CENTER FOR RESPONSIBLE LENDING

NC Justice Center
Opportunity and prosperity for all

January 29, 2007

VIA ELECTRONIC MAIL

North Carolina Office of the Commissioner of Banks
Re: Non-traditional mortgage guidance comment
4309 Mail Service Center
Raleigh, NC 27699-4309
comments@nccob.org

Re: Center for Responsible Lending comments on North Carolina Office of the Commissioner of Banks' Proposed Guidance on Non-Traditional Mortgage Product Risks

Ladies and Gentlemen:

The Center for Responsible Lending (CRL)[1] appreciates the opportunity to comment on the Office of the Commissioner of Banks (NCCOB)'s proposed Guidance on Non-Traditional Mortgage Product Risks.

General Comments

CRL applauds NCCOB for taking this important step to protect North Carolina homeowners from some of the most abusive practices associated with non-traditional mortgage products. By adopting the model guidance drafted by the Conference of State Bank Supervisors (CSBC) and the American Association of Residential Mortgage Regulators (AARMR), NCCOB will join the federal banking regulators, the Office of Housing Enterprise Oversight (OFHEO) and other state bank supervisors in putting a stop to practices that lure borrowers into loan products that appear affordable initially, but are designed with a substantial built-in payment shock and cannot be sustained.

Like other federal and state regulators, NCCOB has noted that mortgage lenders have increasingly disregarded traditional underwriting standards and extended loans without adequate regard to borrowers' ability to repay. These practices contribute to rising foreclosure rates, and will devastate communities across North Carolina if allowed to continue. We strongly endorse the proposed guidance, which will level the playing field

[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, one of the largest non-profit community development financial institutions nationwide.

between depository institutions covered by the federal Interagency Guidance on Non-traditional Mortgage Products and state chartered non-depository mortgage lenders.

For the reasons discussed below, we believe that NCCOB should include in the guidance loan products other than non-traditional mortgages that pose similar risks, and strongly recommend that the guidance be extended to cover subprime 2/28 and 3/27 hybrid adjustable rate mortgages ("2/28s" and "3/27s"). These products raise many of the same concerns as non-traditional mortgages, and are by far the most prevalent product in the subprime market today. We also urge NCCOB to include in the guidance an express statement putting mortgage lenders and brokers on notice that failure to follow the guidance will be deemed a violation of the Mortgage Lending Act, and will result in disciplinary action under the Act and other enforcement measures by NCCOB.

State-chartered mortgage lenders and brokers currently dominate the subprime market. This market raises particular concern, for three main reasons: first, the subprime market is where the most egregious abuses most commonly occur; second, this market is driving the explosion in home mortgage foreclosures; and third, abuses in this market are wreaking particular havoc on the lives and financial security of African-American and Latino borrowers.

The proposed guidance will address some of the abuses in the subprime market by reaching non-traditional subprime mortgages, but it needs to go further. The most common product in the subprime market is the 2/28 hybrid ARM, which carries a relatively low "teaser" interest rate for the first two years, and which jumps commonly by *up to three percentage points* at the end of the second year. This increase is scheduled to occur even if interest rates remain constant. Below we describe the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years. These products should be covered by the guidance.

The steep payment shocks on subprime 2/28 hybrid ARMs that follow from dramatic scheduled increases in the interest charges just two years into the loan represent precisely the sort of "deferral of interest" addressed by the proposed guidance. In the case of subprime 2/28 hybrid ARMs, the change in interest rates is typically so large at year two that these terms may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[2] The magnitude of this deferral is significantly larger than that typically found in prime ARM loans. Federal Reserve Board Governor Susan Bies reached a similar conclusion, recently stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[3] In

[2] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[3] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

addition to being consistent with the notion that these subprime hybrid ARMs present a deferral of interest, this quote also illustrates a second dimension on which subprime ARMs tend to differ from their prime counterparts. Specifically, low introductory rates on subprime ARMs are typically associated with high up-front financed fees whereas fees on prime ARMs tend to be much lower.[4] In other words, subprime ARMs routinely find borrowers trading equity in exchange for dramatically lower interest payments—in essence, an exercise in negative amortization.

