CENTER FOR
RESPONSIBLE
LENDING

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Mar. 29, 2006

VIA ELECTRONIC MAIL

Office of the Comptroller of the Currency
Attention: Docket Number 5-21
250 E Street, SW, Mail Stop 1-5
DC Washington, DC 20219
regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
Attention: Docket Number OP-1246
20th and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

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 Washington,
1700 G Street, NW
Washington, DC 20552
Attention: No. 2005-56
regs.comments@ots.treas.gov

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428
Attention: Comments on Interagency
Guidance on Nontraditional Mortgages
regcomments@ncua.gov

Re: **Center for Responsible Lending comments on proposed Interagency Guidance on Nontraditional Mortgages submitted to** the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Association (NCUA) (collectively, **the "Agencies"**)

Ladies and Gentlemen:

The Center for Responsible Lending (CRL)[1] appreciates the opportunity to comment on the proposed Interagency Guidance on Nontraditional Mortgages. CRL will limit its comment to the making of nontraditional mortgage loans to *subprime* borrowers.

News of the potential threat posed by the prevalence of nontraditional mortgages has increased in recent months. As of September 2005, adjustable rate mortgages (ARMs) accounted for roughly

[1] The Center for Responsible Lending is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, the nation's largest non-profit community development financial institution.

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70% of the prime mortgage products originated and securitized and 80% of the subprime sector.[2] Hybrid ARMs and hybrid interest-only ARMs are "the main staples of the subprime sector."[3]

Especially risky are the 2/28 hybrid ARMs that predominate in the subprime market. The interest rates on many of those loans will recast in the near future. According to Barron's, over the next two years, reset of two-year teaser rates on hybrid ARMs will lead to increased monthly payments on an estimated $600 billion of subprime mortgages.[4] Fitch Ratings has stated that in 2006 payments will increase on 41% of the outstanding subprime loans—29% of subprime loans are scheduled for an initial rate reset and another 12% of subprime loans will face a periodic readjustment. If subprime borrowers with such mortgages are unable to make payments when the interest rates increase, the repercussions likely will be grave, especially in those markets that have not experienced rapid house price appreciation.

CRL is pleased that the Agencies are addressing problems with nontraditional mortgages and generally supports the proposed guidance. This letter will highlight concerns with nontraditional mortgages in the subprime market.

First, with respect to underwriting, CRL urges the FRB, the NCUA, and the OTS to use their authority under 15 U.S.C. § 57a(f) to declare it to be an unfair and deceptive act or practice to (A) underwrite a subprime loan without using the fully indexed rate or (B) to exclude from the repayment analysis of a subprime loan the cost of hazard insurance and property tax escrows. Such declarations, made through regulation, would ensure that non-depository institutions would be subject to at least some of the same underwriting standards as depository institutions. Note that for purposes of this letter, CRL will not attempt to differentiate between practices that are unfair and those that are deceptive, but rather will recommend that the aforementioned underwriting practices be declared "unfair and deceptive."[5]

Second, CRL recommends that the Agencies follow their Guidance by enacting specific regulations on the origination of reduced documentation loans and loans associated with special risks of payment shock.

Third, this letter responds to specific questions the Agencies posed regarding debt qualification standards related to minimum payments and to anticipated future income. Finally, this letter raises concerns about consumer assistance and restitution, the effect of violations of the Guidance (or, if the Agencies issue them, the regulations), updates to existing subprime lending guidance, and disclosures to consumers.

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[2] *2006 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis*, FITCH RATINGS CREDIT POLICY (New York, N.Y), Jan. 17, 2006, at 12.

[3] Id.

[4] Jonathan R. Laing, *Coming Home to Roost*, BARRON'S (New York, NY), Feb. 13, 2006, at 26. .

[5] In general, the standards the Agencies and the FTC use to determine whether an act or practice is *unfair* is that: (1) the practice causes, or is likely to cause (2) substantial consumer injury (3) that is not reasonably avoided by consumers and (4) is not outweighed by countervailing benefits to consumers or competition. For an act or practice to be *deceptive*, the standard is that (1) there is a representation, omission, act or practice that is likely to mislead; (2) the act or practice would be likely to mislead a consumer acting reasonably (if an act or practice targets a particular group, considering reasonableness from that group's perspective); and (3) the misleading representation, omission, act or practice is material.

