AMERICAN BANKERS ASSOCIATION ®

1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

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Paul A. Smith
Senior Counsel
Phone: 202-663-5331
Fax: 202-828-4548
psmith@aba.com

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Filed via e-mail

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429
Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.,
Washington, DC 20552
Attention: No. 2005–56
regs.comments@ots.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 1–5
Washington, DC 20219
regs.comments@occ.treas.gov

Re: **FDIC** (No docket number provided); **FRB** Docket No. OP–1246; **OCC** Docket No. 05–21; **OTS** Docket No. 2005–56; Proposed Interagency Guidance on Nontraditional Mortgage Products; 70 Federal Register 77249; December 29, 2005.

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies") have proposed an Interagency Guidance on Nontraditional Mortgage Products ("Guidance") that would greatly increase the level of supervision applicable to these mortgage products and create new consumer protection requirements. While not all commercial banks or savings associations originate or purchase these mortgage products, a number of them do and some of them hold significant portfolios of these products. Therefore, this Guidance may well have significant impact upon the banking industry in general. The American Bankers Association (ABA) appreciates the opportunity provided by the Agencies to comment upon the proposed Guidance, and we particularly appreciate that the Agencies granted our request for a 30-day extension in the comment period in order to develop these comments more fully.

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.

I. General comments

Summary

While the banking industry agrees that these products need to be carefully managed, the industry has a number of concerns about the proposed Guidance. In brief, we believe that:

1. The Guidance overstates the risks of these mortgage products.
2. The Guidance is overly prescriptive and needs to be made more flexible and clearer.
3. The Guidance combines safety and soundness guidance with consumer protection guidance, creating confusion that is best addressed by separating them.
4. The Guidance's detailed consumer protection recommendations add a layer of additional disclosure before and around the legally required Regulation Z disclosures, thereby perhaps creating significant compliance problems.
5. The Guidance's new consumer protections will apply only to regulated financial institutions and their affiliates and not to other lenders, which is inconsistent with other consumer provisions under Regulations B and Z and Section 5 of the Federal Trade Commission Act (unfair and deceptive practices) and which leaves a significant portion of the mortgage industry unaffected.

Analysis

1. The Guidance overstates the risks of these other mortgage products.
Much of the tenor of the Guidance is that nontraditional mortgage products are inherently riskier than other products. We believe that is incorrect; rather, they simply present different types of risks that may be well-managed by prudent lenders. In fact a number of savings associations and national banks have managed the risks from these products for two decades. We are concerned that the Guidance pays little heed to that experience and the increased supervision over the last two decades.

We note that two of the Agencies, the OCC and the OTS, have had regulations authorizing adjustable rate mortgages (ARMs) with negative amortization features since 1981. The reasons for this were simple: consumers could no longer obtain the housing that they wanted using the fixed rate mortgages then available at extremely high interest rates. Further, the Agencies wanted regulated institutions to move away from fixed rate mortgages as being too risky in the volatile interest rate environment of that time. In fact, these products provided not only a consumer benefit but also improved interest rate risk management for the lenders. The success of these products led to Congress enacting the Alternative Mortgage Transaction Parity Act in 1982. This Act authorized the federal banking regulators to pre-empt by federal regulation state-created limits on adjustable rate mortgage lending by state-charted entities, and soon thereafter the federal thrift and national bank regulators specifically extended to state-chartered mortgage lending entities the authority to make negative amortization ARMs.

In the early years of these products, they were largely confined to the housing markets of southern California, where rapid increases in housing costs made their adoption by consumers reasonable.

Today, there are a number of markets around the country that have shown rapid increases in housing costs, and consumers want these mortgages because housing prices have become much less affordable without the use of interest-only mortgages, option ARMs, or variations of such products. But this Guidance now goes far beyond any previous regulatory restrictions on these mortgage products, without a significant showing that the risks in these mortgage products have materially changed since they were created over two decades ago. We believe that this is an overreaction on the part of the Agencies that will greatly restrict the availability of these mortgage products to knowledgeable consumers who want them — unless the Guidance is materially revised.