Other federal policy-makers have concluded that the guidance should be extended to 2/28 hybrid ARMs. Federal Deposit Insurance Corporation Chair Sheila Bair recently stated:

> The underwriting standards in the alternative-mortgage guidance should apply to those [2/28s,]' and lenders should 'make sure there's an ability to pay.' …. '[2/28s] were the type of mortgage that certainly was intended to be within the spirit of the alternative-mortgage guidance.[5]

This was reinforced by a recent letter from six United States Senators to all of the federal regulators and the CSBS expressing the view that "these [2/28] mortgages have a number of the same risky attributes as the interest only and option-ARMs and, therefore, should be covered by the new guidance."[6]

Additionally, lenders' and brokers' failure to account for the payment shock is compounded by the failure to escrow property taxes and hazard insurance. We recommend that the proposed guidance include the requirement that lenders escrow for property taxes and insurance on subprime loans, and include these payments in the calculation of the borrower's ability to repay the loan.In contrast to the prime market, where it is common practice to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay, most subprime lenders and brokers sell loans based on low monthly payments that do not take taxes or insurance into account. This deceptive practice gives the borrower the impression that the payment is affordable, when in fact there are additional costs that the borrower will likely need to finance. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of their pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes

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[4] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[5] Joe Adler, *In Brief: FDIC May Treat 2/28s Like Other Exotics*, American Banker, November 15, 2006, vol. 171, no. 220, (Attached); Patrick Rucker, *U.S. bank regulators eye new mortgage guidance*, January 10, 2007, (Attached).

[6] December 7, 2006 letter from U.S. Senators Paul S. Sarbanes, Wayne Allard, Christopher J. Dodd, Jim Bunning, Jack Reed, and Charles Schumer to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 2 (Attached).

and insurance virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two.

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Lenders have been able to substantially insulate themselves from the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has largely removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is passed onto borrowers and sometimes investors.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted, and in some instances have demanded the repurchase of bad loans where these practices were not adequately disclosed to investors. In a few highly publicized cases, lenders have been forced out of business as a result.[7] This may force lenders to make fuller adjustments to accommodate investor concerns, but this will not help those borrowers who are in 2/28s now, who will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

For all of these reasons, we strongly support the steps taken by NCCOB to date, and urge the further actions described in the recommendations herein.

NCCOB's Specific Questions

1. Are there unique characteristics of non-bank mortgage lenders or mortgage brokers that should be considered in developing and/or applying guidance on non-traditional mortgage loan products?

Two aspects of non-bank mortgage lenders and brokers are particularly important in the context of this proposed guidance. *First*, unlike depository institutions, non-bank mortgage lenders and mortgage brokers are not subject to safety and soundness oversight by the federal banking agencies. Thus, while banks receive guidance and supervision from federal regulators on practices that may entail excessive risk, non-bank lenders and brokers do not. This is a particular concern in markets like the current one, in which competitive pressures have pushed lenders to lessen their underwriting requirements and abandon traditional standards of sound lending.

As the proposed guidance and other regulators have recognized, throughout the market lenders and brokers have extended loans with less stringent income and asset verification requirements, and without adequate regard to the borrower's ability to repay from sources

[7] Patrick Crowley, *Repurchases Stinging Subprime Sector*, MortgageDaily.com (Jan. 5, 2007).

other than the sale or refinancing of the mortgaged property.[8] Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender, which recently filed for bankruptcy protection after investors asked it to buy back *well over one hundred million dollars worth* of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[9] With respect to non-bank lenders and brokers, consumers will be unprotected without guidance from the states.

Second, non-bank lenders and brokers originate the majority of the mortgage loans in the subprime market. The subprime market requires particular regulatory attention because this is where most predatory lending occurs, and it is driving the surge in foreclosures in North Carolina and nationwide.[10] A CRL analysis of 2004 and 2005 Home Mortgage Disclosure Act (HMDA) data shows that in 2004 58% of first-lien higher-cost home loans were made by non-federally-supervised lenders that reported their data to the U.S. Department of Housing and Urban Development (HUD) (and 56% were non-federally supervised lenders in 2005).[11] Mortgage brokers accounted for 59.3% of subprime originations in 2005.[12] Thus, the majority of subprime mortgages are originated by state-chartered non-bank lenders and brokers.

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[8] *See* Reuters, *Bies Says Lenders Should Tighten Standards* (Jan. 11, 2007) ("Many industry observers believe the poor performance of more recently originated subprime loans is due primarily to looser underwriting standards, including limited or no verification of borrower income and high loan-to-value transactions," Bies said. She added that lenders need to be "specially diligent" when making such loans.”), available at
http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=OBR&Date=20070111&ID=6335528.

