March 29, 2006

Docket No. 05-21
Attention: Public Information Room, Mail Stop 1-5
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Docket No. OP-1246
Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

Attention: Docket No. 2005-56
Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street NW
Washington, DC 20552

Re: *CRC Comments on Interagency Guidance on Nontraditional Mortgage Products*

Dear Banking Regulatory Agency Officials:

The California Reinvestment Coalition (CRC) submits this timely comment letter on the proposed Interagency Guidance on Nontraditional Mortgage Products. CRC thanks the regulators for addressing this important issue, as these products are being aggressively sold and are having a huge impact on home ownership and home preservation in California. CRC hopes that the Guidance can be strengthened in order to better enable Californians to build and maintain home equity, and to establish stronger integrity in the banking system.

The California Reinvestment Coalition is a nonprofit membership organization of more than two hundred (200) nonprofit organizations and public agencies across the state of California. We work with community-based organizations to promote the economic revitalization of California's low-income communities and communities of color. CRC promotes increased access to credit for affordable housing and community economic development, and to financial services for these communities. Over the last few years, CRC has focused increased attention on fighting predatory financial practices in California and the nation.

Background: The Need for Agency Guidance

California has been inundated with nontraditional mortgage products, such as interest only, option ARM, low doc/no doc, and stated income loans. Interest only and option ARM loans are being sold to unsuspecting consumers as affordable products that can help them purchase homes in California that come with increasingly high price tags. Low document/no document and stated income loans can be vehicles for qualifying borrowers who really cannot afford a home loan, and alternatively, for charging more to borrowers who can qualify for lower cost loans.

In 2005, 63% of new mortgages were interest-only and adjustable-rate mortgages.[1] Over an 18-month period in 2004 and 2005, approximately one-third of homebuyers did not put any money down for their loan.[2] Approximately one-third of the $924 billion in residential mortgages originated in the third quarter is IO and option ARMs.[3] And in California, negative amortization loans accounted for 27.5% of non-agency securitizations in the state.[4]

Merrill Lynch & Co. says the rates on about $400 billion of mortgages will reset this year, while Deutche Bank puts the figure at $436 billion. As a result of interest only loans, some borrowers' monthly payments could nearly double, according to many executives and analysts.[5] Of great concern is that $507 billion of ARMs issued to borrowers with poor credit will reset over the next four years.[6]

As lenders increasingly and excessively target borrowers with these dangerous products, the risk of payment shock, negative amortization, loss of equity and ultimately loss of home will also continue to escalate for borrowers. In California, where much of the problem resides based on reviews of SEC prospectus filings for subprime securitizations, borrowers are thought to be able to deal with any payment shock issues through refinancing or selling their appreciating (at least for now) homes.

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[1] Michael Powell, "A Bane amid the Housing Boom: Rising Foreclosures," *Washington Post*, May 30, 2005.

[2] Edmund L. Andrews, "A Hands-Off Policy on Mortgage Loans," *New York Times*, July 15, 2005.

[3] Brian Collins, "Tough Guidance Coming for IOs," *Origination News*, January 2006.

[4] "Infographic: Tracking Neg-Am Loans," *American Banker*, December 22, 2005.

[5] Jody Shenn, "ARM Lenders Prep for Wave of Teaser Rate Expirations," *American Banker*, January 18, 2006.

[6] Ruth Simon, "Lenders Try to Keep Mortgage Boom Alive," *Wall Street Journal*, January 31, 2006.

But borrowers who face difficult debt to income and loan to value ratios as a result of some of these products will be in a bad position to qualify for refinance loans when rates are about to reset. For those who are able to refinance, "The Fed's campaign of raising interest rates may inevitably force people into riskier products," according to Keith Gumbinger, of HSH Associates.[7] Additionally, the majority of these loans have prepayment penalty provisions, which will put many borrowers in the position of having to refinance and incur steep prepayment penalties in order to stave off impending or realized rate resets.

While refinancing into riskier loan products or selling a home to stave off foreclosure may ease the financial impact of nontraditional mortgage products on the industry, these mitigating factors will be devastating to California residents and communities. We expect to see a huge increase in defaults, delinquencies and foreclosures as a result of the over selling of these products.

Capacity to Repay

CRC believes that lenders underwriting these loans should assume, as is often the case, that borrowers will opt to make minimum payments and thereby increase the likelihood of sticker shock and negative amortization, as the case may be. In addition, lenders should conduct stress tests that include assessing borrower ability to repay at interest rates higher than the fully indexed rate.

CRC agrees with the notion that ability to repay should focus on income, and not on credit scores or other criteria.