I. *UNFAIR OR DECEPTIVE UNDERWRITING ACTS OR PRACTICES*

Section 18 of the Federal Trade Commission (FTC) Act directs the FRB, the NCUA, and the OTS[6] to "prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."[7] According to an article written by Julie S. Williams and Michael S. Bylsma of the OCC,

> Congress appeared to have had two primary goals when it amended the FTC Act in 1975. One goal was to strengthen consumer protection under the FTC Act by enhancing enforcement of the FTC Act *through rulemaking*. The other goal was to ensure that there would be *substantial similarity* in the FTC Act regulations that are applicable to banks and those that are applicable to other companies (after concluding that the FRB—not the FTC—would be best suited to develop regulations that are appropriate to banking functions).[8]

Congress clearly has instructed the FRB, the NCUA, and the OTS to address unfair or deceptive acts or practices through specific regulations.

Promulgating unfair or deceptive acts or practices (UDAP) regulations that address some of the worst abuses associated with underwriting of nontraditional mortgages under Section 18(f) also would help "level the playing field" between depository institutions and non-depository institutions. The proposed Guidance as drafted would apply to banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Other mortgage lending institutions would not be subject to the Guidance.[9] A CRL analysis of 2004 Home Mortgage Disclosure Act (HMDA) data shows that 58% of first-lien subprime home loans were

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[6] Since the 1989 abolition of the Federal Home Loan Bank Board, to which Section 18 originally referred, the OTS has been the federal agency that determines for savings associations whether acts or practices are unfair or deceptive.

[7] The (FTC Act both bans unfair or deceptive acts or practices *and* instructs certain of the Agencies to issue regulations to prohibit *specific* unfair or deceptive acts or practices. Section 5 of the FTC Act (15 U.S.C. § 45) states that "unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." The OCC, the FDIC, and the FRB already have made clear that the general prohibition of Section 5 applies to the institutions they regulate and that they are authorized to enforce that law under Section 8 of the Federal Deposit Insurance Act. See 12 C.F.R. § 7.4008(c); Unfair or Deceptive Acts or Practices by State-Chartered Banks, FRB & FDIC (Mar. 11, 2004) (FRB-FDIC Guidance). See also Guidance on Unfair of Deceptive Acts or Practices, OCC Advisory Letter AL 2002-3 (Mar. 22, 2002); FDIC Financial Institution Letter, Guidance on Unfair or Deceptive Acts or Practices, FIL 57-2002 (May 30, 2002); Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to Rep. John J. LaFalce (May 30, 2002). CRL requests that the Agencies not rely simply on Section 5 of the FTC Act, but rather that authorized agencies issue regulations under Section 18.

[8] Julie L. Williams & Michael S. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 BUS. LAW. 1243, 1248 (May 2003) (emphasis added).

[9] CRL notes that if Fannie Mae and Freddie Mac incorporate the final guidance into their own securitization standards, and if the ratings agencies rate favorably only those loan portfolios that comply with the Guidance, then the Guidance probably would have a significant indirect effect on institutions to which the Guidance did not apply directly. Still, regulations would provide for broader and more certain coverage.

made by non-supervised lenders that reported their data to the U.S. Department of Housing and Urban Development (HUD).[10] In other words, a majority of subprime loans are made by lenders that will not be subject to safety and soundness oversight by the agencies. CRL strongly recommends that at least some of the underwriting standards apply to all mortgage lenders and brokers,[11] not only to depository institutions. To accomplish this goal, the Agencies could work with the FTC to begin rulemaking proceedings to declare certain acts and practices related to underwriting of nontraditional mortgages to be unfair or deceptive acts or practices under Sections 18(a) & 18(f) of the FTC Act, 15 U.S.C. §§ 57a(a) & (f). Given the need to address abuses related to nontraditional mortgages sooner rather than later, CRL recommends that the Agencies issue final Guidance *before* embarking on a rulemaking process with the FTC.

A. Underwriting Without Using Fully Indexed Rate

CRL concurs with the Agencies' view of appropriate methods for determining a consumer's ability to repay a subprime nontraditional mortgage loan.

The Agencies state:

> For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The amount of the balance increase should be tied to the initial terms of the loan and estimated assuming the borrower makes only minimum payments during the deferral period.

Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,252 (proposed Dec. 29, 2005).