[9] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.

[10] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 3-5, available at
http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[11] 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 the proportion of subprime loans in 2004. 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).

[12] *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 Examinations Council Jan. 1, 2004), at 6.

Moreover, these loans are heading into foreclosure at a staggering rate. CRL recently released a study of more than six million subprime mortgages made from 1998 through the third quarter of 2006. Using housing price forecasts from Moody's Economy.com, the study projects that 1 in 5 (19.4%) subprime loans originated in 2006 will end in foreclosure. Taking account of the rates at which subprime borrowers typically refinance from one subprime loan into another, and the fact that each subsequent subprime refinancing has it's own probability of foreclosure, this translates into projected foreclosures for *more than one-third of subprime borrowers*.[13]

Further, subprime lending is hardly a small problem affecting only a few homeowners; to the contrary: *one in every four* home loans originated in 2005 was a subprime loan, and the subprime sector now has *$1.2 trillion* of mortgages currently outstanding.[14] Our recent report projects that NC foreclosures among the 2006 cohort of subprime loans are substantial at 17.5% of all such originations, the projection trails that made for the nation by almost two percentage points. At the same time, foreclosures among the 2006 subprime cohort in North Carolina are projected at two percentage points higher than that made for loans originated in the state from 1998 to 2001.[15] These loans will have a particularly damaging impact on communities of color. According to the most recent HMDA data, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[16] while four in ten loans to Latino[17] borrowers were higher-rate.

Worse, many borrowers who receive subprime loans could have qualified for a more affordable and responsible product in the first place. Freddie Mac, for example, has publicly commented that one in five subprime borrowers in recent years could have qualified for a lower-cost conventional loan.[18]

2. Would this guidance affect your operations? What impact would it have on your compliance systems and costs?

The proposed guidance requires nothing more than a return to sound lending practices. Basic underwriting principles require a determination that a borrower can afford to repay the loan. This cannot be accomplished without determining the cost of a fully indexed, fully amortizing loan payment and the borrower's ability to make such payments. The

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[13] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 4, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[14] Inside B&C Lending, 9/1/2006; *See also* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

[15] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 4, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[16] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.

[17] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.

[18] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005).

mortgage processing handbook published by the Mortgage Bankers Association expressly states:

> Briefly stated, the underwriter is required to answer a series of questions: (1) Is this property acceptable as security for our loan? (2) Does the value of the property support the loan amount being applied for? (3) Does the applicant have sufficient cash (or other liquid assets) to close the transaction? (4) *Is the applicant's income adequate to make the mortgage payments and meet other anticipated obligations and is that adequate income likely to continue into the foreseeable future?* (5) Assuming all of the other answers are positive, *is it likely the applicant will be able to make the payments* if the application is approved?[19]

Similarly, the requirement that lenders and brokers more diligently verify and document a borrower's income and debt reduction capacity using pay stubs, tax returns, or bank account statements would dramatically reduce inflated income statements common with so-called "no doc loans," which are used by subprime lenders and brokers to obscure unacceptably high debt-to-income ratios. Fitch recently noted that, "loans underwritten using less than full documentation standards comprise more than 50% of the subprime sector." [20]

In reviewing a sample of "no doc" loans, the Mortgage Asset Research Institute recently found that *over 90% exaggerated income* by 5% or more and almost 60% exaggerated income by over 50%. The MARI report notes, "When these loans were introduced, they made sense, given the relatively strict requirements borrows had to meet before qualifying. However, competitive pressures have caused many lenders to loosen these requirements to a point that makes many risk managers squirm."[21]

And brokers succumb to similar pressures, finding ways to approve borrowers when there is not enough income to support paying the loan. A survey of 2,140 mortgage brokers (constituting a national sample) found that forty three percent of brokers who use low document loan products know that their borrowers "can't qualify under standard [debt-to-income] ratios."[22] For this reason, lenders and brokers should be required to verify and

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[19] Cheryl J. Diehl, *Handbook of Mortgage Processing*, Mortgage Bankers' Association of America (Washington, D.C. 1997) at 173 (emphasis supplied).

[20] *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 4.

[21] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *See also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

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[22] "How Mortgage Brokers View the Booming Alt A Market," survey conducted by Campbell Communications cited in Inside Mortgage Finance ,Volume 23, Number 42 (November 3, 2006 available

document all sources of income using either tax or payroll records, bank account statements or other reasonable third-party verification.

