Comment on

Docket No. 2007-09
proposed subprime guidance

Submitted to the Office of Thrift Supervision

By the Community Reinvestment Association of North Carolina
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The Community Reinvestment Association of North Carolina is a nonprofit that seeks to help individuals and communities gain access to capital with the goal of building wealth. Often we work to eliminate systemic barriers for low income and minority consumers. Our work has catalyzed agreements to bring billions of dollars in capital to these neighborhoods. We have also worked to fight predatory lending that strips wealth.

We need a strong federal anti-predatory lending standard.

At the same time, we recognize the important regulatory resource that exists in state law, and believe that legislation must preserve the progress made by states to govern lending within their borders. In the wake of the recent *Wachovia* decision, that authority is now in limbo.

Discussion

Non-traditional mortgages represent a new wrinkle on an old story. While broadening access to credit, they may become predatory as lenders push and borrowers use a product that is unsuitable and perhaps unsustainable. Although they include many different products, they are alike in their ability to introduce risk to the financial system. Some borrowers can handle a nontraditional mortgage. But many others are not prepared to plan for a balloon payment, for the reset of adjustable rate loan, or for some of the other products now available in the marketplace. The problem is as much one of scale as anything. Simply put, nontraditional mortgages have become common place and that suggests that they are no longer going to the narrow group of consumers prepared to handle the responsibility that they require.

What are we talking about?

Non traditional mortgages include interest only (IO), pay-option adjustable rate mortgages. Some of the features that regulators should focus upon:

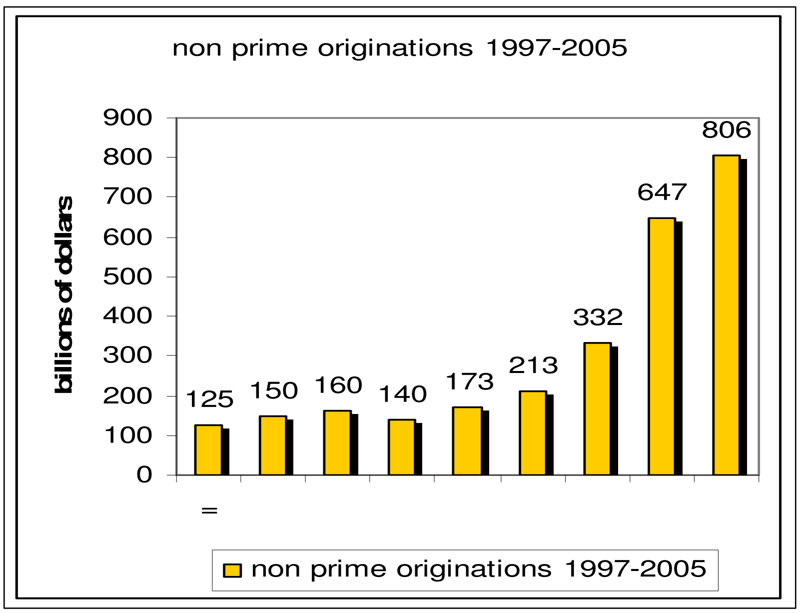
- No or low documentation of income
- Negative amortization: borrower debt increases over the life of the loan when unpaid interest is added to principal
- Teaser rates (interest rates in the short-term that are much lower than the index rate that will form the basis of the loan's pricing for the majority of its life.
- Interest-Only loans
- The simultaneous use of second lien mortgages (piggyback loans) to skirt loan-to-value criteria.
- Loans that combine more than one of these features

CRA-NC's concerns extend beyond the Federal and North Carolina defined universe of non-traditional mortgages. We are also concerned about the impacts of home equity line of credit loans (HELOCs) and reverse mortgages.

We commend the Commissioner of Banks for identifying this problem. We believe that the extent of the problem is growing. As a community, we have not yet known the impact of the new easy credit rules used by the non-prime mortgage industry. As portfolios season, they will include more frequent mortgage problems.

Nontraditional mortgages are slightly different than nonprime or subprime mortgages.

Nevertheless, the two often interact. Let's examine the size of the nonprime mortgage lending industry: The next graph shows the scope of non-prime originations.



