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The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
[Transmitted by e-mail to regs.comments@occ.treas.gov]

RE: OCC, Docket Number 05-21, Interagency Guidance on Nontraditional Mortgage Products

Dear Comptroller Dugan:

On behalf of more than 1.2 million members of the National Association of REALTORS® (NAR), I am pleased to provide comments to the federal banking agencies and the National Credit Union Administration on the proposed Interagency Guidance on Nontraditional Mortgage Products (Guidance) published in the Federal Register on December 29, 2005.[1]

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®. The proposed Guidance will have an impact on the availability of financing homeownership and, therefore, is of vital concern to REALTORS®.

The proposed Guidance would set standards for how lenders (insured banks, thrifts, and credit unions) should underwrite, manage, and inform consumers about nontraditional mortgages, including interest-only and payment option adjustable rate mortgages.

While the Guidance states that lenders "should" take various actions, we believe they will understand that if they do not comply with the guidance they are at risk of an examination finding that this aspect of their operations is not being conducted in a safe and sound manner. To

[1] 70 Federal Register 77249 (December 29, 2005).

avoid any misunderstanding, we suggest that the agencies explain this in the Guidance. If our understanding is not correct, we believe the agencies should initiate rulemaking so it can enforce the Guidance. Where the Guidance uses the word "could," we assume the agencies intend to signal that the particular action is truly optional.

The Guidance would, in effect, require lenders (including all of their affiliated mortgage lenders) to do three things:

1. Review their current underwriting standards for nontraditional mortgages and make any necessary changes to ensure prudent lending;
2. Develop policies and internal controls that address the risky nature of nontraditional mortgages; and
3. Make sure that consumers have "clear and balanced information" about the benefits and risks of nontraditional mortgages.

NAR applauds your decision to apply the Guidance to all mortgage lenders within a holding company structure and not just to the insured depository institutions themselves. This policy is crucial to avoid the situation where questionable loans are made by an affiliate of an insured institution so that institution can disavow engaging in risky lending. We believe the Guidance will also influence the underwriting and consumer education and disclosure practices of other lenders that are not subject to banking agency supervision.

Consumer Protection Issues

Under the proposed Guidance, lenders would be required to:

- Explain the risks as well as the benefits in a clear and timely way;
- Alert borrowers about payment shock, negative amortization, prepayment penalties, and any pricing differences for "low doc" loans; and
- Issue monthly statements that explain the impact of various choices, when the borrower has an option about how much to pay.

NAR shares the concerns of the banking agencies that some borrowers are using nontraditional mortgages without fully understanding the risks associated with such products and congratulates you on proposing to establish high standards to protect consumers from unknowingly agreeing to inappropriately expensive products. Last summer, NAR, in partnership with the Center for Responsible Lending, issued two consumer education brochures, "Specialty Mortgages: What Are the Risks and Advantages?" and "Traditional Mortgages: Understanding Your Options."[2] The brochures emphasize how important it is for consumers to make sure that they fully understand how these mortgages work before deciding which is the right choice. We have a few suggestions for strengthening this section of the Guidance.

Disclosures. We suggest that the Recommended Practices section of the Guidance on the subject of Payment Shock[3] be strengthened to make it clear that lenders "should" disclose to

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[2] The brochures are available on NAR's website: http://www.realtor.org/housopp.nsf/pages/mortgages?OpenDocument

[3] See page 77256, center column.

consumers, up front, an example of the impact of typical nontraditional mortgages. For example, consumers should see how the payment would change for a typical mortgage amount (such as $100,000 or $200,000) if they pay only interest or, for payment option ARMs, pay less than needed to amortize the loan for the first years of the mortgage. In particular, the example in the promotional materials section should state that product descriptions "should"—not "could"—specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical, worst-case example.

To promote compliance and clear, concise disclosures, NAR recommends that the banking agencies develop model disclosure forms. Model forms would be particularly helpful for consumers who are shopping for loans and comparing the extremely complex terms for nontraditional mortgages. Even though variation among these products would require tailoring the model to the particular product, having a uniform base document would make a significant contribution to promoting consumer understanding.

Prepayment Penalties. The draft Guidance states that lenders should inform consumers if a prepayment penalty is a feature of the mortgage and the amount of the penalty. Lenders typically justify prepayment penalties as a trade-off for a lower rate. NAR recommends that you amend the Guidance to state that lenders should specify the benefit the borrower is receiving in exchange for accepting a prepayment penalty to give the applicant enough information to decide whether to select a mortgage with a prepayment penalty.

Other Suggestions for This or Other Guidance. We also have several suggestions that are not limited to the proposed Guidance, and we urge you to consider them in this and other appropriate contexts.

<u>Bait and Switch</u>. Families seeking nontraditional mortgages may face an especially high risk of "bait and switch" tactics that some lenders use to, in practical effect, force a family to take a higher cost mortgage loan at closing. One way to help deter this unscrupulous behavior by some lenders would be to establish policies that give borrowers the option and sufficient time to obtain a new loan, without penalty, if the lender changes the terms of the loan within a reasonable number of days before closing, with a refund of any fees or other charges already collected by the lender. Adding this concept to the Guidance would be a significant step and signal to lenders and their affiliates that bait and switch tactics are unacceptable.

<u>Steering</u>. Another way to strengthen consumer protections would be to adopt policies to minimize steering of applicants that would qualify for a traditional prime mortgage to a nontraditional mortgage or even to a subprime mortgage instead. One approach would be to require lenders to initially process every application as an application for a conventional prime mortgage. Since underwriting is now computerized, this should add very little cost or time to the process. Borrowers approved for a conventional prime mortgages would still have the option of electing a nontraditional prime mortgage. Those who do not qualify for a conventional prime mortgage could then consider other options.