Any costs associated with following the proposed guidance are merely the cost of doing business responsibly.

3. Are non-traditional mortgage loans a significant portion of the mortgage lending business here in North Carolina? Are these loans concentrated in particular segment of the marketplace here in North Carolina (e.g. subprime borrowers, urban areas, etc.)?

Based on research described below, mortgages with interest-only features or that allow negative amortization appear to account for a minority of loans in North Carolina. However, we also present research that suggests that loans with these features carry scheduled payment shocks that present formidable and sometimes insurmountable hurdles to borrowers. Moreover, we present research that shows that subprime hybrid ARM loans that lack explicit interest-only or negative amortization features nevertheless present even greater hurdles to borrowers in the form of higher payment shocks that occur sooner through quicker payment adjustments than are found on prime hybrid ARM loans. Indeed, the payment shocks we document on subprime hybrid ARMs exceed even those found on prime hybrid ARMs with interest only features. Consequently, we comment elsewhere in this letter that subprime hybrid ARMs should be included in the guidance.

In North Carolina, the most common form of courthouse filings made to secure a home loan is called a deed of trust. In instances when the security interest is associated with an adjustable rate mortgage (ARM), the courthouse records frequently provide detailed information about the initial interest rate and the timing and magnitude of scheduled adjustments.[23]

To explore the proportion of ARM loans (all of which carry some risk of payment shock) and the accompanying risk of payment shock on those loans in North Carolina, CRL reviewed a random sample of 293 deeds of trust filed in November 2006, drawn from four counties, including Durham, Guilford, Mecklenburg and Wake counties.[24]

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at http://www.imfpubs.com/issues/imfpubs_imf/23_42/news/1000004789-1.html and cited in Harney, Kenneth, *"The Lowdown on Low-Doc Loans,"* The Washington Post 11/25/2006 page F-1 (November 25, 2006), available at **http://www.washingtonpost.com/wp-dyn/content/article/2006/11/24/AR2006112400503_pf.html**

[23] It is not clear that all deeds of trust that lack detailed ARM information secure fixed-rate loans. Consequently, we categorize loans associated with deeds of trust that lack such information as loans with "no indication" of ARM status, rather than as fixed-rate loans. Consequently, the reported proportions of ARM loans should be treated as baseline estimates and not as upper limits.

[24] From this compilation of data, we arrived at an analysis sample of 156 records by dropping 10 records indicating the associated loan was originated prior to October 2006, 23 securing loans to commercial borrowers, four securing loans for land acquisition or construction, 99 loans securing second lien or home equity lines of credit, and 1 anomalous filing. In other words, we developed a dataset that allowed us to analyze presumptive first-lien, non-construction loans to non-commercial borrowers. All proportions and measurements reported in this section relate to this analysis sample. ARM Loans were further divided into

According to our analysis of 2005 Home Mortgage Disclosure Act data, these courthouses together account for over one-third of all mortgages originated and reported in North Carolina. These counties were selected for this reason and because all made their records freely available in electronic form.

Tables 1 and 2 report the proportion of loans in the analysis sample that carried indications of (1) ARM status and (2) interest-only or negative amortization features, respectively. Specifically, Table 1 shows that 9% of all mortgages in the analysis sample were subprime ARMs, however, see discussion of Wake county below. (Tables 1 and 2 also report a 95% confidence interval for each proportion). To understand the import of this confidence interval it is helpful to observe the following: if we were to draw 100 additional samples using the same procedures followed here, we would expect that 95 of the samples would have measurements within the reported confidence interval. For example, Table 1 informs us that we should expect 95 of an additional 100 samples to be composed of between 11.9% and 20.2% prime ARMs.

Table 2 shows that a relatively modest proportion of land records revealed interest-only or negative amortization features. Since it has not been established that all deeds of trust securing loans with such features will identify those features, these figures should be treated as a floor rather than a ceiling on the proportion of loans with such features.