2. The Guidance is overly prescriptive and needs to be made more flexible and clearer.
While we agree with the general approach of the Guidance, we are very concerned that if it is not made both more flexible and clearer, then it will be excessively burdensome and will probably greatly reduce availability of these products. To address these concerns, ABA first suggests that the Agencies make clear that the Guidance is limited to nontraditional mortgage products described in the Guidance and does not have wider application. Specifically we note that the Agencies have already issued recent guidance on home equity loans and home equity lines of credit (HELOCs). These products typically do not include negative amortization features and do offer extended interest-only periods that avoid payment shock in the near term. Agencies should make clear that the Guidance should not be seen as amending the recent guidance on home equity lending and that home equity lines of credit and second lien home equity loans are excluded from the Guidance.

In addition, we are concerned that the Guidance is not very clear as to what is a nontraditional mortgage product subject to the Guidance. The lack of a clear definition of an "alternative mortgage" in the Guidance is extremely problematic and could weaken the very controls and consumer protections the Agencies seek to provide. Related to this concern, we urge the Agencies to redraft the Guidance to distinguish more clearly between the risks posed by negative amortization products (whether option ARMs or below-rate, interest-only mortgages) and the risks posed by interest-only mortgages that are not negative amortization products. Interest-only and payment option ARMs are different products, especially if the interest-only ARM does not allow negative amortization.[1] It is our understanding that each of these is treated differently by lenders in terms of credit policy, underwriting, and risk management. The Proposed Guidance does not appear to recognize these differences. A number of banks have indicated that they do make available to their customers interest-only mortgages, and they are concerned that the Guidance appears to make little distinction between the risks to the institution and the consumer posed by those mortgage products versus mortgage products with potential negative amortization. This is unnecessary in terms of addressing the risks of interest-only mortgages without negative amortization as well as addressing concerns about adequate consumer protections.

In addition to these general concerns, we note the following concerns about specific provisions of the Guidance.

<u>A. Loan Terms and Underwriting Standards</u>
As to specific loan terms and underwriting standards, the Agencies highlight several questions in the request for comments under the general issue of qualification standards. First, they ask: (1) 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?

[1] The Guidance clearly considers some interest-only mortgages to be negative amortization products, such as when the initial interest rate is below the contract rate, and the difference is added to the principal. ABA notes that many bankers use the term "interest-only" <u>only</u> when there is no negative amortization.

This requirement appears to be excessive. While ABA agrees that these products should certainly not be underwritten at an introductory rate, the proposed underwriting standard is too prescriptive and conservative. A properly constructed stress test would not assume that every single borrower would make only minimum payments over the life of the loan, but would make appropriate assumptions about the worst-case percentage of borrowers who would actually experience payment shock (e.g., on a payment option loan, (1) have not opted to amortize their loan; (2) are still borrowers when the higher, amortized payments apply and (3) cannot afford those payments at that time). Performance of these loans may well vary with the local market and certainly will vary depending upon other credit underwriting conditions, such as the lender's acceptable LTV ratio, credit score for borrower, and other factors. Moreover, lenders need to be able to model their underwriting based on these considerations. For example, payment shock will not be an issue if the borrower pays off the loan during the initial period, which is often the case, and lenders should be allowed to recognize runoff rates. Institutions with significant experience with these mortgage products state that a significant segment of borrowers in fact prepay principal at a faster rate than would occur on a 30-year fixed rate loan.

The Agencies then ask: (2)(a) 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? (b) What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? (c) Whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers?

This appears to assume that "stated income" is generally inappropriate for interest-only and option ARMs, but depending on the bank's policies for using "stated income" with other mortgage products, that might be an erroneous assumption. Bankers agree that use of "stated income" generally requires other risk mitigation, such as higher credit scores, substantial reserves or higher down payments, or the use of mortgage insurance. In the case of subprime borrowers, inherently there is no higher credit score to mitigate possible higher credit risk from using reduced documentation, but lower LTV ratios or adding mortgage insurance or co-signers may be successful risk mitigants. Additionally, in cases in which the bank already holds a seasoned first mortgage, a stated income refinance would be appropriate. Thus the blanket categorization of using stated income as "generally inappropriate" appears to be overly prescriptive and inflexible.

The Agencies also ask: (3) Should the Guidance 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? 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?