Source: New Century Financial Investor Conference

This chart shows the market for non-prime loans in the United States, courtesy of New Century Financial. New Century should know about the market, as they are the second leading originator of nonprime mortgages in the United States. This data comes from an August, 2006 investor's conference.

The point of the graph is to show that nonprime mortgages have grown in volume recently. For years, their use stayed steady. The chart shows a slight increase in 1999, followed by a drop in the subsequent year.

However, beginning in 2002, nonprime originations took off. Now they make up almost one quarter of the $3 trillion annual mortgage lending market.

Non traditional mortgage lending is slightly different than descriptors like “nonprime” or “subprime.” Its definition owes less to the bad credit quality of the applicant as it does to the unusual structure of the terms of the mortgage itself. Of course, sometimes the nontraditional mortgage structure proves attractive to the class subprime borrower. One instance is the no or low-documentation of income – whereby a borrower can skirt a debt-to-income or payment as a percent of income ratio.

Moreover, it is the features of nontraditional mortgage lending that make it so closely aligned to the general idea that people allude to when they use the otherwise hard to define term “predatory lending.”

The scope of the problem is growing. Nontraditional mortgages are taking off even faster and have become an even larger factor in the marketplace: in 2005, for example 63 percent of all mortgages were either interest-only or adjustable rate mortgages[i]. In three states, negative amortization loans accounted for at least 14 percent and as much as 27 percent of all loans in 2005[ii]. For 18 months of 2004 and 2005, almost one in three borrowers put no cash down when they purchased their home[iii].

A recent study by the Federal Reserve concluded that nontraditional lending is relatively specialized: about half a group of surveyed banks indicated that nontraditional mortgages constituted less than 5 percent of their outstanding portfolios. Two of three indicated that it was less than 15 percent. However, about one quarter reported that nontraditional mortgage loans accounted for more than 30 percent of their home loans! Moreover, it’s the biggest banks that are most likely to avoid the nontraditional mortgage market: the group of banks where nontraditional mortgages make up less than 5 percent of business make up 60 percent of originations by loan amounts.[iv]

That means that the set of financial institutions who are making most of the nontraditional mortgages come from less than familiar sources. Fieldstone Investment Corporation, for example, makes many of its loans over the Internet. Many people know that Wachovia, Wells Fargo, Bank of America and BB&T are among the top lenders by volume in North Carolina. But would you be surprised to know that Countrywide Home Loans ranks fourth, First Franklin Financial ranks ninth, and American Home Mortgage ranks tenth, followed closely by Option One Mortgage (12th), CitiFinancial (16th), Fremont Investment and Loan (17th), and Dover Mortgage Company (20th)? The new face of mortgage lending is not familiar. This way of doing business is yet to be understood outside of a low-interest rate environment.

The truth about subprime and nonprime is becoming painfully clear on Wall Street. Friedman, Billings, and Ramsey, a leading investment firms and one with a reputation for expertise in banking, recently produced an internal report on subprime lending. Their focus was on the recent performance of the existing mortgage portfolios of publicly trading companies in the subprime mortgage field. Their study included Aames, Accredited Home Lenders, Ameriquest, Countrywide Financial, Delta Credit, Equity One, Fieldstone Investment Corporation, Finance America, Fremont, GMAC, New Century, Novastar Financial, Option One, and Saxon.

What they found suggests that the bad news that everyone fears about nonprime origination and subsequent credit problems has begun to materialize.

- Default rates for Friedman, Billings, and Ramsey's list of studied "nonprime" lenders increased to 3.21 per cent in November 2006.
- The 2006 pools issued by Option One posted the worst defaults performance with a 3.95 per cent default rate, followed by GMAC RFC at 3.94 per cent and Aames at 3.90 per cent.

In general, default rates for FBR's universe of companies increased from 2.52 per cent in October 2006 to 3.21 per cent in November 2006.

In the Federal Reserve report, forty percent of lenders holding non-traditional mortgages indicated in a survey that they expect the credit quality of their nonprime portfolio to deteriorate in the next twelve months[v]. Even though the economy can be characterized as "relatively strong" by analysts like Moody's, mortgage delinquency rates are higher than anytime since 2001.[vi] The next chart shows that more and more borrowers are struggling to keep up with their mortgage payments.