Table 1: Indications of ARM status in Select N.C. Land Records

	Percentage of Sample
No Indication	75.0 (70.1, 79.9)
Subprime ARM	9.0 (5.7, 12.1)
Prime ARM	16.0 (11.9, 20.2)

Note: n=293, N=17,927; 95% confidence intervals shown parenthetically

Table 2: Indications of Interest-Only and Negative Amortization in Select N.C. Land Records

	Percentage of Sample
Subprime ARM with Interest-Only	0.6 (0, 1.5)
Prime ARM with Interest-Only	7.7 (4.7, 10.7)
Subprime ARM with Negative Amortization	0.6 (0, 1.5)
Prime ARM with Negative Amortization	1.3 (0, 2.6)

Note: n=293, N=17,927; 95% confidence intervals shown parenthetically

Interestingly, as shown in Tables 3a-3d, the proportion of subprime ARM loans in Wake County is distinctly different from the other three. While Durham, Guilford, and Mecklenburg County records show the proportion of subprime ARMs at 25%, 19%, and 25%, respectively, Wake county records have a corresponding proportion of 5.1%. This

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prime and subprime categories on the basis of their interest rate. Loans with introductory and fully-indexed rates below 9% were deemed prime, while all other loans with rate information reported were deemed subprime.

may indicate that Wake County is less representative of lending patterns in North Carolina than the other three counties.

Table 3a: Indications of ARM status in Durham County, NC Land Records

	Percentage of Sample
No Indications	75.0 (70.1, 79.9)
Subprime ARM	25.0 (6.2, 43.8)
Prime ARM	0 (Not Available)

Note: n=20, N=1,337; 95% confidence intervals shown parenthetically

Table 3b: Indications of ARM status in Guilford County, NC Land Records

	Percentage of Sample
No Indications	75.0 (70.1, 79.9)
Subprime ARM	18.8 (5.7, 12.1)
Prime ARM	6.3 (0.0, 14.5)

Note: n=33, N=2,825; 95% confidence intervals shown parenthetically

Table 3c: Indications of ARM status Mecklenburg County, NC Land Records

	Percentage of Sample
No Indications	66.7 (58.2, 75.2)
Subprime ARM	24.6 (16.8, 32.4)
Prime ARM	8.7 (3.6, 13.8)

Note: n=115, N=7,194; 95% confidence intervals shown parenthetically

Table 3d: Indications of ARM status in Wake County, NC Land Records

	Percentage of Sample
No Indications	84.7 (70.1, 79.9)
Subprime ARM	5.1 (5.7, 12.1)
Prime ARM	10.2 (11.9, 20.2)

Note: n=126, N=6,531; 95% confidence intervals shown parenthetically

In addition to the proportion of ARM loans and loans with interest-only or negative amortization features, it is also relevant and useful to understand the schedule of payments as of origination. This is especially true for hybrid ARM loans, loans with a fixed introductory interest rate period followed by an extended loan term with adjustable interest rates. In these cases, borrowers are at risk of experiencing payment shocks as their interest rate adjusts from a low introductory rate to a higher fully-indexed rate. Deeds of trust securing ARM loans commonly report the initial interest rate, a formula describing the fully-indexed rate and other measurements needed to understand the payment schedule as it stood at origination. To understand the payment shocks borrowers might experience, we calculate payment shocks as the percentage change in payment from initial monthly payment to fully indexed payment. Further, we calculate this change assuming that interest rates remain constant.

Tables 4 shows that subprime hybrid ARMs without interest-only or negative amortization features carried a trimmed mean payment shock of 29% and a median payment shock of 30%. This reflects an enormous payment increase. In contrast, Table 5 shows that the trimmed mean payment shock for corresponding prime hybrid ARM loans is 13% and the median is 12%. In fact, even the payment shocks on prime hybrid ARM loans with interest only or negative amortization features pale compared to those on subprime hybrid ARMs with a trimmed mean and median payment shock of 23%.

Moreover, subprime hybrid ARMs carry three traits that exacerbate the payment shock: First, subprime hybrid ARMs commonly have the initial interest rate serve as the floor below which interest rates can never fall, while prime hybrid ARMs allow the mortgage to float up or down at the first adjustment.[25] Second, the time in which the borrower has to prepare for the payment shock (that is, the duration of the initial teaser rate) is far shorter on supbrime hybrid ARMs – 2.5 years on average (2.5 year median value) as compared with 5.5 years on average (5.0 year median value) for a prime hybrid ARM. Third, subprime hybrid ARMs are subject to additional upward adjustments more frequently than are prime hybrid ARMS – typically every six months for subprime as compared with every year for prime.[26]

Figure 1 shows the proportion of subprime hybrid ARMs and prime hybrid ARMs that have their first adjustment and subsequent adjustments scheduled at various time intervals. For example, the largest circle shows that 62% of subprime hybrid ARMs had an initial fixed interest rate period of 24 months and then were scheduled to adjust subsequently every 6 months. In contrast, most prime hybrid ARMs take longer to reach first adjustment and then tend to adjust annually. For example, the most common schedule for prime ARMs included a five-year fixed-interest period followed by annual adjustments. Interestingly, on this chart, the 7-year subprime hybrid ARMs were originated by one lender—Banco Popular. The figure is based on data from the 22 prime hybrid ARMs and 13 subprime hybrid ARMs shown in Tables 4 and 5.