ABA believes that it would be very difficult for the Guidance to attempt to address use of future income in the qualification standards. Future income is very difficult to predict, and other potential events merely add to the unpredictability. Most of the bankers consulted by the ABA on this letter did not consider future income on any consistent basis, though none ruled out the possibility that a particular borrower might have circumstances in which his or her future income could be validly estimated. The potential for future income increases is generally seen as a compensating factor for future payment increases.

Collateral-dependent loans
The Guidance provides with respect to collateral-dependent loans that "[l]oans to borrowers who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound." The Agencies appear to suggest that low-documentation (low-doc) loans could be considered *per se* collateral-dependent. We believe that it is incorrect to imply that low-doc loans are generally made to borrowers who do not demonstrate a capacity to repay, without reference to other significant credit risk factors. The ability to pay may be fairly determined by information from credit bureaus and use of scoring models. ABA believes that the Agencies should provide clearer guidance as to what they will consider a collateral-dependent loan. For instance, a loan to a borrower whose income is not verified, but who has substantial verified assets can be a sound credit and not collateral-dependent, as that term appears to be used in the Guidance.

Risk-layering
The Guidance lists several additional factors that are labeled "risk-layering" and are required to be offset by higher levels of controls or credit risk mitigation. We find that the Guidance makes little distinction among the factors, with the result that it applies unnecessary restrictions to some less risky factors. It does not appear to our lenders that all of the factors cited as creating risk-layering in fact do so, nor do these factors represent equal amounts of additional risk. We are particularly concerned that the Guidance's provisions on the use of simultaneous second liens raising the LTV ratios also will be applied to a lender's underwriting of home equity lines of credit (HELOCs) when the lender does not hold the first mortgage. There appears to be no consideration of the seasoning of the first mortgage when adding a second mortgage HELOC, and we believe that this is an error. As previously noted, we urge the Agencies to clarify that this Guidance does not also apply to HELOC lending, as the Agencies have recently released new guidance in that area.

The goal of the underwriting process is not to prevent all defaults, but to evaluate the risk and make mortgage credit available at a price that reasonably reflects risk. The trend in underwriting, exemplified by automated underwriting systems, has been to take a layered approach in which the lender can give a quick response to the majority of straightforward applications while devoting underwriting resources to the most difficult cases. Thus, this approach to underwriting allows low documentation underwriting by looking at other factors, such as credit score, lower LTV ratio or other risk mitigants. The Guidance should not be so overly prescriptive so as to prevent lenders from taking this same approach to nontraditional mortgage products.

Reduced-documentation
As noted above, low documentation procedures are authorized by the secondary market in prescribed situations, often in conjunction with specific underwriting systems. We are concerned that this proposed Guidance appears to conflict with such underwriting systems, and believe that any agency guidelines should be based upon discussion and agreement with established secondary market sources such as Freddie Mac, Fannie Mae, the USDA's Rural Housing program, FHA, VA, GNMA, and the Rating Agencies.

Non Owner-Occupied Investor Loans.
The proposed Guidance provides that "[b]orrowers financing non owner-occupied investment properties should be qualified on their ability to service the debt over the life of the loan." In most cases, our lenders do not find that in fact investors hold the property over the life of the loan. A

more reasonable standard might be based on the ability to service the debt over a shorter period reflective of actual customer patterns for prepaying loans, such as 5 to 7 years.

Additionally, the Guidance requires that the investor demonstrate sufficient resources to service the debt in the near term. The Guidance does not provide a definition of near term, but our lenders seem typically to look for the ability to service the loan over the next six months. We recommend that the Agencies clarify "near term" as approximately six months.

B. Portfolio and Risk Management Practices

The requirements of the Guidance for written policies and the segmentations of the portfolio for various risk factors, concentration limits, monitoring and reporting seem excessive for smaller institutions. The Guidance does not appear to consider any scaling of the monitoring of these loans and of the portfolio management policies commensurate with the size and complexity of the portfolio and bank. This appears to us to be contrary to the direction of supervision for the last decade. Increasingly, the size and complexity of the organization leads to recognition of the need for such scaling, particularly when imposing additional burden on community banks. Otherwise, the impact of full implementation of the Guidance simply may be to drive smaller institutions out of the market.