Though the statement regarding proper underwriting methods appears to indicate a mandatory rule rather than a recommended practice, CRL urges the Agencies to clarify this fact by issuing a *regulation* setting forth the foregoing underwriting standards. Such a regulation should indicate

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10 The HMDA regulations applicable to loans originated in 2004 required lenders to report the difference between an originated first-lien home loan's annual percentage rate and the yield on U.S. Treasury securities of a comparable term if that difference was greater than or equal to three percentage points and the loan was subject to the Truth-in-Lending Act. This new reporting field was developed specifically to allow observers to understand subprime lending patterns. However, there is some evidence that this measure may still underestimate those loans that are subprime in the HMDA data set. For more information, see Avery, R.B., G.B. Canner, and R.E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (Federal Reserve Bulletin, Washington, DC), Summer 2004 at 344-394, *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf. For further explanation of the lenders that report HMDA data to HUD, see U.S. Department of Housing and Urban Development, Mortgagee Letter 05-17 (April 15, 2005) (detailing who must report HMDA data to the agency).

11 Mortgage brokers accounted for 59.3% of subprime originations in 2005. *Brokers Flex Their Muscle in 2005, Powering Record Subprime Year*, INSIDE B&C LENDING (Bethesda, MD), Mar. 17, 2006. When a reporting institution makes loans through a mortgage broker, the institution rather than the broker reports the HMDA data. *A Guide to HMDA Reporting: Getting It Right!* (Federal Financial Institutions Examination Council Jan. 1, 2004), at 6.

the concrete actions the Agencies' examiners will take if they discover violations of the regulation.

CRL also believes that the FRB, the NCUA, and the OTS should go further and exert their authority under Section 18(f) of the FTC Act (and the FTC should exert its authority under Section 18(a)) to declare it to be an unfair and deceptive practice:

1. to evaluate a subprime borrower's ability to repay the debt by final maturity using a rate that is less than the fully indexed rate.

2. to evaluate a subprime borrower's ability to repay the debt by final maturity for products with the potential for negative amortization, to exclude from the repayment analysis the initial loan amount or any balance increase that may accrue through the negative amortization provision.

3. to calculate any balance increase without tying the increase to the initial terms of the loan or without estimating the increase assuming the subprime borrower makes only minimum payments during the deferral period.

Underwriting subprime loans using unrealistic or otherwise inappropriate criteria is an unfair and deceptive practice that causes substantial consumer injury. Furthermore, consumers cannot reasonably avoid injuries that stem from underwriting decisions. Realistically, there is no way for a consumer to have access to the complex and secret underwriting criteria financial institutions use to make credit decisions.

A study by the Federal Reserve System's Study Group on Disclosure issued in March 2000 focused on improving transparency in bank reporting through disclosures to such stakeholders as regulators, ratings agencies, securities firms, and institutional investors; the study did not mention consumers. The study group reported that while "a wide spectrum of market participants would like to see information on credit exposures broken down by a bank's internal credit-rating system," "[s]ome banks argued that the credit-evaluation process that yields internal loan ratings is highly proprietary" or that "internal risk ratings were so subjective that they would not be meaningful if disclosed."[12] If powerful players face such resistance to disclosure regarding how banks analyze credit quality, consumers certainly do not receive adequate information about banks' "proprietary" underwriting systems.[13]

Only lenders have access to key information about the interplay of various borrower and loan characteristics that underlie credit decisions. When a lender inputs this information into a "black

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[12] Study Group on Disclosure of the Federal Reserve System, *Improving Public Disclosure on Banking*, Staff Study 173 at 22 (Mar. 2000), available at http://www.federalreserve.gov/pubs/staffstudies/2000-present/ss173.pdf (last visited Mar. 13, 2006).

[13] Cf. Avery et al., *supra* note 10, at 366 ("[T]he fact that lenders differ in the factors they consider in setting loan prices makes it difficult to select additional data elements that would allow a complete understanding of the determinants of a particular lender's pricing method.").

box" and then offers a loan product to a consumer, it essentially says to the consumer "Based on the information I have, here is a loan that would work for you." It is unfair and deceptive for a lender, who controls the black box, to rig the underwriting process or underwriting criteria to "get to a yes," regardless of the consumer's actual ability to repay the loan without refinancing or selling the home. Underwriting practices that misrepresent a subprime borrower's ability to repay a loan benefit neither consumers nor the economic stability of financial institutions.