Stated Income

CRC would argue against combining stated income loans or loans with reduced income documentation with *any* nontraditional mortgages and/or subprime mortgages. Stated income loans provide too many opportunities for mortgage fraud and over-estimating borrowers' ability to repay, which in turn leads to unaffordable loans being originated. These loan products are perhaps appropriate for consumers who have steady income that is hard to document.

There are two sides to the problem of stated income loans. First, some unqualified borrowers can easily have their incomes inflated by brokers or loan officers, resulting in the sale of an unaffordable loan that may lead to default and foreclosure and a worsening financial situation. Second, stated income loans can be easily sold to unsuspecting

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[7] Jody Shenn, "ARM Lenders Prep for Wave of Teaser Rate Expirations," *American Banker*, January 18, 2006.

consumers who can document their income and qualify for a lower cost loans, but are sold a more expensive stated income product to support the greed of brokers, lenders, funders, or secondary market players. Institutions that originate, purchase, fund, and invest in reduced documentation loans should be required to review a large sample of such loans, and business line managers should be held accountable for any significant number of problematic loans originated under her watch.

Future Income

Actual figures from borrowers' financial history and current situation should be used in the assessment of borrowers' ability to repay. Future events should only be considered in borrowers' ability to repay to the extent that they are predictable, likely, and relevant. Estimating future incomes, for example, should not be considered in this calculation, as it is not a reliable, foreseeable or necessarily likely event.

Yet if future income is considered in the underwriting process, future costs should be factored in as well. In some cases, borrowers know they will be incurring a large expense in the future. Certainly, the impact of future rate resets or balloon payments should be considered. Unlike future income for an individual, future interest rates are widely predicted by economists.

In discussions with industry players around the state, it appears lenders may be underwriting using a worst-case scenario for consumers – considering future earnings, but not future expenses and costs. In practice, this analysis likely results in overestimating the borrower's income and underestimating costs. This may facilitate the sale of a loan, but it also increases the likelihood a consumer will take out a loan that she cannot afford.

While borrowers may be able to repay their monthly mortgage payments at introductory low interest rates and even at record-low fully-indexed rates, many may face severe difficulty making monthly payments as interest rates rise and rates adjust according to loan terms. When ARMs first came out in the 1980s, lenders protected themselves and borrowers from risk by calculating some extra cushion into the analysis of the borrower's ability to repay. Lenders should continue this responsible lending effort by assessing borrowers' ability to repay at 2 percentage points beyond the fully indexed rate or at the capped rate, whichever is greater.

Loan Terms and Underwriting Standards

CRC is pleased that Agencies asked lenders to avoid making collateral-dependent loans, that set borrowers up to fail. Lenders falsely reason that property values will keep increasing and serve as a safety net for borrowers who did not have the capacity to repay their debt in the first place. This will not continue to be the case. Yet even if appreciation does continue, the forced sale of a home or refinance to get out of a bad loan are too high a price to pay to justify these products. For similar reasons, CRC agrees with the

Agencies’ proposal to curb lenders from making simultaneous second-liens that allow for negative amortization when there is minimal or no invested equity.

CRC supports the Agencies’ proposals to require lenders to sufficiently compensate for risk layering and to carefully come up with ways to minimize impending payment shock for borrowers with low introductory rates. In addition, CRC agrees that in order to minimize the risk of unnecessary default, lenders must develop strategies for managing the payment shock by eliminating large disparities between low introductory rates and adjustable rates.

Importantly, CRC strongly agrees “institutions should also consider the potential risks that a borrower may face in refinancing the loan at the time it begins to fully amortize, such as prepayment penalties.” (p. 77252). The Guidance should tie initial interest rate periods to the length of a prepayment penalty period, so that no prepayment penalty can be incurred by a borrower seeking to refinance at the time of, or anytime after, the initial resetting of rates.

Portfolio and Risk Management Practices

CRC was pleased with several of the suggested guidelines for managing portfolio practices, including requiring lenders to consider the effects of employee incentive programs to increase levels of nontraditional mortgages and closely monitor and enforce their practices on their third-party originators. Focused on incentives that reward loan volume above all else, brokers and loan officers may feel pressure to ease up on qualifying standards and disclosure requirements and offer risky products to borrowers.

CRC strongly endorses the Agencies’ requirement that lenders monitor their third-party relationships to ensure that these agents follow lenders’ policies and procedures. We also agree that lenders must immediately sever ties with third-party originators if harmful lending practices are discovered. Such a task will, however, require strong oversight and enforcement from the regulators to ensure these guidelines are being followed. CRC recommends that regulators review lenders on their compliance with these guidelines during their fair lending and safety and soundness reviews.