In particular, we are concerned about the projected level of mandated stress-testing. Loan-level stress-testing is unprecedented and, if taken literally, would drastically reduce nontraditional lending. If the same approach were applied to traditional lending, it would significantly reduce all lending. No lender would feel comfortable making a 30-year fixed-rate loan to a 45-year-old couple if the lender had to establish that the borrowers would still be (1) alive and (2) able to make the full payment at age 75.

Valid stress-testing, which lenders should and do conduct for their entire portfolio, makes reasonable worst-case assumptions for default and runoff rates. The proposed Guidance should clarify that the need to consider the borrower's ability to absorb higher payments does not require unrealistic assumptions about the whole portfolio. In particular, lenders should be allowed to consider reasonable, although still worst-case, default rates and assume that many loans will be paid off before amortization begins.

ABA is also concerned that the requirement in the Guidance that lenders consider particular product features when establishing a reserve methodology is not only unworkable but also appears to conflict with existing accounting policy and industry standards for such reserve methodology. Rather than create additional problems, we recommend that the Agencies adhere to existing policy guidance on establishing appropriate reserves. To the extent credit risk at an institution is increasing in certain portfolios, judgmental reserves can be allocated during examination.

Further, the Guidance appears to apply to any nontraditional mortgage, no matter at what stage the bank becomes involved with the loan. Wholesale transactions undertaken through brokers do not allow the institution to focus on the marketing practices that the Guidance emphasizes. Neither do transactions with correspondents or the securitization process. It is simply impossible, to put it bluntly, for institutions to monitor all of the marketing or disclosure practices of correspondents. Most large lenders have thousands of correspondents and bulk sellers with whom they do business. It would overwhelm the resources of any institution and would simply put them out of this business.

In particular, the Guidance asserts that banks will be liable for all violations of the Guidance, even if the loan were originated by a non-covered lender or broker. We believe that this actually overstates the reach of the law and could have significant impact on the secondary market by creating uncertainty over legal liability and by putting companies with depository institutions at a significant disadvantage, largely without clear legal basis for the application of the Guidance. Brokers and correspondents are subject on their own to the Truth in Lending Act and other consumer protection laws and are subject to liability for violations. As independent companies, their legal responsibilities must be independently monitored and enforced by the appropriate agencies and not put on the backs of the financial institutions with which they do business—representations and warranties notwithstanding.

Similarly, securitizers cannot ensure that all the loans in the pools they securitize comply with the Guidance. Neither are they in any position to monitor or control the marketing and disclosure practices of the financial institutions.

Thus ABA concludes that several components of the Portfolio and Risk Management Practices are literally unworkable, and need to be considerably amended by the Agencies before they could be issued as guidance. Imposition of these provisions would essentially dismantle significant portions of the broker market, because banks could not police the large number of brokers that they may occasionally use. Moreover, these disruptions to the market, we believe, will significantly reduce consumer choices and the competitiveness of the marketplace.

3. The Guidance combines safety and soundness guidance with consumer protection guidance, creating confusion that is best addressed by separating the them.

To begin with, the Guidance is limited to banks and their affiliates and subsidiaries. According to the preamble, "the Guidance would apply to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions." While this makes sense for safety and soundness regulation, it does not make sense to add these additional consumer protection provisions with respect to products that are already subject to consumer protection disclosures under the Truth in Lending Act and its implementing Regulation Z as well as other consumer protections under Regulation B and Section 5 of the Federal Trade Commission Act. Regulation Z, Regulation B and Section 5 of the FTC Act apply to virtually all lenders, whether affiliated with banks or not. The application of this Guidance only to banks, savings associations, credit unions and their affiliated lenders creates confusion in availability of consumer protections that are unnecessary and possibly harmful to consumers.

