March 3, 2006

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

To whom it may concern,

After years of writing local representatives and banking regulators I am pleased that you have finally decided to address the risk layering and terrible declines in lending standards. I hope we can someday learn to address similar issues before they become a pandemic. Stated income guidelines have always been suspect, but due to recent declines in standards are now best defined as fraudulent. Option ARM loans are ticking time bombs and extremely misleading. The American Dream of homeownership should not have been exploited. Millions of borrowers, investors and the banking industry will be devastated when these loans begin to recast.

Future loan loss projections based on prior loan loss history will not provide accurate forecasts. The historical data does not reflect the existing risk layering, inadequate underwriting criteria, rapid appreciation, historically low rates or proliferation of option arms.

Option ARM originations

2002 4% of all originations
2003 10% of all originations
2004 27% of all originations
2005 37% of all originations

I have yet to find data on stated income loan originations, but 100% financing for purchases is in excess of 25%. The biggest issue I have with this data is that it is national. The percentages of option ARM originations in California and other bubble markets are considerably higher. I have heard estimates of 75% or more in some areas of California. The additional risk to lenders who are concentrated in the bubble markets is worrisome.

A specific request for comment on the analysis of option ARM borrowers' repayment capacity at final maturity is ridiculous, that task is impossible. Interest rates, home prices, negative amortization, local, national and global economic stability/prices are all unknown variables.

There has been a perfect storm building in the financial and real estate market for years. The amount of foreign owned debt is at record highs and the catalysts for keeping our interest rates low is beginning to change. Japan will begin raising rates, housing appreciation has stopped and the consumer is finally beginning to tire. I don't like to be so negative, but we need to be realistic. Doesn't anyone remember all the surplus projections from 1999?

I have heard numerous comments from lending executives regarding the healthy track records of option ARMs and negatively amortized loans. I find these statements extremely misleading at best. Obviously, the level of market exposure is unprecedented. Home prices, appreciation, DTI and LTVs have never been higher as reduced or no documentation guidelines have become the underwriting standard. Loans that can have minimum payments which are 40% of traditional payments should have excellent credit ratings, but even under current payment caps that is not the case. In addition, the components of prior option arms or negatively amortized loans are completely different now.

During their 2005 earnings call, Countrywide, America's biggest mortgage lender changed option ARM default reporting from 60 days to 90 days. It took an analyst's question to address the change. The 90 day delinquencies did not include 60 day or 30 day delinquencies. The increases in 90 day delinquencies were up 500% year over year even though 7.5% payment caps were in place. A 7.5% payment cap is ridiculously low considering the low start rates and high amounts of negative amortization.

Reported accumulation of negative amortization is up 7500% and loans with negative amortization are up 42,300%. These are very alarming statistics and the manipulation of default reporting should be equally alarming. The agencies willingness to rely upon proper controls from the lenders is about like the fox watching the chicken coop. It is time for a little more "hands on" in regards to financial regulation.

http://about.countrywide.com/presentations/docs/4Q05%20Conference%20Call%20Slides%20FINAL.pdf (page 18)

The footnotes on the page above are also very misleading and could provide much more damning information. Countrywide is now charging 3.125 pts to originate an option arm loan. This is a dramatic shift from par or 1% origination fees previously charged by CFC and the par pricing that still exists in the industry. The terrible demand for this product in the secondary markets has already had a huge impact on the value of lenders' portfolios and the true risks are unknown and incalculable. Neither the agencies nor the analysts have warned investors about these material facts. The value of the option arm lenders' portfolios have already been hit hard, but the investor is unaware.

I have seen lenders approve buyers when over 100% of their GROSS income was required just to service the minimum payments on an option ARM. Needless to say these approvals were under stated (inflated) income guidelines. Let it be noted that the borrower did originally provide their income documents, but was told they were not needed. When the borrower questioned about the new income, he was told that this was acceptable and everyone was doing it.

It is well documented that option arm start rates are dangerously too low. Fully indexed rates have increased over 350 basis points in the last 18 months. Negative amortization has and will continue to increase at a faster pace as this spread increases.

I realize comments are to be directed towards non-traditional mortgage products, but since we are talking about risk layering, banking M&A and trading activity should also be addressed. We are clearly in uncharted waters with regards to lending standards and loan products. Future M&A activity should not be allowed until realistic payment histories are established for the current risk. In the next two years record volumes of option ARMs will begin to recast. In many cases loan payments could triple from original minimum payment requirements, even if the Fed stops raising rates. In addition to loan loss risks are the risks from the banks' trading activity. Trading activity in derivatives has accounted for huge percentages of banking profits and losses.

