

MORTGAGE BANKERS
ASSOCIATION OF THE CAROLINAS, INC.



January 29, 2007

Mark Pearce
Deputy Commissioner of Banks
State of North Carolina
Office of the Commissioner of Banks
4309 Mail Service Center
Raleigh, NC 27699-4309

Dear Mr. Pearce:

Thank you for your letter of January 11, 2007 requesting the comments of the Mortgage Bankers Association (MBA)¹ concerning your office's contemplated issuance of final guidance on nontraditional mortgage products for the State of North Carolina (the Guidance). Specifically, you request information on whether the Guidance should encompass adjustable rate mortgage (ARM) products, including hybrid ARMs, in light of recent correspondence from MBA opposing such an expansion. MBA greatly appreciates the opportunity to present its views on this subject and is joined in this response by the Mortgage Bankers Association of the Carolinas (MBAC). We would caution, however, that if additional details were provided on the specific provisions under consideration by the State, along with sufficient time for comment, we and our members could provide more comprehensive, relevant information to inform the State's decision-making on this matter.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web Site: www.mortgagebankers.org.

Both MBA and MBAC strongly believe that the issue of whether to expand the Guidance beyond truly nontraditional products is critically important to our industry and the consumers we serve.

As detailed below, ARMs, including hybrid ARMs, are tried and true mortgage financing options that have provided needed credit choices to tens of millions of consumers and helped millions achieve the dream of homeownership. These are not nontraditional products as defined by the federal Interagency Guidance on Nontraditional Product Risks (Federal Guidance)², parallel guidance recommended by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) (CSBS/AARMR Guidance),³ or in the marketplace. Making these products subject to the Guidance would not help consumers in the State; it will only curtail the availability of these options for those who are most in need of credit.

Given the increasing availability of nontraditional mortgage products in response to consumer demand, the undersigned greatly appreciate the efforts of financial regulators at both the federal and state levels to provide guidance concerning these products. Most importantly, we appreciate the efforts of the regulators to develop guidance that is consistent among federal and state regulated institutions. Consistency of guidance better serves consumers; increases competition and lowers costs.

We do not share the view that the Guidance should be used to restrict the availability of credit options in the marketplace. Instead, the Guidance should remain true to its original objectives of protecting the safety and soundness of lenders while at the same time protecting consumers demanding nontraditional products. Unwarranted expansion of nontraditional guidance will adversely affect the primary and secondary markets and potentially the larger economy and the economy of North Carolina as well.

In this vein, we note that the Federal Guidance covers only nontraditional products and not other ARM products including hybrid ARMs. State regulators with the encouragement of the CSBS and AARMR are establishing parallel guidance to the Federal Guidance. The CSBS/AARMR template did not recommend expansion beyond nontraditional products and, to our knowledge; no states have chosen to extend the guidance for that purpose. Considering these facts, and what we believe are compelling reasons to exclude hybrid ARMs from the Guidance's coverage altogether, MBA and MBAC respectfully request that: (1) the State of North Carolina confine the Guidance to the truly nontraditional

² Interagency Guidance on Nontraditional Mortgage Product Risks (Federal Guidance), 71 Federal Register 58609 (October 4, 2006)

³http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/CSBS_AARMR_Guidance_.htm

products covered by the Federal Guidance and the CSBS/AARMR Guidance, i.e., interest only and payment option mortgages, at this time; (2) that the State carefully consider whether additional guidance is necessary to address hybrid ARMs; and (3) if the State determines that an expansion of the guidance or other guidance is necessary, the State provide a full and fair opportunity for the full range of stakeholders to comment on the provisions proposed. Further details on each of these points are provided below.