Delinquency Rates, 1 to 4 family homes

	delinquency (30+)	
	3Q 06	4Q06
prime	2.44	2.57
subprime	12.56	13.33
FHA	12.8	13.46
VA	6.58	6.82
prime ARM	3.06	3.39
prime Fixed	2.1	2.27
subprime ARM	13.22	13.44
subprime fixed	9.59	10.09

Source: Mortgage Bankers Association
3Q and 4Q 2006

Wall Street has doubts. CRA-NC worries about how this will play on Main Street. Studies show that foreclosures pull down the property values of homes in their immediate neighborhoods. That demonstrates some of the safety and soundness concerns that in our minds justify the interest of the NC OCOB in this issue.

Extrapolating further, we would like to point out that the downside impact of nontraditional mortgage lending will inevitably be concentrated in some neighborhoods. Subprime lending is more likely to lead to foreclosures, and neighborhoods with high amounts of subprime lending are simultaneously ones with high amounts of foreclosures.[vii] A Department of Housing and Urban Development (HUD) report found that subprime lending is also disproportionately concentrated in minority neighborhoods.[viii] Now nontraditional mortgage lending threatens to introduce new strains of neighborhood distress.

Income and Asset Verification

The number of mortgages originated without adequate verification of income concerns us. Financial institutions adopt a policy of low or no documentation of income for good and bad reasons. Sometimes, it frees up an institution to make loans to borrowers who do not fit within the norm. For example, a "no-doc" program can give a retired borrower a means of qualifying for a loan without getting marked as higher risk. Without other checks for assets, though, it relies upon the collateral value of properties. In a market where home values stay steady or go up, safety and soundness concerns are met. When changes drop the value of homes, as has occurred in many markets in the last half of 2006, it can be just the opposite: borrowers can owe more than they have to pay on homes worth less than the value of the outstanding debt.

This amounts to a system that skirts proper underwriting. It invites the kind of trouble that has developed in recent months: in the last half of 2006, delinquencies have jumped. Some lenders, such as H&R Block's Option One Mortgage, report rates of delinquency among their originations that were almost 4 percent.

Income and asset verification have an important role in underwriting. It seems like this should be a statement that advocates should not have to make. It makes common sense. Yet given the recent practice among some groups, it has to be said.

Actions we encourage:

- Full documentation (no stated income loans). In the event that a lender provides a "low-doc" or "no-doc" loan, we would ask lenders to disclose any price premium for the privilege.

- Face-to-face, know your customer originations coupled with standard industry FICO scoring
- Examination of w-2s and tax returns
- Make debt service ratios pass internal affordability tests with the assumption that interest rates might increase by 200 basis points. Debt to income ratios should be examined. While a strict ceiling on debt to income might have unintended consequences that harm access to credit, there is some place for the DTI in the examination of lending. It is fair to say that loans with DTI's above 50 percent are "stressors" and should be elevated for further underwriting analysis.
- More disclosure about the maximum potential monthly payment after an adjustable or interest-only loan resets. We would suggest something institutionalized in its form, such as the "Schumer Box" in the Truth-In-Lending disclosure form that tells the real interest rate (APR) cost, the amount being borrowed, and the amount of interest necessary to finance the loan over the life of its term.
- Cap loan amounts at 105 percent of the original loan amount. This would serve as a protection with negative amortization loans.
- Monitor debt to income ratios, particular on non-owner occupied properties.
- Do not allow for simultaneous collateral (piggy back loans) in conjunction with negative amortization. This combination only works when property values go up. In the event of a downside, borrowers, lenders, and their surrounding communities will all suffer the downside.
- Lenders should implement incentives for their brokers and loan originators that align their pay with the long term performance of loans. The arms length relationship that lenders keep with brokers permits both to escape culpability for poor underwriting decisions.

Interest Only Loans

Interest only loans are easy to understand: borrowers only pay interest and no principal on their mortgage debt. They are not new to this period. They were actually popular, although usually with a 10 year mortgage, during the 1920s. During that period, many home buyers opted for interest only loans so that they could put their outside cash into the booming stock market.[ix] Ultimately, when the stock market crashed at the end of the 20s, interest only loans led to more foreclosures.[x] For the next seven decades, interest only loan products remained uncommon.