Additionally, while from a safety and soundness supervisory view, application of supervisory guidance to subsidiaries of holding companies may be justified, application of the consumer protection aspects of the Guidance to those subsidiaries appears to conflict with long-standing policy of the Federal Reserve Board not to conduct consumer examinations of such nonbank affiliates. Since these nonbank entities are properly under the direct authority of the Federal Trade Commission or of the Department of Housing and Urban Development, the apparent new assertion of supervision by the Federal Reserve Board is surprising. As the Board noted in its attachment to its Consumer Advisory Letter 04-2:

> A number of agencies have authority to combat unfair or deceptive acts or practices. For example, the FTC has broad authority to enforce the requirements of section 5

of the FTC Act against many non-bank entities.[4] In addition, state authorities have primary responsibility for enforcing state statutes against unfair or deceptive acts or practices. The Agencies intend to work with these other regulators as appropriate in investigating and responding to allegations of unfair or deceptive acts or practices that involve state banks and other entities supervised by the Agencies.

[4] 15 U.S.C. § 45(a)(2) and Gramm-Leach-Bliley Act § 133, published in notes to 15 U.S.C. § 41.

We believe that this situation mirrors the fair lending jurisdiction of the Agencies. When the Government Accountability Office suggested that the Federal Reserve Board broaden its fair lending examination and enforcement of nonbank entities affiliated with banks and bank holding companies, then Chairman Greenspan wrote to the GAO with the following observations:

> Enforcement of the fair lending laws, including the authority to determine compliance, has been specifically granted by statute to various agencies other than the Board, except with respect to state member banks of the Federal Reserve System. (The Board is in the same position regarding most federal laws, including the securities and equal employment laws, as well as various state statutes.) For example, Congress specifically granted the Federal Trade Commission, and not the Board, jurisdiction over the enforcement of the fair lending laws as they apply to nonbank companies; this includes all nonbank subsidiaries of a bank holding company. This is in direct contrast to the treatment of state member banks, where the Board expressly has been granted authority to enforce the fair lending and other federal laws.
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> * * * * *
>
> The report's third recommendation is that the Board monitor the lending activities of nonbank mortgage subsidiaries of bank holding companies and reconsider our policy with respect to routine examinations. <u>We do not agree with this recommendation.</u> The matter is one that we recently studied at length. As the report notes, in January 1998 the Board concluded that while we have the general legal authority to examine these entities, we have neither the clear enforcement jurisdiction nor the legal responsibility for engaging in such activities, as the Congress has directly charged the Federal Trade Commission with these duties. <u>But we did not then, and do not now, rule out making a decision to investigate further a particular case in connection with an application, as we have done in the past, when factors present suggest that discriminatory practices are occurring – and when it seems appropriate for the Board to do so because the matter may relate to relevant managerial factors. Even in this situation, however, the Board's authority seems limited to referring our examination results to the appropriate agency for enforcement.</u> [Emphasis added.][2]

This Guidance appears to reflect a broad change in enforcement, supervision and jurisdictional policies of the Federal Reserve Board with respect to nonbank subsidiaries of bank and financial holding companies without clear discussion of any authority or necessity for the change. Certainly the Guidance's application of additional consumer protection requirements to nonbank affiliates exceeds the Board's previously expressed limits as noted above.

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[2] See letter dated September 20, 1999, to Mr. Thomas MacCool, GAO, from Federal Reserve Board Chairman Greenspan, <u>GAO/GGD-00-16 Large Bank Mergers and Fair Lending</u>, Appendix IV, pp. 44-47 (November 1999).

Here, rather than investigating a particular case, the Board exerts a broad mandate to all nonbank affiliates. Rather than doing so because the Board has evidence of a violation of law, the Board would apply this Guidance without any showing of existing violations or problems. ABA is concerned that these apparent changes in supervisory and enforcement policy may arise simply from the Board trying to marry safety and soundness supervision with consumer protection supervision. The result of this marriage of inconvenience between supervision and consumer protection appears to blur long-established jurisdictional lines. At a minimum, a change of this magnitude in examination and supervision policy should not be made as a side effect of the consideration of this proposed Guidance.

Second, the combination of safety and soundness guidance with consumer protection guidance appears to create confusion in the Guidance. In the discussion of appropriate underwriting standards, the Guidance states that "an institution's qualifying standards should recognize … that nontraditional mortgage loans often are **inappropriate** for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores." The use of the term "inappropriate" in a discussion of underwriting seems to confuse creditworthiness with suitability, and we find this echoed in the discussion of consumer protections when the Guidance states, "also **appropriately** alert consumers to the risks of these products…." In discussing underwriting, the Agencies should be focusing on risk levels of default and loss and creditworthiness of borrowers rather than "appropriateness." We are concerned that the Agencies are creating a new "appropriateness" or "suitability" standard that we are very reluctant to see applied in lending, if "suitability" is to mean something other than creditworthiness.