The State Should Confine the Guidance to Truly Nontraditional Products at This Time

As you are aware, the Federal Guidance was issued on September 29, 2006 following public notice of proposed guidance issued December 29, 2005⁴ and after careful consideration of comments submitted in response. The Federal Guidance was promulgated to apply uniform guidance on these products to all financial institutions regulated by the five federal agencies.⁵ A key issue in the development of the Federal Guidance was the scope of its coverage. To address these concerns, the Federal Guidance provided that it applied to all residential mortgage loan products referred to as nontraditional mortgage loan products that allow borrowers to defer repayment of principal and interest. This expressly included interest-only and payment option products and negative amortization mortgages with the exception of HELOCs.^{6 7}

The Federal Guidance defined mortgage products as including “interest only loans where a borrower pays no loan principal for the first few years of the loan and ‘payment option’ adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.”⁸ Although the Federal Guidance acknowledged that interest only loans and payment option ARMs are a subset of ARMs, it clearly did not extend its coverage to these products.⁹

Subsequently, on November 14, 2006, CSBS and AARMR encouraged the states to adopt guidance which tracked the Federal Guidance and to this end both organizations published their template as CSBS/AARMR Guidance. This guidance is based on the Federal Guidance, and only modified or deleted those provisions that were inapplicable to non-depository institutions.

⁴ 70 Federal Register 77249 (December 29, 2005)

⁵ Board of Governors of the Federal Reserve, Comptroller of Currency, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of Thrift Supervision

⁶ Federal Guidance, p.4

⁷ Reverse mortgages were also excluded from coverage. Guidance, footnote 1, p 9.

⁸ Guidance, p. 9

⁹ See footnote 1, p.9. The Guidance notes that interest only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products.

In their press announcement, the organizations noted that consistent guidance “will allow the opportunity to gauge the impact on the mortgage market and consumer behavior.” As of this date, 23 states and the District of Columbia have adopted or begun the process of adopting the CSBS/AARMR guidance.

To our knowledge, none of these jurisdictions have expanded the guidance beyond nontraditional products. A contrary position by the State of North Carolina would place it in a unique position at the cost of denying its citizens valuable financing options.

As you are aware, mortgage lenders have been subject to a patchwork of lending requirements, in areas other than nontraditional products, emanating from the federal, state, and even local governments. These diverse standards, while well-intentioned, have lessened competition, increased regulatory costs and, thereby, increased costs to the consumer. Restrictions that vary from locality to locality lessen the number of entrants that are willing to learn and comply with particular requirements. Increased regulatory risks and compliance costs for those who do compete translate into increased costs for consumers.

Recently, pressure has been exerted by some advocacy organizations to extend the Federal Guidance to ARM products, including hybrid ARMs, notwithstanding that neither the federal guidance nor the CSBS and AARMR products encompass them.

As of yet, no regulatory action has been undertaken to expand the Federal Guidance. We understand, however, that the federal regulators are carefully considering this matter. We believe the options available to them include addressing hybrid ARMs under separate guidance, expanding the Federal Guidance to cover them, or taking the position that additional coverage of these products is unnecessary. We expect the regulators to make a decision on this matter shortly and we trust that during any additional rulemaking the public, including but by no means limited to industry and advocacy organizations, will have a full and fair opportunity for comment.

Accordingly, because guidance at both the state and federal levels has been restricted to nontraditional products, any action by North Carolina at this time to expand the coverage of the guidance beyond nontraditional products would undermine consistency and begin a costly patchwork of state laws in this area.

While we recognize that a state must protect its citizens, we strongly believe that further review will conclude that such action would be precipitous, raise competitive concerns and ultimately result in fewer choices and higher housing costs for its citizens.

There are strong reasons to determine not to provide guidance respecting hybrid ARMs and to do so only after careful consideration as discussed below.

The State Should Carefully Consider Whether Additional Guidance Is Necessary or Whether Such Guidance Will Only Increase the Patchwork of Inconsistent Laws

ARMs, including hybrid ARMs, are tried and true credit options. Hybrid ARMs offer a borrower some of the certainty of a fixed rate mortgage with the lower payments of an ARM. ARMs, first developed in the 1970s, permit borrowers to lower their payments if they are willing to assume the risk of interest rate changes. Hybrid ARMs, introduced in the mid-1990s, combine the benefits of fixed rate mortgages and adjustable mortgages and allow borrowers to opt for a lower initial interest rate and lower monthly payments, which are fixed for a period of two to ten years (including 2-28 ARMs and ARMs with longer fixed payment periods). After the fixed payment period ends, the hybrid ARM converts to an adjustable rate mortgage with the interest rate and payments adjusting periodically (usually yearly) based on interest rate changes in the capital markets.