The recent acquisition of Providian Financial by Washington Mutual without public hearing is one for reference. This merger allowed additional risk layering within one of the largest mortgage companies in the United States. Increased minimum credit card payments, huge levels of short-term debt and a customer base of primarily sub-prime borrowers will prove to be extremely problematic for Washington Mutual. The combination of a sub-prime credit card company with an aggressive option ARM lender at the peak of a credit cycle should have been looked at closer. Sub-prime lending is becoming more prevalent. Recent epic failures from rampant M&A in the telecom and energy sectors should have been an adequate warning. Small corporate failures should be preferable to large failures, especially when increasing demands are continually placed upon our society: Baby boomer retirement, Medicare, Iraq, Katrina, etc.

Home Loan Debt (in trillions)

Year	End of Year	% Increase from prior period	Fed Funds prior 4 year average
1985	$1.45		
1989	$2.27	57%	7.56%
1993	$3.01	33%	5.08%
1997	$3.78	20%	5.20%
2001	$5.29	40%	5.11%
2005	$8.82	67%	1.84%
1985-2005		600%	

Home loan debt is up over 600% from the last real estate peak and the average Fed funds rates are down almost 600 basis points. The lower interest rates and nontraditional products have temporarily helped service this large amount of debt, but the inflection point is rapidly approaching. The prospects do not look favorable, especially as wages have remained stagnant and downsizing is gaining speed.

The majority of this increased debt is due to increased demand for securitized assets. The demand was created by a lucrative carry trade and profits from oil producing nations. This data tells volumes for recent banking profits, home prices and future risks. The increased use of securitizations has not been properly tested under stress.

The secondary markets are now seeing a dramatic decrease in demand for securitizations, especially option ARMs. All of the option ARM originators are now retaining more of the option ARM products in their portfolios and the marketing efforts are not slowing. Risks are growing exponentially. I would estimate that 80% or more of lending advertising is targeting the option ARM product, marketing needs to be stopped until performance can be established!

Risk layering from favorable market conditions

Beyond the layering of risk from stated/no documentation guidelines, nontraditional products and leverage is the layering of favorable market conditions: Incredibly low interest rates, rapid appreciation, recent demand for securitizations, perception of real estate price stability/speculation, $500,000/$250,000 capital gain tax exemptions and low CORE inflation. To exclude homeownership costs, food and energy from inflation is just another game of "smoke and mirrors". Globalization has kept core inflation low and the dollar is now dependant upon high oil prices and higher interest rates.

Option ARMs, Stated Income & Low defaults

The current option arms are completely different than prior negatively amortized loans. LTVs and potential for negative amortization were much lower. Caps were previously based on interest rates versus payments. A 2% increase per year to the interest rate would be a much more substantial increase than a 7.5% payment cap, thus reducing negative amortization, compounding interest and payment shock. High levels of appreciation and reduced credit standards have made it easy for troubled borrowers to find access to more debt paying capital. The declines in lending standards have also allowed "bigger fools" to play their part. Delinquencies under prior guidelines were experienced earlier and LTVs were lower, which allowed lenders to mitigate loss. Current option ARMs have higher LTVs, lower start rates and more negative amortization. At the time the loan is recast it is very likely that the initial payment will triple and this will place a whole new meaning on payment shock. There is no comparison with current/prior negatively amortized products and market conditions!

Stated/no documentation guidelines

Stated income guidelines previously required that you were self-employed, had excellent credit, 6 months of stated income in reserves and an LTV of 75-80% or lower. Now, stated income guidelines can be for 100% financing, marginal credit and wage earners. In addition, the reliance of FICO scores is very over-rated. FICO scores are great at predicting the past, but not the future, especially with additional debt loads and payment shocks. Earning and saving potential is a better barometer for future risk. Factual income and savings documentation should be used to quantify future risks not FICOs.

Excessive executive compensation and expansion

The acceptance of excessive compensation has provided incentives for executives to stretch prudent lending guidelines. Shareholders and executives became accustomed to the huge lending volumes and profits of the 2003 refinance boom. Instead of being prepared for the eventual slow down or market saturation, most lenders began a race to the bottom. Huge branch expansions were underway hoping to win market share. As loan volume dried up, the promotion of non-traditional, exotic, extremely risky lending products took off. Qualification standards were literally thrown out the window because the "carry trade" brought many buyers into the secondary markets. The securitizations of most of these loans have recourse and it may be years before we know the consequences of this irrational exuberance. Demand for these products has slowed and now both the borrowers and lenders are more leveraged and exposed than ever before. Additional branch expansions may result in a continued “carry trade” effect. Investors will transfer from real estate secured assets to FDIC insured assets. The increased deposits will force lenders to make additional risky loans or experience inverted/negative margins. Branch expansions should be limited until the effects of the slowing credit boom, slowing housing market, carry trade and nontraditional products have been quantified. We are now facing issues much larger than just the risk layering of nontraditional mortgage products.

We can not continue to allow these bubbles to be created under the guise of "laissez faire" and later place blame on greed or corruption. Who among us would be able to withstand the performance pressures or lure of excessive wealth? I know if I was in such a powerful position I would prefer to have more regulation over my decisions and especially that of my subordinates.

