted to subprime borrowers. If the Agencies do not make its scope and applicability clear, the overbroad definition of "subprime" will make compliance difficult. ABA also believes that the Agencies need to make the additional clarifications recommended by the ABA, such as clarifying the standard to be used to determine the ability to repay.

Because of the uneven application of the proposed Statement to the mortgage lending industry, ABA believes that the proposed Statement actually serves to undermine the intended results of the proposed consumer protections. ABA urges the Agencies to use their existing authority to craft a more uniform consumer protection regulation applicable to all mortgage lenders and brokers, not just federally insured depository institutions. Otherwise, ABA believes that the proposed Statement will have limited value in protecting consumers in practice.

Finally, ABA believes there is a need for the Agencies to provide for greater flexibility under the proposed Statement for the refinancing of existing subprime ARMs. Otherwise, we believe that the effect of the proposed Statement will be to trap some borrowers already facing the reset of their subprime ARMs because they cannot qualify for a fixed rate product that would allow them to refinance.

If there are any questions about these comments, please do not hesitate to contact the undersigned at (202) 663-5053.

Sincerely,

Paul Alan Smith

Paul Smith
Senior Counsel