ARMs, including hybrid ARMs, are not simply refinancing tools; these mortgages are affordable financing options that have helped millions of borrowers achieve the dream of homeownership. Hybrid ARMs offer a lower monthly payment during the fixed payment period than a fixed rate mortgage. Nearly half, or 45 percent, of nonprime loans are purchase loans, with 25 percent of nonprime purchase mortgages originated for first-time homebuyers. A significant portion of the recent gains in homeownership are attributable to hybrid ARMs. In the first half of 2006, 67 percent of new subprime loans were ARMs, and 52 percent of nonprime ARMs were hybrids.

Making hybrid ARMs subject to the Guidance and its underwriting guidelines will unnecessarily disqualify borrowers from homeownership and affordable credit. The Guidance would likely demand that nontraditional mortgages be underwritten to the fully indexed rate after adjustments. However, hybrid ARMs are frequently underwritten using more flexible guidelines based on reasonable repayment expectations. This difference makes many more borrowers eligible for these loans. If ARMs and hybrid ARMs were underwritten pursuant to these new standards, it is estimated that many hybrid ARM borrowers simply will not qualify for mortgages to buy the homes they want or to get needed credit.

For many borrowers, the choice is not between an ARM and a fixed rate mortgage to finance the property they want; it is an ARM or no mortgage at all. Flexible underwriting for hybrid ARMs is appropriate. Relatively few hybrid ARMs experience any adjustment at all; hybrid ARMs are usually refinanced very early in their terms. Data indicate that of the prime loans originated in 2003 only 44

percent remain in effect. For nonprime loans originated in 2003, only 22 percent remain in effect today.

Hybrid ARMs are not “exploding mortgages;” payment increases are generally much smaller than alleged and frequently never come. The rates and payments under hybrid ARMs do not normally increase by 40-50 percent, after the option period has expired, as has been alleged. In fact, whether there are any payment increases depends on the structure of the ARM and what happens to interest rates during the fixed period. Data from lenders demonstrate that today the change between the average start rate and the average fully indexed rate under these mortgages is generally no more than 2-3 percent percentage points. Lenders do not gain from borrowers' defaults and underwrite loans prudently to prevent them. To protect borrowers from unmanageable payment increases, lenders often structure hybrid ARMs so that there is a cap on the periodic adjustment that is even if less than the amount interest rates have gone up more than that. Also, as indicated, only slightly more than a fifth of borrowers remain in these mortgages for more than three years. In any event, the potential increase in payments for borrowers later in the life of a hybrid ARM pales by comparison to the initial up-front savings to hybrid ARM borrowers.

Adjustable rate mortgages (ARMs) were never proposed to be part of the Guidance for good reason; they are not nontraditional products. As indicated, the Guidance, as proposed, following the CSBS/AARMR template, addresses the underwriting and disclosure concerns that attend nontraditional mortgage loan products.¹⁰ The Federal Guidance explicitly excludes fully amortizing mortgages from its coverage.¹¹ Other ARMs, including hybrid ARMs, are fully amortizing and do not involve the deferral of principal or interest. Therefore, if other ARMs, including hybrid ARMs, are to be restricted, the Guidance is not the appropriate vehicle.

Making changes in the underwriting of ARMs would have major ramifications for the primary and secondary mortgage markets and potentially for the economy. ARM products now comprise approximately 25 percent of the overall mortgage market. Making these products subject to the Guidance and limiting their availability would adversely affect the primary and secondary mortgage markets including lenders and investors as well as borrowers.

Most importantly, the significant lessening of credit options will markedly diminish the number of borrowers able to finance homes and thereby contribute to the downward pressure on real estate prices, adversely affecting the economy as a whole.

¹⁰ 71 Federal Register 58609, 58610

¹¹ 71 Federal Register 58609, 58613, footnote 1

Both ARMs and hybrid ARMs have been regulated and examined for a long time and have a strong record of performance. Both ARMs and hybrid ARMs have had a strong track record since they were introduced.

