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Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Attn: Docket # 05-21

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th St. & Constitution Avenue, NW
Washington, DC 20551

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

RE: **Interagency Guidance on Nontraditional Mortgage Products**

Ladies and Gentlemen:

The Charles Schwab Bank, N.A. (Schwab Bank) appreciates the opportunity to comment on the proposed inter-agency guidance on nontraditional mortgage products. Schwab Bank agrees with the members of the Federal Financial Institutions Examination Council (collectively, the "Agencies") that it is important to establish industry guidance on the origination and management of nontraditional mortgage loans to ensure the safety and soundness of the lending industry, as well as to ensure consistent consumer protection practices throughout the industry.

This letter responds to the Agencies' request for comment on the proposed guidance regarding loan terms and underwriting standards; portfolio and risk management practices; and consumer protection issues. Schwab Bank wishes to express its appreciation for the Agencies' solicitation of broad based comments and we have endeavored to respond accordingly.

Loan Terms and Underwriting Standards

Schwab Bank appreciates the Agencies' concern regarding nontraditional mortgages, and agrees that some of the loans so classified do create additional risk exposures for lenders. For example, loans that permit negative amortization, do not amortize at all, that contain "payment options," or allow for Loan to Value (LTV) ratios greater than 100%, certainly carry additional risk exposure for the consumer, and for the lenders who grant such loans. We would suggest, however, that Interest Only (IO) loans not be painted with the same carry additional risk exposure for the consumer, and for the lenders who grant such loans. We would suggest, however, that Interest Only (IO) loans not be painted with the same broad brush as other nontraditional loans, but rather be categorized based upon how they are structured and underwritten. While some IO loans certainly may bear some of the riskier characteristics noted above, many do not and are underwritten to consider the impact of rising interest rates and are structured to reset after a prescribed period so that they begin normal amortization. For example, the Agencies may want to consider excluding IO loans from any proposed prescriptive guidance if the loan met certain thresholds for LTV, Credit Score, DTI, or some combination of such credit characteristics; and/or if the loan were underwritten in a manner that ensured the borrowers' debt capacity could withstand interest rate increases of a certain amount; and/or if the loan were structured in a way that did not allow for negative amortization.

Additionally, while IOs may carry a higher risk of default at the time of conversion if not provided to the right borrower, they can be an effective and beneficial financial tool and very appropriate for borrowers in certain circumstances. Also, when the limited amount of principal amortization in the first few years of a traditional mortgage is taken into consideration, the lack of principal reduction in the first few years of an IO loan may be negligible. In a traditional mortgage, assuming a thirty year amortization, only 7% of the principal balance is reduced in the first five years (and only 4% in the first three years). From the perspective of potential loss exposure, a 70% LTV IO loan might actually be less risky than an 80% LTV traditional mortgage. Therefore, we suggest that any formal guidance issued by the Agencies give consideration to the fact that these various nontraditional product types may present different levels of risk, depending upon how they are structured and underwritten.

The Agencies request comment on three particular issues. Those issues, and our responses, are noted below:

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? What are current underwriting practices and how would they change if such prescriptive guidance is adopted?

We appreciate the Agencies' concern that borrowers be able to make payments on the loan once it begins to amortize, that is, that borrowers be able to handle the "payment shock." The risk of payment shock, however, is based in large part on the type of mortgage loan and how it is structured. Certainly an option ARM that allows the borrower to make no monthly payment, or a minimum payment each month, coupled with qualifying the borrower at the note's "initial rate" even when interest adjustments are scheduled to begin to increase immediately, is a higher risk transaction. Such a borrower's loan would immediately begin to negatively amortize. Contrast that with the risk of a borrower who took out an Interest Only loan, but made full interest payments each month, and was qualified using an interest rate that was 2% or more higher than the initial rate if the interest adjustments were more frequent than every two years. In the latter scenario, the borrower would suffer no negative amortization and would have sufficient debt capacity to handle a 200 basis point rate increase two years later, even assuming no increase in the borrower's income. Again, the type of mortgage product, and its structure, greatly determine the level of risk to the borrower and the lender. Additionally, other mitigating factors such as a high credit score, a low LTV ratio, a low Debt-to-Income (DTI) ratio, substantial liquid asset reserves, property owner-occupancy, no cash-out refinance, etc, all play a role in determining the risk of an individual loan transaction. As such, we would suggest that the Agencies not offer such prescriptive guidance that did not consider the potential differences in risk exposure, giving due consideration to mitigating factors.

2.) 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? What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? Please include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.

We appreciate the Agencies' concern that the risk of nontraditional mortgages can increase when "layered" with underwriting practices that might introduce even more risk to the transaction. Using "stated income" as opposed to verified income might certainly be one of those compounding characteristics. But again, we feel that depending upon how and when it is employed in the underwriting process, stated income can be a very appropriate underwriting tool. We would support the use of stated income in cases where the risk profile of the transaction was lower (i.e.: where the borrower meets certain higher credit score thresholds, lower LTV limits, lower DTI limits, substantial liquid asset reserves, and/or certain occupancy or purpose types such as owner-occupied and no cash-out refinance). In such cases, the lack of verified income would likely have little effect on the risk of the transaction. But more importantly, how the stated income program is introduced into the underwriting process can have a significant effect on the risk of the transaction. We endorse the use of "lender-selected conditioning" in establishing the income and asset documentation requirements for loans, including Interest Only loans. In lender-selected conditioning, the lender may choose to apply such reduced verification conditioning levels after the evaluation of the applicant's risk profile. With lender-selected conditioning, the lender selects the applicants that meet their reduced documentation requirements, resulting in less or no documentation only for those applicants who have demonstrated a strong credit profile and ability to repay their mortgage debt. Contrast that with lenders who market "no documentation/low documentation" loans, which attract an adverse population of applicants who are unable or unwilling to verify their income and/or assets, and seek out such lenders, even willing to pay premium rates for the lack of documentation. With the appropriate thresholds and lack of marketing, stated income and stated asset programs can be valuable underwriting tools, improving the client experience and efficiency of the transaction without increasing the risk of the loan. Conversely, "no doc/low doc" loans might not be an appropriate product for subprime borrowers, assuming that term is used to describe applicants with higher risk profiles such as low credit scores and/or high LTV and DTI ratios.