In the last decade, some markets have witnessed a transformation around interest only borrowing. An I/O loan allows a borrower to qualify to buy a much larger home. It can allow a borrower to finance several properties at once. I/O loans appeal to real estate investors who want to buy property with a positive cash flow.

Negative Amortization
Negative amortization loans seek to provide flexibility to borrowers with fluctuating incomes. They allow borrowers to defer their interest payments. That's a good idea in the right situation, but probably something that most people should consider with a lot of hesitation.

Giving a borrower the option to pay only a portion of the interest due on their debt leaves open the possibility of a repayment schedule where debt grows over time.

With negative amortization loans, the piper does come calling sooner or later. Some institutions reset the minimum payment every year. When borrowers have underpaid in the previous 12 months, resetting will increase their debt service.

Introductory Rates
Our perspective is that consumers, the public and financial institutions share an interest in seeing capital allocated in a responsible manner. Foreclosures bring a crisis not just upon homebuyers and the balance sheets of banks, but also upon the neighborhoods where those homes are located. A foreclosure harms property values. When multiple foreclosures take place in the same neighborhood, the threat is great and the possibility exists of a "tipping point" in neighborhood home valuation. One study in Chicago, often cited but worth repeating, found that each foreclosure in a neighborhood lowered the value of surrounding single family homes by 0.9 percentage points[xi].

The most common product in the new subprime mortgage lending field is the "2/28 adjustable rate mortgage[xii]". As we pointed out, this is the kind of product that draws specialists. Fieldstone Investment Corporation, an internet lender based in Columbia, Maryland, made 94.9 percent of its 3rd quarter 2006 origination through the 2-28 hybrid. To attest to the linkage between nontraditional mortgage products and credit quality, the average FICO for their loan pool was 648.

In the typical "2-28", the interest rate can change every 6 months after the first two years of the mortgage. Remember that most adjustable rates are made up of two factors – the index and the margin. The index rate is the base interest rate that the product draws from such as the LIBOR or the prime rate. The margin is the amount of spread between the index and the actual rate. In this product, a borrower pays a lower rate for the first two years of the mortgage. That can be the index, or even a rate below index. When the two years is up, the margin is introduced. All of this means trouble for a borrower with a tight budget. When there is a change in the interest rate, a borrower sees a big jump in their monthly mortgage payment.

We would like to highlight one company to illustrate the problem of teaser rates. H&R Block promises that it will not make loans to borrowers where debt service exceeds 45 percent of income. We believe that this policy in and of itself is too high. Nevertheless, that is the stated policy. The promise is all the more specious, though, in the context of Block's use of adjustable rate mortgages. In 2006, 80 percent of Block's non-prime mortgage originations came with adjustable rates[xiii].

In their 10-K, H&R Block describes their business this way:

> [Our] Non-prime mortgages are those that may not be offered through government sponsored loan agencies and typically involve borrowers with limited income documentation, high levels of consumer debt or past credit problems. Even though these borrowers have credit problems, they also tend to have equity in their property that will be used to secure the loan.

In essence, Block choose to look past income or high debt knowing that government guarantees will bail them out in the event of trouble. Moreover, they believe that the risk that comes from low documentation of income is made up for by targeting borrowers with high amounts of existing equity in the properties. That is borne out in their operating statistics, as well. In spite of the high debt and low wealth characteristic of their customer base, the portfolio still has a loan-to-value below 80 percent. The average cost (WAC) within the portfolio was 7.87 percent. Even now, more than 72 percent carried a prepayment penalty[xiv].

This reads like a playbook for predatory lending.

It amounts to a strategy that harms communities coming and going: first it saddles consumers with debt that they are incapable of paying. Then, it requires public funds to guarantee bad debts or it consumes equity with foreclosures.

The impact of this underwriting is coming to bear: In the first 11 months of 2006, Option One (one of Block's two mortgage origination channels) had a default rate on its pool of loans of 3.95 percent[xv].

A better system is to underwrite loans that gauge debt service ability based upon the maximum potential payment of a loan.