Recent increases in mortgage payment delinquencies among borrowers generally and nonprime borrowers, in particular, make this no less true. In the third quarter of 2006, the delinquency rate for nonprime loans was 12.56 percent up from 11.70 percent.¹² This includes a delinquency rate for nonprime fixed-rate loans of 9.56 percent and a delinquency rate for nonprime ARMs of 13.22 percent. Increases in these rates of delinquency are not surprising given that nonprime borrowers always have higher delinquency rates than prime borrowers and prime delinquency rates have increased as well.

MBA data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. Delinquencies are also caused by divorce and illness. The delinquencies among nonprime borrowers are still low by historical standards; delinquency and foreclosure rates have been particularly low the last two years.

At least as much attention should be given to the very high success rate of nonprime homebuyers and homeowners who use these financing innovations by the mortgage industry to meet their credit needs and to achieve the dream of homeownership. Based on the most recent data, more than 87 percent of borrowers are able to keep current on their mortgage payments. These borrowers have the opportunity to build wealth and wellbeing for themselves and their families. Their high degree of success should be the primary consideration to assure that future nonprime borrowers are not denied these important credit options.

Prime and nonprime borrowers find ARM products particularly useful where they plan to refinance or move before the period of fixed payments ends. Depending on interest rate movements, the average borrower pays off his or her loan every 3-5 years. ARMs and particularly hybrid ARMs offer significant cost savings for these borrowers. Also, in a given year, 30 percent of households with members in their 20's will move. For this reason, ARMs are preferred by mobile young families in high cost areas to achieve homeownership and lower their mortgage payments.

Some borrowers use these products to manage financial demands during the start period of fixed payments that they anticipate will recede. If a borrower faces

¹² These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers and the borrowers actually losing their homes are approximately a fourth of that group.

short term tuition or healthcare payments, for example, a hybrid ARM can be a useful option.

Making hybrid ARMs subject to the Guidance would add a new and unnecessary layer of disclosure when a comprehensive revision of the disclosure process is really what is needed. The Federal Guidance requires the provision of new descriptive materials and disclosures for borrowers under nontraditional products. These materials and disclosures would require significant revision to address hybrid ARMs. But the added value of such disclosures is not evident. Lenders already provide ARM borrowers the Consumer Handbook on Adjustable Rate Mortgages (CHARM Booklet) and other ARM disclosures under the Truth in Lending Act (TILA). MBA and MBAC have been long committed to comprehensive improvement of the mortgage process.

This same commitment on the part of Congress, the regulators and the advocacy community would be better for consumers than adding another layer of disclosures pursuant to the Guidance to the pile of disclosures that consumers already receive.

If North Carolina Determines that Guidance Covering Hybrid ARMs May be Necessary, the State Should Provide a Full Opportunity to Comment on Any Guidance the State Would Adopt

We strongly believe the foregoing substantive reasons militate against action to expand the Guidance. If, however, the State determines to expand the guidance or separately address the issue, the State should clearly propose the changes to be made to the Guidance and the products to be covered.

Although the State's proposed guidance asks whether the definition of nontraditional mortgages is appropriate and whether there are similar products that pose similar risks that should be included, this is far short of identifying the types of products proposed to be covered for public comment.

There are significant differences among hybrid ARM products in terms of the periods of fixed payments, margins and indices, to name a few. A full airing of views in response to a specific proposal will afford stakeholders an opportunity to provide sufficient information to assure that any future guidance serves and does not harm consumers.

For all of these reasons and more, we respectfully request that there be no expansion of this Guidance and that, if and when any change is made, the public be provided a full and fair opportunity for comment.

Deputy Commissioner Pearce
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We would appreciate the opportunity to meet with you to further detail our concerns and those of our member companies. If you have any questions, please contact Ken Markison, Senior Director and Regulatory Counsel at (202) 557 2930.

Thank you again for your consideration of our comments. We look forward to working with you on this critical matter.

Sincerely,

Mortgage Bankers Association

Mortgage Bankers Association of the Carolinas