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? Also, 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?

We appreciate the Agencies' consideration for the use of future income in loan qualification standards. As suggested in the question above, however, giving consideration to future income implies that lenders should offset that with consideration for future increases in the interest rates. We believe that either practice would be difficult to implement on a consistent basis throughout the industry. Additionally, it would place lenders in the precarious position of speculating on future direction of the economy, and the impact on employment, income, and the interest rate environment. That would lead to significant inconsistency in lending practices throughout the industry. In fact, we would be concerned that basing underwriting decisions on projected income would result in such inconsistency as to potentially give rise to questions of fair lending. We believe that the current practice of qualifying borrowers based upon their current financial situation is the most prudent method of underwriting. However, it is important for nontraditional mortgage lenders to appreciate the impact that rising interest rates will have on their borrowers, and to take reasonable measures to ensure that any potential interest rate and payment increases over the first couple years of the loan can be supported by the borrowers' current capacity to pay. Using a qualifying interest rate that is higher than the initial rate for interest only loans with rate adjustment periods of less than two years is an appropriate method of managing that risk. Consideration of the impact of future economic impacts on the credit portfolio is an exercise that is best explored in establishing the adequacy of the lenders' Allowance for Loan and Lease Losses (ALLL) and capital.

Portfolio and Risk Management Practices

We support the Agencies' proposed guidance in the areas of portfolio and risk management practices. We concur that lenders should establish appropriate policies, procedures, and risk management practices to prudently measure, monitor, and control risk exposures in their portfolio. Such risk management practices should include the following:

- Well-documented underwriting guidance
- Maintain performance measurements and management information that provides warning of increasing risks
- Maintain the ALLL at levels appropriate for the risk in the portfolio
- Maintain capital at levels that reflect the portfolio characteristics, the level of the ALLL, and the effect of stressed economic conditions on portfolio quality
- Apply sound practices in valuing servicing rights of nontraditional mortgage portfolios, and consider risks to the institution if demand in the secondary market dissipates

Consumer Protection Issues

Schwab Bank agrees with the Agencies' desire to ensure that consumers have information that is timely and sufficient for when evaluating a non-traditional mortgage product. In regard to the proposals on consumer protection issues, we feel that the proposals being made are consistent with the tenets of the Truth-In-Lending Act and Section 5 of the Federal Trade Commission Act. However, we are concerned about the manner of implementation for these guidelines. Many mortgage lenders are not regulated by the Agencies. These mortgage lenders may not feel obligated to comply with the proposed guidelines, which would place those entities that are regulated by the Agencies at a competitive disadvantage.

More importantly, consumers who are solicited for these non-traditional mortgage products by who choose not to comply with the consumer protection elements of the guidance may not be afforded with same level of information around these products to allow those consumers to make an informed decision regarding the suitability of these mortgages to their personal situation.

We believe that if the Agencies would like to enhance consumer protection in regard to non-traditional mortgage products they should implement the articulated guidelines through appropriate revisions to the Federal Reserve Board's Regulation Z or its corresponding commentary. Along with changes to Regulation Z, the Board of Governors of the Federal Reserve and the Federal Home Loan Bank Board should update their publication "*Consumer Handbook on Adjustable Rate Mortgages*" to include appropriate information related to non-traditional mortgages.

The Agencies, in conjunction with the FTC, may also consider providing joint guidance related to the practice of marketing non-traditional products, specifically, which practices may be considered to be inconsistent with Section 5 of the Federal Trade Commission Act.

It is our strong belief that any guidance short of the broadly applicable regulatory changes noted above would leave consumers at a disadvantage and vulnerable to aggressive marketing techniques of lenders believe the guidance is not applicable to them.

Summary

We applaud the Agencies' interest in protecting both consumers and lenders in proposing the guidance on nontraditional mortgages. We appreciate the concerns noted, and certainly join with the Agencies in seeking consistent, industry-wide application of prudent lending practices. We fully support the Agencies' proposed guidance in the areas of portfolio and risk management practices, and in its concern for consumer protection issues. We do agree that some consistent guidance in the area of loan terms and underwriting standards would be helpful, but again caution that all nontraditional mortgage loans not be painted with the same broad brush, but that consideration be given to the actual risk of the various product types, as determined by their structure, underwriting, and marketing practices. And we would strongly suggest that if the Agencies' do issue prescriptive guidance for nontraditional mortgage lending, that they ensure that guidance applies to all lenders in the industry, and not be limited to lenders regulated by the Agencies. Applying the guidance consistently amongst all lenders is the only way to effectively ensure consistency in lending practices and consumer protections.

We look forward to continuing dialogue on this important subject, and can be reached via the contact information below.

Sincerely,

Richard F. Kenny
President and Chief Executive Officer
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