





in the spread between the short-term rates banks pay on deposits and the long-term rates they earn on outstanding mortgage loans.

We agree, of course, that underwriting of all loans should be done prudently, but overly conservative underwriting policies can be as destructive as overly liberal policies. It is essential that the Proposed Guidance not discourage products that will facilitate increased home ownership and liquidity without undue risk to the lenders or the borrowers. Consequently, The Clearing House believes that the Proposed Guidance should be structured to avoid discouraging, much less preventing, the use of nontraditional mortgage products in a safe and sound manner. The following recommendations are designed to effectuate that objective.

**I. Overview: Scope and Applicability of Guidance**

As a threshold matter, The Clearing House acknowledges that its member banks should maintain safe and sound underwriting standards for so called “nontraditional” products and adhere to fair marketing and disclosure practices -- as should be the case with every loan product. Almost every loan product is subject to abuse if not properly underwritten or marketed. Accordingly, The Clearing House supports the Agencies’ initiative to issue guidance in this area.

Our member banks also agree that certain nontraditional products need to be underwritten with particular care and managed particularly well. A special level of concern applies to negative amortization loans. It seems prudent to limit negative amortization products to borrowers with higher levels of financial wherewithal and sophistication.

Our views on negative amortization loans do not apply to reverse mortgages, and we request the Agencies to acknowledge the difference between the two products. Although reverse mortgages may seem similar to negative amortization products in that the original balance is usually exceeded by the then current balance, reverse mortgages are specifically tailored for and only offered to borrowers that are 62 years or older and that live in the

mortgaged property. These loans are designed for the purpose of supplementing social security or to help borrowers meet unexpected medical expenses.<sup>3</sup>

Additionally, we are concerned that many of the proposed guidelines, especially those that deal with interest-only products, are too prescriptive and place restrictions on our member banks that would place them at a competitive disadvantage without providing a corresponding benefit. We recognize that regulated mortgage lenders such as banks are held to a higher standard than lenders who are not subject to comprehensive functional regulation. At the same time, however, we believe that the Proposed Guidance should more directly recognize that banks have substantial experience underwriting nontraditional products and have developed risk management procedures to ensure the soundness of their loan portfolios. Specifically, banks that take affirmative steps to manage the risks in their loan portfolios should, in appropriate situations, be allowed to depart from certain standards included in the guidelines. The particular standards at issue relate to borrower qualification standards, collateral dependent loans and reduced documentation.

Many of our member banks offer mortgage products that may fall within the Proposed Guidance's rubric of "nontraditional", but do not implicate the concerns cited in the Proposed Guidance. We believe that at least exemptions are appropriate.

First, it seems unnecessary to apply the guidelines to loans to high-net-worth individuals. To that end, private banking nontraditional mortgage portfolios should be exempted from the guidelines, especially where the loan-to-value ratio ("LTV ratio") is conservative (*e.g.*, 80% or less), non-real estate collateral is pledged, or where nontraditional mortgage loans are underwritten using traditional mortgage loan standards.

---

<sup>3</sup> See Reverse Mortgages for Seniors, *available at*: <http://www.hud.gov/buying.rvrsmort.cfm>; Facts for Consumers; Reverse Mortgages, *available at*: <http://www.ftc.gov/bpc/online/pubs/homes/rms.htm>.



We also believe that the Agencies' consumer protection goals will not be most effectively realized through the Proposed Guidance. The guidelines will affect only a portion of the market -- federally regulated institutions and their affiliates. Other industry participants, such as state regulated entities and unregulated brokers and originators, will not be subject to the Agencies' guidelines.

Currently, there are comprehensive Federal laws and regulations that govern a broader spectrum of the residential mortgage lending industry, including non-functionally regulated lenders. Indeed, many provisions in the Proposed Guidance that relate to disclosure incorporate requirements that have traditionally been regulated through the Truth in Lending Act ("TILA"),<sup>6</sup> Regulation Z<sup>7</sup> and the Real Estate Settlement Procedure Act ("RESPA").<sup>8</sup> We suggest that the most appropriate method to ensure the effectiveness of consumer protection initiatives and to ensure that our member banks are not placed at a competitive disadvantage is through amendments to already existing Federal laws and regulations, as opposed to adopting the consumer protection Proposed Guidance. Our member banks welcome the opportunity to work with the Agencies in devising constructive regulations that will benefit all consumers through a more inclusive approach that will not hinder the competitive mortgage marketplace and will ensure that all consumers and lenders realize the intended benefits.