ABA does not believe that the lender's role is to limit the borrower's choice of mortgage products or features for which he or she qualifies. We would expect the first response of an applicant who is told that while the lending institution deems him or her to be creditworthy, nonetheless the lender is denying the application on the grounds that the mortgage product is simply "not appropriate" for the applicant, will be to file a fair lending complaint. Given the lack of guidance on what would be appropriate, we believe that it would be hard for the lender to defend against such a complaint.

Third, the Guidance incorporates other guidance already issued for banks that does not clearly apply to nonbank lenders. The Guidance specifically references the Interagency Guidelines Establishing Standards for Safety and Soundness and other real estate lending regulations and guidance. By implication, it also incorporates all guidance on the proper reserving for the Allowance for Loan and Lease Losses. Since several of these do not apply to nonbank entities, even if they are affiliated with banks or savings associations, the use of the Guidance to extend additional real estate lending guidance to nonbank lenders is problematic.

ABA recommends that the safety and soundness provisions relating to underwriting and to portfolio management be separated from the consumer protection provisions. We also recommend that the application of these safety and soundness provisions to nonbank lenders be reconsidered, since it appears essential for such application that it be determined that the nonbank affiliate actually could pose a safety and soundness concern for its bank affiliates or that its activities violate existing law or regulation, reflecting upon the management of the bank or financial services holding company.

4. The Guidance's detailed consumer protection recommendations add a layer of additional disclosure before and around the legally required Regulation Z disclosures, thereby apparently creating significant compliance problems.

While the banking industry strives to provide adequate disclosures to consumers, particularly as required by existing consumer protection regulation, the Guidance's detailed recommendations add a layer of additional disclosure before and around the legally required Regulation Z disclosures that may create confusion in consumers and also appear to create significant compliance problems for banks and savings associations. Nontraditional mortgage loans are already subject to consumer disclosures under Regulation Z. Regulation Z requires, among other things, at the time of application or before the fee is paid (whichever is the earlier), that the applicant be given certain detailed disclosures:

a) The fact that the interest rate, payment, or term of loan can change;
b) The index or formula used to make adjustments, and the source of information about the index or formula;
c) An explanation of how the interest rate and payment will be determined, including an explanation of how the index is adjusted (*e.g.,* addition of margin);
d) A statement that the consumer should ask about the current margin and interest rate;
e) The fact that the interest rate will be discounted and a statement that the consumer should ask about the amount of the interest rate discount;
f) The frequency of interest rate and payment changes;
g) Any rules relating to changes in index, interest rate, payment amount, and outstanding loan balance, including, for example, an explanation of interest rate or payment limitations, negative amortization and interest rate carryover; and
h) At option of creditor, either
   (1) An historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program disclosures using the most recent 15 years of index values. The example shall reflect all significant loan program terms, such as negative amortization, interest rate carry over, interest rate discounts, and interest rate and payment limitations that would have been affected by the index movement during the period, or
   (2) The maximum interest rate and payment for a $10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan program disclosure assuming the maximum periodic increase in rates and payments under the program; and the initial interest rate and payment for that loan and a statement that the periodic payment may increase or decrease substantially depending on changes in the rate.

Regulation Z applies, under the Truth-in-Lending Act, to all individuals or businesses that regularly extend consumer credit that is subject to a finance charge, but the Guidance will apply only to federally-insured institutions and their holding companies and their nonbank subsidiaries.

The difficulty in applying the Guidance is that the Guidance calls for consumer information that is similar but not identical to the disclosures required under Regulation Z, which we believe will lead to further consumer confusion at time of application. The proposed Guidance related to consumer communication could be considered redundant in parts, and it also differs from the Regulation Z requirements regarding timing, type, and amount of information provided. Essentially, the consumer section of the proposed Guidance focuses on payment shock and negative amortization, which is clearly already addressed in Regulation Z with very specific requirements. We note that the Regulation Z disclosures on these items are not more highlighted than other important information about the loan. Thus, we are concerned that two similar but not identical disclosures to the consumer, one during "shopping" and the other at application, will prove confusing. Additionally, there is the issue of answering consumer questions raised by the Guidance disclosures during the application, so that the lender is required to provide information outside of the Regulation Z disclosures. ABA believes that this is also problematic, in that it is likely to confuse the customer and may in fact reduce the value of the Regulation Z disclosures.