One way that lenders and brokers can manipulate the underwriting process for a nontraditional mortgage loan is to analyze a subprime borrower's ability to repay the loan at an interest rate that is lower than the fully indexed rate. Another way to rig the process is not to count potential balance increases caused by negative amortization. At a minimum, the Agencies should issue safety and soundness regulations that make clear that the underwriting practices that institutions "should" employ indeed are required. The better course of action, and one that would apply across the board to all lenders, would be for the FRB, the NCUA, the OTS, and the FTC to declare contrary underwriting practices to be unfair and deceptive under the FTC Act.

B. Lack of Escrow for Property Taxes and Hazard Insurance

Another underwriting-related problem is that few subprime lenders (or brokers selling subprime products) require an escrow for hazard insurance or property taxes. Rather, most sell loans based on low monthly payments that do not take taxes or insurance into account. Then, when borrowers are hit with large tax and insurance bills they cannot pay, deceitful lenders can entice the borrowers to refinance the loan. This dishonest practice constitutes loan flipping.

The Agencies state:

> Institutions should avoid the use of loan terms and underwriting that may result in the borrower having to rely on the sale or refinancing of the property once amortization begins. Loans 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. Institutions determined to be originating collateral-dependent mortgage loans, may be subject to criticism, corrective action, and higher capital requirements.

70 Fed. Reg. at 77,253.

CRL responds:

It would be best to *require* subprime lenders to provide for tax and insurance escrow.

At the least, however, lender's underwriting should take into account charges that borrowers certainly will incur. Therefore, CRL recommends that the Agencies declare it to be an unfair and

deceptive practice to exclude from the repayment analysis the cost of hazard insurance and property tax escrows in connection with subprime loans.[14]

II. REGULATIONS ON NONTRADITIONAL MORTGAGE LOANS

A. Prepayment Penalties on Subprime Adjustable Rate Mortgages (ARMs)

CRL agrees with the views the Agencies express on prepayment penalties on ARMs as applied to subprime loans.

The Agencies state:

"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." 70 Fed. Reg. at 77,252.

CRL urges the Agencies to prohibit institutions from charging prepayment penalties on subprime ARM loans where monthly payments increase when the loan begins to amortize. In addition, the Agencies should disallow prepayment penalties on hybrid ARMs that extend beyond the time period when interest rates are scheduled to adjust, which, given the use of teaser rates, generally means to increase regardless of interest rate movements.

Subprime ARMs are risky for borrowers. According to the Mortgage Bankers Association's National Delinquency Survey, in the fourth quarter of 2005 the delinquency rate (90+ days) for subprime ARMs was 2.71%, compared with 0.37% for prime ARMs. Given the risks associated with subprime ARMs, subprime ARMs should not be structured, through the use of a prepayment penalty, to prevent borrowers from exiting from the product when it becomes more difficult to repay. While prepayment penalties are common on IO ARMs, it appears that few subprime lenders currently impose prepayment penalties whose term outlasts the interest- only period. Analyzing Loan Performance data on March 22, 2206, CRL found that 53.1% of IO ARMs had a prepayment penalty at origination; on 0.9% of loans, the prepayment penalty term was greater than the interest only period. By acting now to prohibit prepayment penalty terms on subprime loans from extending beyond a loan recast, the Agencies can protect subprime borrowers from being trapped in unaffordable loans without causing a major disruption to the subprime ARM market.

B. Reduced Documentation Loans

Many have portrayed nontraditional subprime loans as "affordability" products, implying that interest-only features and other techniques are used to achieve monthly payments deemed affordable for a borrower with a given income. This notion of affordability is dangerously short-sighted if borrowers cannot sustain payment after adjustment.

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[14] One possible definition for a "subprime loan" could be a loan on which the interest rate or fees reflects a premium based on the risk of borrower default, bankruptcy, or other occurrence connected to the timely payment of loan

Unfortunately, inadequate documentation of a borrower's income only compounds the problem of underwriting based on the borrower's ability to make payments before adjustment. Based on our analysis of information from the Loan Performance Subprime Asset-Backed Securities (LP) Database, we observe that half (49.3%) of adjustable rate loans with interest-only features originated in 2004 lacked full income documentation.[15] Similarly, others have observed in relation to year 2005 loans that 37.2% of non-agency mortgage-backed securities were alternative documentation or no documentation loans.[16]

The Agencies state:

"Reduced documentation, such as stated income, should be accepted only if there are other mitigating factors such as lower LTV and other more conservative underwriting standards." 70 Fed. Reg. at 77,253.