Underwriting Standards

The Guidance would require lenders to:

- Consider, when underwriting the loan, the ability of the borrower to repay the loan when amortization kicks in, including the maximum potential increases in the principal balance due to negative amortization, and to avoid over-reliance on credit scores instead of full income verification;
- Avoid making loans that the borrower cannot afford without having to sell or refinance the property when full amortization begins;
- Compensate with mitigating factors when nontraditional mortgages are combined with other risky features (such as "low doc" loans and second mortgages). The agencies call this "risk layering";
- Use "low doc" underwriting with caution and only when there are other mitigating factors; and
- Follow other specified guidance.

NAR strongly supports agency efforts to assure that lenders make nontraditional mortgage loans on a safe and sound basis. We are concerned, however, that the Guidance may have the effect of discouraging lenders from making nontraditional mortgages in many appropriate cases, to the detriment not only of families but also their communities. We understand that you face an extremely difficult challenge to establish Guidance that will curtail only those nontraditional mortgage loans that are inconsistent with safety and soundness, but we believe that you can accomplish that goal.

NAR suggests that you add a new sentence to the first paragraph of the text of the proposed Guidance[4] that recognizes the important contribution nontraditional mortgages have made to achieving record homeownership rates and that the agencies expect these mortgages will continue to play an important role in helping families achieve homeownership. The current draft emphasizes the risk of nontraditional mortgages much more heavily than their benefits.

You specifically asked for public comment on several questions, including these two:

> 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?
>
> 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?

These questions appear to be aimed at lenders, but we have several comments that address the concerns they raise.

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[4] Page 77251, third column.

The draft Guidance would require lenders to analyze the ability of borrowers to make payments "at the fully indexed rate" and "assuming a fully amortizing repayment schedule," including any negative amortization. It is not clear whether you propose to require lenders to underwrite each nontraditional mortgage loan based on the proposed borrower's ability to repay, from current income, the maximum potential mortgage payment. If that is the intent, NAR strongly opposes this requirement. It would mean that the only families that could qualify for nontraditional mortgages would be those who do not need them. They would become solely a tool for the wealthy used for so-called "cash management" purposes. The impact on other families in high-cost areas would be severe.

NAR recommends that the Guidance require lenders, in underwriting a nontraditional mortgage, to consider and fully document in writing whether there is a reasonable basis to determine that the potential borrower will be able to meet the borrower's responsibilities under the mortgage. This documentation should be retained for a sufficient time to permit your examiners to determine whether the underwriting of a mortgage that goes into default or is foreclosed was appropriate. During the examination of an insured lender or its affiliate that is experiencing high default or foreclosures rates, the examiner should consider this documentation as part of the process of identifying the problems with the lender's underwriting standards or how its loan officers have applied the standards.

Many factors could support a finding that a borrower will be able to the borrower's obligations under the mortgage after the fully indexed and amortizing payment becomes payable. For example, a nontraditional mortgage may be appropriate—

- When a borrower can expect a significant future increase in income, such as (a) at the conclusion of additional education or training, (b) when children start school, (c) when a small business becomes more established, or (d) when periodic car payments, tuition, or other financial responsibilities will no longer be a family obligation;
- If the borrower proposes to renovate the home to increase its value and upon completion of the work to refinance the loan or sell the property;
- If the borrower intends to own the home for a short time;
- If the borrower has assets sufficient to permit the family to supplement its income from savings in order to meet the higher payments for a reasonable period even if the mortgage market at the time the higher payments kick in would make refinancing difficult or infeasible; and
- Even if the borrower's debt-to-income ratio exceeds standards used by automated underwriting systems or other underwriting criteria of the lender, if the borrower has a history of paying rent or mortgage payments that exceed usual ratios.

Even for borrowers in such circumstances where the lender determines they qualify for a nontraditional mortgage, they should very carefully consider both the risks and advantages of both traditional and nontraditional mortgages before making a decision.

Lender Policies to Manage Risk Associated with Nontraditional Mortgages

The Guidance would require lenders to adopt risk management policies for nontraditional mortgages to minimize risk up front, provide an early warning of developing problems, and establish appropriate levels of capital and reserves for losses.

To the extent lenders interpret the Guidance as requiring them to set aside higher reserves and capital for nontraditional mortgages than they have found necessary based on prior experience, the effect of the Guidance will be to unnecessarily curtail this type of mortgage loan. We are also concerned that the Guidance advises all lenders to establish concentration limits for various types of loans, mortgage broker and other third-party originations, and other categories. NAR recommends that the Guidance distinguish between lenders that have made nontraditional mortgages a key and profitable element of their business plan for many years and those who are chasing yield without sufficient understanding or experience. Arbitrary concentration limits are not appropriate for lenders who have a long and successful record of making and managing the risk associated with nontraditional mortgages.

Conclusion

NAR urges the agencies to work closely with lenders, especially those who have extensive experience in this area, to assure that the final Guidance does cause an overreaction by a significant number of lenders and an unnecessary restriction on nontraditional mortgage loans. We hope that your response to the real and serious risks that some lenders appear to face in making nontraditional mortgage loans can be addressed without eliminating this type lending as an importance source of home financing that has helped make homeownership the growth engine of the economy.

Thank you for the opportunity to provide comments on the proposed Guidance. Please call Jeff Lischer, Manager, Financial Services (202.383.1117) if you have any questions about our comments.

Sincerely yours,

David A. Lereah
Senior Vice President, Chief Economist