In addition, the proposed Guidance focuses on marketing and promotional practices, communications, and unfair and deceptive acts or practices. The Guidance seems to be targeting advertisements as well as individual contact with consumers prior to application. The Guidance envisions each lending institution making these other disclosures sometime *before* application, during the "shopping" period. Not only is this difficult to enfold into a Regulation Z mortgage compliance program, but it may even trigger a need to make Regulation Z disclosures. Worse, these additional disclosure requirements will probably cause consumers to perceive banks' nontraditional mortgages as higher priced than non-regulated lenders' <u>identical or worse</u> products, so that the unintended consequence is to drive consumers away from the better, more regulated lenders to the largely unregulated lenders.

The Guidance also seems to set a multiplicity of standards that each institution's disclosures must meet. At various places in the Guidance, institutions are exhorted to --

> <u>Ensure</u> that consumers have information to <u>clearly understand</u> loan terms and associated risks prior to making a product choice.
>
> ... ensure that consumers <u>have information that is timely and sufficient for making a sound product selection decision</u>.
>
> ... present important information in a clear manner and format such that consumers <u>will notice it, can understand it to be material, and will be able to use it in their decision-making processes</u>. Furthermore, when promoting or describing nontraditional mortgage products, institutions should provide consumers with information that will <u>enable them to make informed decisions and to use these products responsibly</u>.
>
> ...enable[ ]consumers <u>to prudently consider the costs, terms, features, and risks</u> of these mortgages in their product selection decisions....
>
> ... provide clear and comparably prominent information <u>alerting the consumer</u>, as relevant, that these payment amounts will increase....
>
> ... offer <u>full and fair</u> product descriptions when a consumer is shopping for a mortgage, not just upon the submission of an application or at consummation.

Compliance officers reviewing these multiple standards tell ABA that there are too many different goals presented by the Guidance, some of which seem to suggest that the institution will now have an obligation to test that the consumer actually understands and is making a prudent decision. They believe that this is impossible to achieve and that it goes far beyond the type of standardized disclosure of pertinent terms that forms the basis of compliance with Regulation Z and the Real Estate Settlement Procedures Act.

ABA believes that the result of all of this ostensible consumer protection Guidance is counterproductive to the goals of the Agencies and of our members. We believe that it will be confusing, vary considerably from institution to institution, and may set an impossible standard for an institution to meet. It also appears to run counter to at least one of the Agencies' initiatives, namely, the OCC's attempt to make consumer disclosures (a) employ a standardized disclosure format that consumers can readily navigate and (b) use simple language and an otherwise user-friendly manner of disclosure.[3]

ABA recommends that, instead of the approach adopted by the proposed Guidance of each institution crafting consumer disclosures, resulting in a variety of standards and approaches in making disclosures to consumers, the Agencies agree on a generic consumer brochure explaining the risks of both interest-only mortgages and option ARMs, with particular disclosures relating to negative amortization and payment shock, and specify a practical time when a lender should give the consumer the standard disclosure brochure. We understand that the Federal Reserve Board's Division of Consumer and Community Affairs has already prepared such a draft document, which might form the basis for such a solution.

5. The Guidance's new consumer protections will apply only to regulated financial institutions and their affiliates and not to other lenders, which is inconsistent with other consumer provisions under Regulations B and Z and Section 5 of the Federal Trade Commission Act (unfair and deceptive practices) and which leaves a significant portion of the mortgage industry unaffected.

This creates difficult compliance issues for banks, which are being directed to police non-regulated lenders that are not subject to the actual disclosure requirements. We believe this to be a less than optimal solution. The Guidance also provides that "Institutions also should develop and use strong control systems to ensure that actual practices are consistent with their policies and procedures, for loans that the institution originates internally, those that it originates through mortgage brokers and other third parties, and those that it purchases." This will result not only in uneven application of the Guidance throughout the mortgage industry but also in covered lenders being given the task of somehow policing lenders not covered.