CRL largely agrees with the Agencies' statement regarding reduced documentation loans, especially when made to subprime borrowers. When used properly, reduced documentation loans can legitimately benefit consumers. If a lender makes a nontraditional subprime loan, however, reduced documentation should not be permitted. Documentation, after all, serves as a check on the risk of the loan. Increasing risk while reducing checks thereon is a recipe for disaster.

C. Payment Shock and Teaser Rates

CRL agrees with the Agencies that negative amortization presents substantial problems for many subprime borrowers. The following example illustrates the risks of payment shock on subprime ARMs.

Assume you buy a home for $250,000 and choose an interest-only mortgage.[17] The mortgage plan requires interest-only payments for five years and then shifts to an adjustable rate that will be determined by prevailing interest rates during those subsequent years. The chart below compares monthly payments for this loan as a fixed rate and an interest-only mortgage under different scenarios for future interest rates:

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15 For more information on the LP database, *see* R.G. Quercia, M.A. Stegman & W.R. Davis, *NC's Anti-Predatory Lending Law: Doing What it's Supposed to Do: A Reply* (AEI-Brookings Joint Institute for Regulatory Studies, Washington, DC), Nov. 2003, available at http://www.aei.brook.edu/admin/authorpdfs/page.php?id=299..

16 *What Else Is New? ARMs Dominate Subprime Mix*, INSIDE B&C LENDING (Bethesda, MD), Jan. 20, 2006, at 4.

17 Other assumptions: down payment: 10%; interest rate for interest-only ARM: 7.80%; interest rate for fixed rate mortgage: 8.50%; A- credit, 580 FICO.

Payment Changes Under a Hypothetical 30-Year Fixed Rate Mortgage and a Five-Year Interest Only ARM

LOAN TYPE	YEAR 1 - 5	YEAR 6 - 30	PERCENTAGE CHANGE
30-year fixed rate (8.5%)	$1,730	$1,730	0.0%
INTEREST-ONLY ARM			
No change (7.80%)	$1,463	$1,707	16.7%
Small increase (8.80%)	$1,463	$1,857	26.9%
Moderate increase (10.8%)	$1,463	$2,173	48.5%
Large increase (12.8%)	$1,463	$2,504	71.1%

The possibility of such striking increases in monthly payments—almost 50% with even a moderate increase in interest rates and over 70% with a large rate increase—raise concerns that many subprime borrowers will find it difficult to repay IO ARMs loans after rates reset.

The Agencies state:

"More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers." 70 Fed. Reg. at 77,255.

To investigate the potential for payment shock for several subprime interest-only (IO) and non-IO products, Fitch Ratings modeled cash flows. Fitch found that (1) the payment increase for an IO at rate reset is much larger than the increase from amortization of principal; (2) the payment increase at the rate reset is the same even if rates do not rise due to the product's high margins; and (3) all else being equal, if a borrower selects an IO to qualify for a larger loan, his or her debt-to-income ratio will rise more than that of a borrower with a non-IO loan.[18] In Fitch's estimation, the risk of payment shock with subprime IO loans is high.

Our analysis of information from the LP database strongly corroborates Fitch's findings. At origination, 74% of 2/28 hybrid ARM loans with interest-only features were originated with a teaser rate (an introductory rate below the fully-indexed rate) in 2004.[19] Moreover, these loans overwhelmingly contained provisions that mandated that the initial rate would be the minimum rate for the loan. Consequently, these borrowers received a loan with an implicit payment shock; when the introductory period expires, rates—and payments—are going to increase.

Of particular concern, of the borrowers who received a teaser rate, 30% faced an implicit payment shock of 25% or more.[20] Further analysis of the 2004 loan set shows the practical

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[18] Suzanne Mistretta and Grant Bailey, *Subprime Interest-Only Mortgage Rating Criteria,* FITCH RATINGS MORTGAGE PRINCIPALS AND INTEREST (New York, N.Y.), Feb. 2006, at 1, 5.