We urge the Agencies to affirm that the guidelines will not be enforced as if they were new regulations. It is well settled that guidance issued by the Agencies cannot be the basis of a violation of law citation in a bank examination report. We urge the Agencies not only to reaffirm this position upon the issuance of any new guidelines, but to note that acting inconsistently with the Proposed Guidance does not create a presumption of an unsafe and

---

<sup>6</sup> 12 U.S.C. § 3806 *et seq.*; 15 U.S.C. §§ 1604 and 1637(c)(5) (2006).

<sup>7</sup> 12 C.F.R. part 226 (2006).

<sup>8</sup> 12 U.S.C. § 2601 *et. seq.*; 42 U.S.C. § 3535(d) (2006).













acceptable mortgage insurance company; (ii) it reduces the LTV for each loan to less than 90 percent; and (iii) it is effective over the life of each loan in the pool.<sup>17</sup>

From the consumer's perspective, interest-only loans allow consumers to realize significant cost savings without adding any more risk than would otherwise exist under a fully amortizing, fixed-rate loan. For instance, a borrower who qualifies for a fully amortizing fixed-rate loan, for more than 80% of the purchase price, must obtain private mortgage insurance ("PMI") at a significant cost that is not tax deductible. Alternatively, the borrower can obtain a HELOC behind a first interest only mortgage. This allows the borrower to avoid the cost of purchasing PMI and to recognize tax deductions for the interest paid on the HELOC. Of note, under both scenarios, the borrower's equity, or conversely, the amount of the borrower's risk exposure, remains the same. At the same time, pool insurance and securitization are available to lenders in order to mitigate the credit risk of such loans.

We are also concerned that the proposals regarding risk layering are too restrictive and could foreclose lenders' ability to serve certain segments of the market. In fulfilling responsibilities under the Community Reinvestment Act, insured depository institutions provide credit products to segments of the population that have previously been underserved in order to promote responsible home ownership. Banks often need to use risk layering features to make credit products available to those segments of the market. These features can be utilized without deploying those nontraditional mortgage products, such as negative amortization mortgages, that should be directed only to sophisticated borrowers.

D. Reduced Documentation

The growth of reduced documentation products has been driven by an increase in consumers' demand to process and close transactions expeditiously. We urge the Agencies to

---

<sup>17</sup> *Id.*

recognize that various documentation practices contain varying levels of risk. Generally, mortgage loan documentation types range from “fully” documented to “no” documentation, with numerous variations in between (*e.g.*, stated income/verified assets, no income/verified assets, stated income/stated assets).

The riskiness of a loan cannot be evaluated solely on the level of documentation, but only on the basis of all the relevant considerations. Indeed, when borrowers request an eligibility decision based on reduced documentation, our member banks utilize more sophisticated underwriting models. These models are often supplemented with various credit enhancements, such as PMI and mortgage pool insurance, to mitigate the risk of reduced documentation products. Other common credit enhancing tools include the use of spread accounts, reserve accounts, or requiring overcollateralization for reduced documentation loans. For these reasons, it would be inappropriate to issue guidelines that automatically apply similar and more stringent underwriting guidelines for all types of reduced documentation loans.

### **III. Portfolio and Risk Management Practices**

The Clearing House shares the Agencies’ concern that negative amortization mortgage products present risks that necessitate conservative underwriting policies. In addition, even with such policies, the appropriate risk management analysis must be applied in terms of appropriate capital levels and reserves for loan losses, as well as close monitoring of portfolio concentrations. As discussed above, however, these specified considerations do not apply to all mortgage products deemed nontraditional.

#### **A. Concentrations**

The proposal to base concentration limits on loan types is problematic. There are today no generally accepted limits based on the type of products offered (*e.g.*, interest-only, reduced documentation, second lien, etc.). Rather, concentration limits are set exclusively by

each lender, based upon its internal risk assessment. These assessments include the level of geographic dispersion, which, if broad, allows a bank to maintain a diversified portfolio and mitigate collateral risk. Our member banks' continuing efforts to strengthen their credit quality standards has resulted in improved "FICO" distributions and strong LTV ratio cushions. Although some banks may not have formal concentration limits in place, proper portfolio management monitoring and reporting is in place to avoid issues associated with excessive concentrations.