The Guidance should speak more loudly to the importance of the secondary market. The Federal Register notice itself asserts that beyond consumer demand, “secondary market appetite have grown rapidly for mortgage products that allow borrowers to defer payment of principal and, sometimes, interest (p. 77250). Later, the proposed guidance suggests developing written policies that specify acceptable securitization practices, yet offers not guidance as to what that should look like.

CRC believes that much of the clamor for these products comes not from borrowers but from investors. As one example, a major subprime lender reported responding to secondary market concerns by further emphasizing adjustable rate loans over fixed rate loans. “We’re not opposed to making changes in the program where it makes sense,” one executive said. That’s been accomplished in part by incentivizing sales people not to do

fixed rate loans. "Ultimately, the market is driven not by what is best for borrowers, but by what products investors can invest in and what delivers a decent rate for the borrower and allows the company to still make some money."[8] The agencies must provide greater guidance to secondary market participants, so that the secondary market does not create the market for loans that are not in the consumer's interest.

Consumer Protection Issues

CRC supports the Agency view that more accessible and relevant disclosures must be in place. In particular, borrowers need to understand their options, the impact of interest rates and reset dates on their monthly payment obligations, balloons and negative amortization, and the interplay of all of these with prepayment penalty provisions.

Yet disclosure can only go so far. In an aggressive sales environment, in the midst of one of the most complex transactions most Americans will ever experience, consumers need greater education and protection. Financial literacy, consumer education, homebuyer education and post purchase counseling class are important for consumers to understand the impact of key loan terms on their ability to keep up on payments and maintain their homes. The Guidance should seek to emphasize the importance of this education, perhaps requiring mandatory counseling for subprime borrowers who are being sold loans with several of the risk features identified in the guidance.

But disclosure and consumer education cannot defeat predatory lending practices (see "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," GAO-04-412T, February 24, 2004, including chapter entitled, "The Usefulness of Consumer Education, Counseling and Disclosures in Deterring Predatory Lending May Be Limited"). Agency guidance must be strong enough to discourage misleading sales tactics and abusive loan products. And strong agency guidance must be followed through with tough enforcement action.

Lenders still inappropriately target subprime borrowers for these risky products, offering alluring deals of option ARMs, low introductory rates, no money down and low or no-documentation requirements. In 2005, 73.4% of subprime securitizations were adjustable-rate mortgages, 23.5% were interest-only loans, and 37.2% were stated loans.[9] In offering these features in subprime mortgages, lenders are setting the stage for vulnerable consumers to sustain payment shocks and sudden increases in their mortgage payments which they may not be capable of bearing. Several of these dangerous loan features provided to subprime borrowers also overlap, heightening the risk layering further. In addition, nearly two-thirds of the subprime securitized loans in 2005 carried a prepayment penalty making it more difficult for borrowers to escape these hazardous loans before rates reset and increase.

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[8] Inside B&C Lending, "Diversification, Branding, Key to Ameriquest Strategy," remarks of Ketan Parekh, Vice President for Capital Markets, Volume 9, Issue 22, p. 6)

[9] "What Else is New? ARMs Dominate Subprime MBS Mix," *Inside B&C Lending*, January 20, 2006.

Some lenders have acknowledged the associated risk of providing nontraditional mortgages to subprime borrowers. In a recent *Inside B&C Lending* article, many lenders discussed their concern with providing products to subprime borrowers with limited income documentation, interest-only ARMS with quickly approaching reset periods, and second-lien mortgages. As one lender put it, "negative amortization with a subprime product is a scary proposition."[10]

CRC urges the Agencies to prohibit lenders from offering risky nontraditional mortgages to subprime borrowers that allow for negative amortization, risk layering or similarly dangerous features.

Recommended Practices

CRC supports most of the items listed in the Federal Register under "Recommended Practices." In particular, control systems to ensure that practices and policies are consistent, mystery shopping, and stringent review of compensation programs are all important to ensure the goals of the guidance are realized.

Need to Incorporate CRA & Fair Lending in the Guidance

We urge the Agencies to incorporate the Community Reinvestment Act (CRA) into the proposed guidance. CRA mandates lenders to respond to credit needs in a safe and sound manner. The guidance must therefore stipulate that issuing nontraditional mortgages in an unsafe and unsound manner violates CRA.