"Assess a borrower's ability to repay the loan, including any balances added through negative amortization, at the fully indexed rate that would apply after the introductory period. The agencies recognize that this requirement differs from underwriting standards at some institutions and are specifically requesting comment on this aspect of the guidance."

Investors/Non-occupant Ownership
In 2005, many people entered the market for mortgages on property ultimately intended to become rental units.

For many borrowers, 2005 represented an opportunity to take advantage of historically low interest rates. HMDA data taken in North Carolina confirms this. The next table shows the extent of mortgage origination by non-owner home purchasers.

MSA	total	Owner Occupied	Not Owner Occupied	PCT Not Owner
rural	96,292	77,178	18,454	19.2 %
ASHEVILLE, NC	18,399	15,257	3,051	16.6 %
BURLINGTON, NC	5,241	4,660	559	10.7 %
CHARLOTTE-GASTONIA-CONCORD	83,345	72,996	9,979	12.0 %
DURHAM, NC	20,978	18,256	2,626	12.5 %
FAYETTEVILLE, NC	13,701	11,914	1,615	11.8 %
GOLDSBORO, NC	3,720	3,277	426	11.5 %
GREENSBORO-HIGH POINT, NC	30,071	26,304	3,586	11.9 %
GREENVILLE, NC	6,397	5,332	1,025	16.0 %
HICKORY-LENOIR-MORGANTON, NC	12,033	10,742	1,230	10.2 %
JACKSONVILLE, NC	6,915	5,574	1,306	18.9 %
RALEIGH-CARY, NC	58,397	52,457	5,660	9.7 %
ROCKY MOUNT, NC	4,372	3,756	594	13.6 %
VA BEACH-NORFOLK (NC)	2,504	1,625	873	34.9 %
WILMINGTON, NC	24,866	16,422	8,303	33.4 %
WINSTON-SALEM, NC	19,822	17,518	2,222	11.2 %
SUMMARY	**407,053**	**343,268**	**61,509**	**15.1 %**

More than 15 percent of all originations in 2004 went to borrowers who did not intend to live in the home. More than 19,003 of these non-owner occupants took out refinances. Most likely, one common motivation is to buy a home in order to resell it. Another reason might be to acquire a home to make into a rental property.

John Dugan, comptroller of the Currency, notes that "There is no doubt that when several risky features are combined in a single loan, the total risk is greater than the sum of its parts."[xvi]

Brokers have traditionally been rewarded solely upon volume[xvii].

The real test of this guidance remains in the offices of loan brokers. A good OTS guidance would include a rule that internalizes a system of incentivization utilized by lending firms to pay brokers.

Guidance is an appropriate policy response given the legitimate safety and soundness concerns that these nontraditional mortgage portfolios create. Of course, we hope that this guidance will be given the regulatory authority to protect consumers adequately. Non-traditional mortgage lending has blossomed in an era of low interest rates. It has been a relatively safe era, by that respect. We wonder how well the balance sheets and monthly paychecks of banks and American families, respectively, will stand up in the event of a changing interest rate environment. The specter of that possibility under girds our belief in the need for this action.

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[iii] Edmund Andrews. A Hands-off Policy on Mortgage Loans. New York Times. July 15, 2005.
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[v] Ibid. pg. 32
[vi] Simon, Ruth. "Banks Move Earlier to Curb Foreclosures." Wall Street Journal. January 24, 2007. D1-3.
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[xii] Schloemer, Ellen; Wei Li, Keith Ernst, and Kathleen Keest. 2006. Losing Ground: Subprime Mortgages and their Cost to Homeowners." Durham, North Carolina: Center for Responsible Lending. (December):6
[xiii] HR Block 10-K. 2006. p. 94.
[xiv] HR Block 10-K. 2006. p. 94.
[xv]Friedman, Billings, Ramsey. Dec. 22, 2006.
[xvi] Remarks by John Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, October 27, 2005 at 6.
[xvii] Silver, Josh. Interagency Guidance on Non-traditional Mortgage Products. Comments submitted to the Federal Deposit Insurance Corporation. March 15, 2006. Washington, DC: National Community Reinvestment Coalition.