Our lenders tell us that this is an impossible goal. For example, one bank home mortgage lender with regional coverage found that it had purchased or used over 800 mortgage brokers in the last three years. Many of these were only for a few loan transactions; all were part of the open market in mortgage originations that has resulted in greatly lowering mortgage costs and rates over the last decades. If the bank had to develop controls for all of these mortgage brokers, it is obvious that it would simply stop doing business with the vast majority of them. While that would simplify the bank's compliance problem, it would have an enormous adverse effect on the mortgage market, since no institution that portfolios these loans could afford to buy from any broker that did not provide a large enough mortgage business stream to justify the additional "control system" costs. And, in fact, the Guidance essentially tells banks 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.

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[3] See Acting Comptroller Of The Currency Julie Williams' Testimony Before the Committee On Banking, Housing, And Urban Affairs Of The United States Senate, June 21, 2005.

Second, ABA notes that many of the marketing practices that the Agencies seem to be concerned about already are violations of existing regulations or laws, such as advertising requirements of Regulation Z, the unfair and deceptive acts and practices prohibited in Section 5 of the FTC's legislation, or the Office of Thrift Supervision's regulations on false advertising. This highlights the solution that consumers and the industry really need: far more and better enforcement of existing law and regulation rather than any additional guidance, particularly when that Guidance will not apply outside of the banking industry.

Third, we believe that the proposed disclosures are too detailed. We note that the recent Ameriquest settlement, involving allegations of specific deceptive practices, requires a few simple disclosures rather the complex range of disclosures sought by the Guidance. It is interesting to note that the Ameriquest settlement was approved by 49 of the states' Attorneys General and the attorney for the District of Columbia (Ameriquest did not do business in one state). A simple, more generic disclosure that may be prepared by all lenders in advance is preferred over the apparent requirements of the Guidance. Along those lines, we also note that the Federal Reserve's draft of a booklet for consumers on interest-only mortgages and option ARMs may provide a comparison chart that could be made into a general disclosure standard. It might even be incorporated into the existing, already-mandated "Consumer Handbook on Adjustable Rate Mortgages."

Similarly, the Guidance recommends call monitoring and mystery shopping for programs using interest-only mortgages and option ARMs. While lenders should consider these tools as part of an overall compliance program, singling out nontraditional mortgage products for this special treatment is unwarranted. Worse, the specific burden of these mandates on interest-only and option ARM programs will tend to discourage lenders from offering these products. Given the application of the Guidance only to the banking industry, this appears also to discourage good lenders from offering these products. The result is the migration of these products and their customers to the unregulated lenders, which again is a counter-productive result.

Thus, ABA recommends that any final consumer protections be imposed on all mortgage lenders through appropriate amendment of applicable regulations rather than piecemeal through this banking Guidance. To achieve that goal, we reluctantly recommend that the consumer protection part of the proposed Guidance not be done as "guidance" but rather be proposed as part of a formal rulemaking to amend Regulation Z. Only by taking those steps can we ensure consistency between these new requirements and the existing requirements of Regulation Z as well as equally broad application of these consumer protections. This would make these disclosures also available to consumers when choosing lenders not affiliated with banks and savings associations.

Conclusion

For all of these reasons, the American Bankers Association recommends that the Agencies:

a) Separate the safety and soundness provisions relating to underwriting and portfolio management from the consumer protection provisions.
b) More clearly differentiate the concerns over interest-only mortgage products versus concerns over nontraditional mortgage products with negative amortization potential.
c) Make the proposed underwriting and portfolio guidance more flexible and clearer.

d) Only issue new consumer protection requirements through rulemaking under more broadly applicable consumer protection regulations, such as in the form of amendments to Regulations B and Z.
e) Within that process, provide for a standard form of disclosures for interest-only and option ARM products to be used by consumers.

The American Bankers Association appreciates the opportunity to comment on the proposed Guidance. If the staff of the Agencies have questions about these comments, please call the undersigned.

Sincerely,

Paul Alan Smith

Paul Smith
Senior Counsel