Lenders must be penalized via lower ratings on their CRA exams for making exotic mortgages that are unsafe and unsound. The recent changes to the CRA regulation include a new provision that penalizes lenders for discriminatory, illegal and abusive loans. Therefore, regulators must ensure that lenders are not targeting minorities and other protected classes with dangerous and ill-suited exotic mortgages. Lenders targeting minorities, women, elderly, or low-income borrowers must be given a lower rating on their CRA exams and reported for violations of fair lending and equal credit opportunity laws.

Need for More Data

It has been noted that nearly half of all subprime loans were not reported as "rate spread" loans under the new Home Mortgage Disclosure Act (HMDA) reporting requirements. Industry representatives have suggested that the presence of exotic mortgage products makes HMDA data less meaningful, as communities where these products are inappropriately targeted will show up as neighborhoods without significant non "rate

[10] "Doubts Persist About Alt Products in Subprime Space," *Inside B&C Lending,* February 3, 2006.

spread" loans under HMDA, offering no insight into lending practices there. HMDA data should code for these exotic products, or the regulators should conduct their own analysis of this.

Additionally, as noted above, the secondary market provides a big incentive to make and sell particular loans. The banking regulators should scrutinize the securitizing, underwriting, and investing in securities backed by exotic and subprime mortgages. Further, banking regulators should work with the SEC to provide greater and more detailed reporting of loan level data for subprime securities, to the benefit of consumers, investors, and all parties taking on risk from the underlying mortgages. The guidance must go further than merely suggesting, "institutions involved in securitization transactions should consider the potential originated related risks arising from nontraditional mortgage loans, *including inadequacy of disclosures to investors*" (p. 77254, emphasis added).

CRA Beyond Branches

In its analysis of the new HMDA reporting data, the Federal Reserve noted that lending disparities are smaller around the assessment areas of banks.[11] This is an argument for a strong Community Reinvestment Act and for financial institutions to develop strong reinvestment programs in underserved areas. Banks that avoid locating branches in certain neighborhoods may be missing significant business opportunity.[12] They also leave those communities vulnerable to the high cost check cashers and payday lenders. This issue is relevant to the discussion of how to ensure that lenders are more responsible in selling exotic mortgage products. If we want more responsible lending practices, and if lending is more fairly priced in CRA assessment areas subject to regulatory oversight, then the agencies should scrutinize institutions like Countrywide Bank and the new H&R Block Bank and articulate why national banks doing national banking out of national retail outlets should be examined only in narrow assessment areas. It is time for the CRA regulations to catch up to the banking marketplace and for the agencies to require CRA reinvestment in areas where banks are showing significant banking and lending activity.

In Conclusion

CRC remains concerned that risky nontraditional mortgages are becoming commonplace for the average borrower, and too common for low- and moderate-income and subprime borrowers who are extremely vulnerable to risky products. While CRC's mission is to

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[11] "However, whether the loan was originated by an institution in its CRA assessment area does matter. Differences across groups for lending within an assessment area are about one-third of those for lenders outside the assessment area. Moreover, for all racial and ethnic groups, lending within an assessment area exhibits a much lower incidence of higher priced lending," (Avery, Robert B., and Canner, Glenn B., "New Information Higher-Cost Loans Under HMDA and Its Application in Fair Lending Enforcement, Federal Reserve Bulletin," Summer 2005, p. 382).

[12] A recently released report from the National Community Investment Fund notes, "Banks looking for new customers and more deposits might be able to find them in low-income neighborhoods mostly served by check cashers, payday lenders, and other fringe financial institutions." (as reported by Ben Jackson in "Study Argues for Prospecting in Poorer Markets," American Banker, December 6, 2005).

increase equal access to credit and capital, we believe that this must be done in a responsible and appropriate manner for all parties involved. Borrowers, particularly traditionally underserved ones, demand a safe market in which lenders thoroughly explain products, options are understood, and responsible decisions can be made. CRC hopes that through these interagency guidelines, financial institutions will be held accountable to help create that safe environment in which borrowers can realize and maintain their dreams of homeownership.

CRC sincerely appreciates the Agencies' efforts to gain control of the ever-growing trend of risky nontraditional mortgage products and requests that you keep borrowers' best interests in mind when finalizing the guidelines. This can be accomplished by maintaining pro consumer elements of the guidance, clarifying the responsibilities of secondary market players, requiring lenders to tie prepayment penalty periods to the initial interest rates of loans they originate, expand HMDA and SEC reporting requirements, and develop a more clear and thorough oversight and enforcement regime.

Thank you for the opportunity to comment on this proposal. If you have any questions about our recommendations, please feel free to contact me at (415) 864-3980.

Very Truly Yours,

Kevin Stein
Associate Director