We believe that adopting additional concentration limits of the types outlined in the Proposed Guidance could adversely impact programs designed to serve segments of the market that have been historically underserved. Often, borrowers that purchase residential properties located in traditionally underserved areas possess multiple risk attributes. Requiring concentration limits could also implicate fair lending issues by forcing banks to restrict access to credit for certain segments of the borrowing community.

B. Controls

The Clearing House banks generally agree with the concepts outlined in the Proposed Guidance with respect to a bank's quality control, compliance and audit procedures. The Clearing House is concerned, however, that the Proposed Guidance, as written, is overly prescriptive. We respectfully suggest that it should be more principles-based. Moreover, any additional audit and control requirements should reflect industry practices that monitor and control retail credit risk on a portfolio basis, not just on a loan by loan basis. For example, lenders engage in stress testing and monitor risk concentrations by reviewing segments of their portfolios, not by assessing individual borrowers and their future income potential. The ability to originate and manage consumer credit on a portfolio basis is essential to the continued development of the wide-spread, low-cost, consumer credit market that exists in the United States today.

C. Third-Party Originators

We do not question that, in originating loans via third-parties, a lender has the responsibility to monitor the activities of the third-party originator (“TPO”). Currently, the residential mortgage lending industry has numerous generally accepted requirements and controls for approving and monitoring TPOs. These include, but are not limited to: appropriate licensing; minimum experience requirements; minimum net worth requirements; public records searches; watch and exclude lists; fraud product screening; and regular quality control reviews where compliance data is tested.

The Proposed Guidance suggests that lenders should perform additional due diligence reviews on TPOs, especially as they relate to the TPOs’ up-front marketing practices (*e.g.*, advertising). We urge the Agencies to reconsider imposing additional requirements. The market in which our member banks participate already contains safeguards that adequately protect lenders and consumers against the risk mentioned in the Proposed Guidance. Representations and warranties that typically appear in agreements with TPOs incentivize them to comply with applicable rules and protect the lenders from non-compliance with marketing or disclosure requirements. Moreover, it is not feasible for our member banks to monitor the marketing practices of all their correspondents. Most major lenders, including our member banks, purchase loans from thousands of correspondents and bulk sellers, who in turn may purchase loans from other correspondents. It would be impossible for our member banks to monitor the marketing practices of all their correspondents without significantly increasing the cost and time required to purchase loans from TPOs.

The problem is exacerbated when one considers provisions in the Proposed Guidance that could be read to impose similar due diligence requirements on securitizers. We respectfully request that securitizers not be required to ensure that all loans in their pools comply with the requirements of the Proposed Guidance. Securitizers have even less practical capacity

than their correspondents to control the marketing and disclosure practices of the originators of loans in their pools.

Currently, all mortgage brokers and correspondents must comply with TILA, and state-chartered entities must also comply with state advertising requirements. The foundation of TILA is that evidence of violations must appear "on the face" of the documentation when purchasing in the secondary market. In contrast, to comply with the Proposed Guidance, lenders would need manually to review documents beyond the loan files they purchase from TPOs. This would put an insurmountable burden on loan purchasers.

We would like to reiterate that amending TILA and Regulation Z is the best mechanism to achieve the most meaningful consumer protection. Any guidelines issued by the Agencies will only affect a portion of the market. Market participants that are not regulated by the Agencies will not be required to modify their practices. Consumers will most likely migrate to other lenders that continue to offer nontraditional products, and, in the process, put our member banks at a competitive disadvantage.

D. Secondary Market Activity

Lenders' effective use of the secondary marketplace as a risk management tool is evidenced by the robust liquidity of the U.S. mortgage market today. Unfortunately, the Proposed Guidance neglects to recognize the extent to which many lenders use the secondary markets to manage the credit risk in their loan portfolios. Indeed, many lenders' risk models are based on the fact that a majority of loans will be sold in the secondary marketplace shortly after origination. Often, lenders may underwrite loans that seem risky for the lender's portfolio but meet the secondary purchaser's risk tolerance.

We also strongly urge the Agencies to reconsider their assessment of the implicit recourse risk that exists in the secondary marketplace for both traditional and nontraditional

mortgage products. Absent some contractual obligation, banks rarely provide support to poorly performing pools. The Proposed Guidance incorrectly assumes that banks will rescue pools for the sole purpose of maintaining a good reputation in the secondary marketplace.