[19] Here we use "2/28 hybrid ARM loans" to mean loans that carry a fixed interest rate for two years and a variable rate semiannually adjusted for the remaining 28 years with the adjustable rate based on 6-month LIBOR rates plus a margin.

[20] Here we use "implicit payment shock" to mean the difference in interest payments at origination and the payment that the borrower would bear at the fully-indexed rate. The actual payment shock may be buffered somewhat by

realities of these loans. In the current 2006 interest rate environment,[21] as teaser rates expire on these year 2004 loans, 97.5% of borrowers are likely to face an implicit payment shock of at least 25% and three of four (75%) could face a shock of 50% or more. These changes, of course, neglect additional shocks that would result from the repayment of principal.

While subprime lenders and brokers have sold these loans to borrowers as "affordability" products, the reality is that borrowers cannot absorb these payment increases and will have two alternatives—refinance or default. Though marketed as thirty-year loans, it is apparent that these loans will be outstanding for two years or less. While housing appreciation trends appear to have preserved refinancing alternatives for some of these borrowers, it would be dangerous to assume that such patterns will hold indefinitely. Indeed, we believe that it is unfair and deceptive to originate mortgages based on such assumptions. We also believe that the origination of subprime mortgages with teaser rates that entail large implicit shocks are inherently unfair and deceptive. CRL recommends that the Agencies consider some bright line tests regarding teaser depth, minimum payments, and length of adjustment in subprime loans to prevent unmanageable payment shock.

III. *RESPONSES TO SPECIFIC QUESTIONS POSED*

A. 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 [assuming the loan is underwritten in accordance with the proposed Guidance, i.e., that underwriting assumes fully indexed rate, fully amortizing repayment schedule, and negative amortization loan analysis includes initial loan amount plus any balance increase that may accrue]?

When originating subprime loans that permit borrowers to make payments in amounts less than full principal and accrued interest, lenders should analyze each borrower's ability to repay the loan assuming the borrower makes only minimum payments. UBS AG has estimated that approximately 70% of borrowers with option ARMs are currently making the minimum payment.[22]

B. 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 comments on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.

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limits on first adjustments, but, typically, even in cases where those limits apply, by the second adjustment six months later the entire increase can take effect.

[21] Six-month LIBOR rates are now above 5%, *see* Federal Reserve Statistical Release h.15 (March. 28, 2006).

[22] Ruth Simon, *A trendy mortgage falls from favor – Demand for option ARMs, which helped fuel boom, wanes amid rising rates, growing risk*, THE WALL STREET JOURNAL, November 29, 2005, at D1.

Please see CRL's comments on reduced documentation loans above in Section II.B.

C. 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?

The Guidance should prohibit, on safety and soundness grounds, the consideration of future income for loans in connection with subprime loans where deferred principal and/or interest are allowed. Significant harm has resulted from dishonest lenders and brokers misrepresenting subprime borrowers' ability to repay the loan incomes by invoking sham future income. The harm to the subprime borrowers who are duped will far outweigh the benefits to the few subprime borrowers, if any, who can predict their future income with reasonable certainty.

IV. ADDITIONAL CONCERNS

A. Consumer Assistance and Restitution

The Agencies state:

"If appraisal, loan documentation, or credit problems are discovered, the institution should take immediate action, which could include terminating its relationship with the third-party." 70 Fed. Reg. at 77,254.

CRL recommends that the Agencies specify the actions they will undertake to ensure that borrowers receive assistance and restitution when third parties with whom the lender has contracted cheat them.

B. Effects of Violation of Subprime Guidance

The Agencies state that institutions should:

"[r]efer to OCC Bulletin 2001-47—Third Party Relationships, and to AL 2000-9—Third-Party Risk (OCC). The proposed guidance directs federally insured credit unions to refer to 01-CU-20 (NCUA), Due Diligence Over Third-Party Service Providers." 70 Fed. Reg. at 77,254 n.8.

The Agencies should make clear whether the Agencies intend that institutions regulated by the FRB, the FDIC, and the OTS comply with the OCC Guidance or whether those agencies will issue guidance that mirrors the OCC guidance. Also, the Agencies should specify that the relevant federal regulator would consider compliance with the appropriate guidance during examinations. Finally, CRL urges the Agencies to set forth specific consequences that will result from noncompliance with the guidance.