1990 Real Estate Bubble / Securitizations / S&L Crisis / Irrational exuberance

I have been a real estate and mortgage broker for 14 years and have witnessed the aftermath of the 1990 real estate bubble/crash and S&L crisis. The size of the 1980's real estate bubble is miniscule compared to the current bubble. The 1980s bubble was created with more strict guidelines and much higher interest rates, but still resulted in much insolvency. Stated income loans, securitizations and 100% financing was relatively non-existent. Relative to income, home prices were much more affordable then compared to now.

The FBI and others have documented that loan loss rates are understated, especially within securitized loans. If a holder of a securitized asset wants or needs to sell that asset they will obviously get a much better price for tranches with good performance. Is the true performance stated or factual?

At the beginning of 1985 Fed funds were approximately 8%. By the end of 1986 we reached approximately 6% which helped fuel the 1980s housing boom. By the peak of this real estate cycle, rates approached 10% in 1989. Obviously, we had much more room to stimulate the economy than we currently possess. After Fed funds hit historically low levels in 1993 of 3% the real estate market and economy was still sputtering. It was not until around 1996 when the internet boom spurred economic activity. I would argue that it was the internet economy and increased productivity versus monetary policy that was able to finally lift us out of the 1991 recession and real estate crisis. Although unknown, it is very unlikely we will see another boom like the 1990s. We have seen increased productivity since 2001, but most of the economic activity has been debt related to housing and the carry trade. After 1999 everyone was ready and willing to create another bubble.

Proposal

Home price and economic stability should be a goal of all agencies. We have been bouncing from bubble to bubble for decades and the global environment has dramatically changed. At some point all of our increased leverage will come back to haunt us. We continue to hide our financial problems: The elimination of the dollar-gold standard, proliferation of securitizations and now the option ARM/non-traditional lending guidelines. This statement may sound too aggressive, but if we analyze the increased use of the option ARM, stated income guidelines, home appreciation, equity extraction, consumer spending and recent GDP growth there is a direct correlation. We continue to find ways to over-leverage our incomes while forecasting the most optimistic future scenarios. The recent stock market bubble is an excellent example. If our government and economic scholars can not exhibit spending restraint or accurate income forecasts how can we expect the average American homeowner to do so.

There are lenders that have recently increased start rates by approximately 25 basis points from 1% to 1.25% or 1.375%, but this does little to curtail negative amortization and payment shocks. Especially, since lenders have also increased their margins by an equal or greater amount. These same lenders have also increased their qualification rates, but most of the lenders are still using stated income guidelines. This appears to be the same old lip service and manipulation.

I would propose to immediately reduce stated income LTVs to 75% or less. No doc loans should be limited to 70% LTVs. Relative to incomes many of the most expensive-populated areas are already 20-40% over-valued, so this is a conservative reduction. Stated or no doc loans should only be used for self-employed or borrowers with a high net worth. High net worth could be defined as 20% of the proposed loan amount in liquid reserves.

Given that interest rates and option ARM performance are unknowns the agencies should strive to reduce potential payment shocks and defaults. Current option ARM payments could easily triple once the loans are recast and defaults will obviously rise. If the agencies feel option ARMs still have a place in the market for "savvy" borrowers why not increase the start rate to a fully indexed rate or 5% which ever is greater. These loans could still possess negative amortization, but the payment shock will be greatly reduced. I believe interest only loans are an adequate alternative for the savvy borrower.

Interest rate cycles change and the current environment favors 30 year fixed programs to reduce interest expense. If investors and homeowners are looking to save on cash flow perhaps they can not afford the home or should look elsewhere for savings.

First time home buyers with 3-10% down-payments should qualify with full documentation loans on 30 year fixed loans (interest only is acceptable). DTI ratios of 40/45 provided compensating factors (job security, increased income potential, excellent credit, etc). The current difference between a 3, 5, 7, 10 and a 30 year fixed loan is minimal. No one is able to accurately predict future interest rates, but it is known that we are still at historically low levels. More than anyone first time homebuyers need stability.

Other issues

1) Credit card lending should also be looked at closer. Introductory interest rate offers and the new minimum payments are setting up borrowers for huge payment shocks. Income qualifications should be used for credit lines above $5,000.

2) The agencies should report the findings/reform from the nontraditional mortgage product comments to the IRS. I would hope that tighter lending guidelines will be enforced and thus additional risks to the real estate market would be realized. The proposed elimination or reduction of mortgage interest deductions and property tax deductions could layer additional risks to the real estate market.

3) It is obvious that many lenders have not performed adequate control or monitoring of their products. They should not be allowed to engage in real estate commerce outside of finance.

4) The FDIC should change its policy to support M&A activity where one company is insolvent. This could easily prolong the inevitable failure and greatly increase its magnitude.

Sincerely,

Michael S. Blomquist
408-399-0590 ph