Based on the fact that banks rarely repurchase loans from underperforming pools absent some contractual obligation, we respectfully disagree with the suggestion that the potential for recourse is greater for pools of nontraditional products. It is important to note that only sophisticated investors purchase mortgage-backed securities, and they typically do so on a fully disclosed basis. These investors are made aware, and have the ability to understand, the risks that exist in pools containing nontraditional mortgage products. Therefore, we do not believe that depository institutions or their affiliates would feel pressured to rescue such pools in the event that defaults exceed investors' expectations.

E. Stress Testing & Management Information and Reporting

We respectfully submit that the Agencies permit our member banks to exercise their judgment in creating and applying stress testing models. Although our member banks' stress testing models do not include all the factors mentioned in the Proposed Guidance, they adequately identify, monitor and manage portfolio risks. Consideration should also be given to the fact that creating stress-testing models is a subjective process that requires the exercise of judgment. Moreover, we request that the Agencies acknowledge that the sophistication of a lender's management information and reporting systems should be commensurate with the size and risk of the lender's portfolio.

F. Capital and Allowances for Loans and Lease Losses

We believe that requiring lenders to consider particular product features when establishing a reserve methodology conflicts with existing accounting policies and industry

standards.<sup>18</sup> Our member banks continuously review the adequacy of their capital and loss reserves and are guided by their vast experience in the industry and an extensive body of existing rules and guidelines. To the extent that an institution's portfolio is exposed to additional risk, lenders are well suited to use their judgment to establish additional reserves.

#### **IV. Consumer Protection Issues**

We agree that lenders should provide consumers with clear and concise information about the relative benefits and risks of loan products. As the types of mortgage offerings continues to expand, the industry must find new ways to provide consumers with timely, clear and concise information that is relevant to their decision-making process. To that end, our member banks believe they are at the forefront in the effort to improve consumer protection best practices.

That being said, we are concerned that the Proposed Guidance requires lenders to attach a warning label on particular mortgage products. This may unnecessarily confuse borrowers and cause them to overlook the benefits of certain nontraditional products. Ultimately, it is the borrower's responsibility to weigh the benefits and risks associated with various loan products and choose the appropriate product.

As we discuss above, there are already comprehensive Federal laws and regulations related to consumer protection issues that govern all participants in the residential mortgage lending industry, including TILA, Regulation Z and RESPA. Therefore, to ensure the effectiveness of consumer protection initiatives and to ensure that our member banks are not placed at a competitive disadvantage, we suggest that the proper method to enhance disclosure requirements is through amendments to already existing Federal laws and regulations. For

---

<sup>18</sup> See FASB Staff Position SOP No. 94-6-1, Terms of Loan Products That May Give Rise to a Concentration of Credit Risk (suggesting that any such concentrations should be dealt with by disclosure rather than through the reserve).







lenders continue to use traditional methods to verify a borrower's assets, such as requiring the borrower to provide a copy of the two most recent bank statements.

With respect to subprime borrowers, reduced documentation loans can be appropriate in circumstances where there is as a relatively low LTV ratio or where the lender uses mortgage pool insurance.

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 rate for adjustable rate mortgage products?

As stated in Section II.A of this Comment Letter, it is not feasible for lenders to base qualification decisions on future events, such as income growth or future interest rates. There is not only the absence of a reliable method to determine a borrower's long-term income growth, but the variables that are needed to calculate long-term income potential may be considered "prohibited bases" under the ECOA and Regulation B. Additionally, the realities of interest rate movements make it extremely difficult to predict interest rate movements, particularly those 20 or 30 years into the future. Indeed, the recent phenomenon of a flattening and inverted yield curve, partly caused by the increased participation of foreign institutions and hedge funds in the U.S. bond market, makes predicting interest rate movements even more difficult.

\* \* \*

Office of the Comptroller of the Currency  
Office of Thrift Supervision  
Robert E. Feldman, Federal Deposit Insurance Corporation  
Jennifer J. Johnson, Board of Governors of the Federal Reserve System

- 24 -

Thank you for considering the views expressed in this letter. If the Agencies would like additional information regarding this letter, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Very truly yours,

A handwritten signature in black ink, appearing to read "J. R. Nelson". The signature is written in a cursive style with a long horizontal stroke at the bottom.