C. Updating of Subprime Lending Guidance

CRL urges the Agencies to expand the proposed guidance's discussion of subprime lending and to tailor the guidance to current circumstances. The proposed guidance refers institutions to the Interagency Guidance on Subprime Lending, issued March 1, 1999 ("Subprime Guidance"). Certain provisions of that guidance appear to be inappropriate for handling nontraditional subprime loans. For example, the Subprime Guidance states that "[t]o minimize loan losses, successful subprime lenders have historically employed stronger collection efforts such as . . . moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is labor intensive but critical to the program's success." CRL disagrees that rapid foreclosure is necessary for a subprime lending program to succeed. While not every lender will be able to engage in substantial loss mitigation, there are steps—such as waiving prepayment penalties—that a subprime lender can take to protect its interests without foreclosing on the borrower. Quick foreclosure may deny the subprime borrower the ability to refinance to a more affordable loan or to sell the home at market price.

Subprime borrowers with a nontraditional loan likely have an extra risk of payment shock, for example due to the expiration of a teaser rate or a loan recast due to negative amortization on an option ARM. Immediately foreclosing on the mortgage of a borrower surprised by an increase in monthly payments on a subprime loan does not serve lenders or borrowers well. If the borrower's credit history has improved over time, or if the borrower was sold a subprime loan but had a strong credit history all along, allowing the borrower time to refinance into a more advantageous loan often will yield a better result both for borrower and lender.

D. Communications with and Disclosures to Consumers

The Agencies state:

> As with all communications with consumers, institutions should present important information in a clear manner and format such that consumers will notice it, can understand it to be material, and will be able to use it in their decision-making processes. Furthermore, when promoting or describing nontraditional mortgage products, institutions should provide consumers with information that will enable them to make informed decisions and to use these products responsibly. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers.

70 Fed. Reg. at 77,256 (footnote omitted).

When it passed the Truth in Lending Act (TILA) in 1968, Congress did not contemplate our current deregulated consumer financial markets . Today, disclosure is touted as *the* appropriate means of protecting consumers from overreaching by lenders. While CRL believes that legislatures should pass, and law enforcement officials and other government agents should enforce, meaningful consumer protection statutes, it is true that disclosure is better than non-disclosure. If disclosures are to serve as the primary protection against market abuses and

failures, then they should be designed to be meaningful in the real world to impact real consumer behavior.

CRL strongly encourages the Agencies to keep in mind the TILA's goals[23] and utilize focus groups and other research mechanisms to determine the best ways to give consumers the information they need when they obtain a loan secured by their home. As with all disclosures. the information should be clear, conspicuous, and timely.

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Section 158 of the Truth in Lending Act requires for the FRB, in consultation with its Consumer Advisory Council, to hold regular public hearings "to examine the home equity loan market and the adequacy of existing regulatory and legislative provisions and the provisions of [HOEPA] in protecting the interests of consumers, and low-income consumers in particular." There has been some indication that the FRB will hold hearings in the summer of 2006 on home equity loans. If held, such hearings would be an appropriate place to discuss nontraditional mortgage products as well. CRL urges the Agencies to issue strengthened Guidance, hold hearings involving the FTC, and promulgate regulations addressing the most troubling unfair or deceptive acts or practices related to the sale of nontraditional mortgage products.

Thank you for considering CRL's comments. If you have any questions, please feel free to contact the undersigned.

Sincerely,

/s/ *Deborah N. Goldstein*
Deborah N. Goldstein
Executive Vice President

/s/ *Jamie Z. Goodson*
Jamie Z. Goodson
Policy Counsel

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[23] The TILA's goals include: (1) promoting meaningful disclosure to facilitate comparison shopping and to avoid the uninformed use of credit, (2) protecting consumers against inaccurate and unfair credit billing and credit card practices, (3) enhancing honest competition and protecting both consumers and "ethical" and efficient lender or credit extender," (4) protecting the marketplace from "fraudulent, deceitful, or grossly misleading information," and (5) stabilizing the economy by giving consumers the information they need to recognize credit's increased appeal when interest rates drop and decreased appeal when rates increase. 15 U.S.C. § 1601(a); 109 Cong. Rec. 2029, (1963) (remarks of economist and bill sponsor Sen. Paul Douglas), quoted in National Consumer Law Center, *Truth in Lending*, § 1.1.1 (6th Ed. 2003).