[25] Only 8 of the 13 subprime hybrid ARMs reported in Table 4 provided lifetime rate floor information. Of these 8, 7 had a lifetime floor equal to the initial interest rate. None of the 22 prime hybrid ARMs in Table 5 reported a lifetime floor equal to or greater than the initial rate.

[26] 11 of 13 hybrid subprime ARMs secured by deeds of trust that provided this information adjusted every six months, while 18 of 22 prime hybrid ARMs that provided this information adjusted annually or less frequently. Notably, the only two subprime hybrid ARMs not to adjust every 6 months had an initial interest rate higher than its corresponding fully-indexed rate.

Table 4: Higher, Quicker, Sooner—Payment Shocks on Subprime ARMs

Lender	Loan Amount	Term (Mos)	Initial Rate (%)	Initial Principal & Interest Payment	Fully Indexed Rate (%)	Fully-Indexed Principal & Interest Payment	Scheduled Payment Shock	Years to Scheduled Fully-Indexed Payment	Interest Only or Negative Amortiz-ation Feature
Popular Financial Services, LLC	$ 100,100	480	8.070	$ 701	11.875	$ 995	41.9%	2.5	None
WMC Mortgage Corp.	$ 243,000	360	8.470	$ 1,863	12.375	$ 2,600	39.5%	2.5	IO
WMC Mortgage, Inc.	$ 125,100	360	8.145	$ 931	12.125	$ 1,282	37.8%	3.5	None
New Century Mortgage Company	$ 106,400	360	8.050	$ 784	11.375	$ 1,036	32.1%	2.5	None
Citigroup/Consumer Finance, Inc.	$ 120,000	360	8.950	$ 961	12.375	$ 1,262	31.3%	2.5	None
Wells Fargo Bank, NA	$ 320,293	360	8.625	$ 2,491	11.875	$ 3,246	30.3%	2.5	None
First Franklin/National City Bank	$ 118,750	360	8.500	$ 913	11.750	$ 1,187	30.0%	3.5	None
Home Loan Center, Inc. dba Lending Tree	$ 125,200	360	8.000	$ 919	10.750	$ 1,155	25.8%	3.0	None
Wells Fargo Bank, NA	$ 99,920	360	7.125	$ 673	9.625	$ 842	25.1%	2.0	None
Suntrust Mortgage, Inc.	$ 259,350	360	8.500	$ 1,994	11.000	$ 2,454	23.1%	2.0	None
Fieldstone Mortgage Company	$ 123,000	480	9.800	$ 1,025	10.875	$ 1,128	10.0%	2.0	None
Banco Popular North America	$ 84,000	360	9.750	$ 722	8.000	$ 668	-7.4%	7.0	None
Banco Popular North America	$ 102,600	360	10.500	$ 939	8.000	$ 774	-17.5%	7.0	None
Median	$ 120,000	360	8.500	$ 931	11.375	$ 1,155	30.0%	2.5	NA
Trimmed Mean	$ 120,583	360	8.490	$ 929	11.375	$ 1,157	28.7%	2.5	NA
Median Excluding IO/Neg. Am.	$ 119,375	360	8.500	$ 925	11.188	$ 1,142	27.9%	2.5	NA
Trimmed Mean Excluding IO/Neg. Am.	$ 117,038	360	8.443	$ 925	11.250	$ 1,127	27.8%	2.3	NA

Notes: (1) Trimmed mean averages use the middle 80% of measurements to provide a mean value that excludes potential outliers.

(2) Wilcoxon-Mann-Whitney Non-parametric Test results show that the median measurements for initial rate, fully-indexed rate, scheduled payment shock, and years to scheduled fully-indexed payment for subprime hybrid ARMs without indications of interest-only or negative amortization features are significantly different ($P<0.05$) from those reported in Table 5 for prime hybrid ARMs that lack indications of interest-only or negative amortization features.

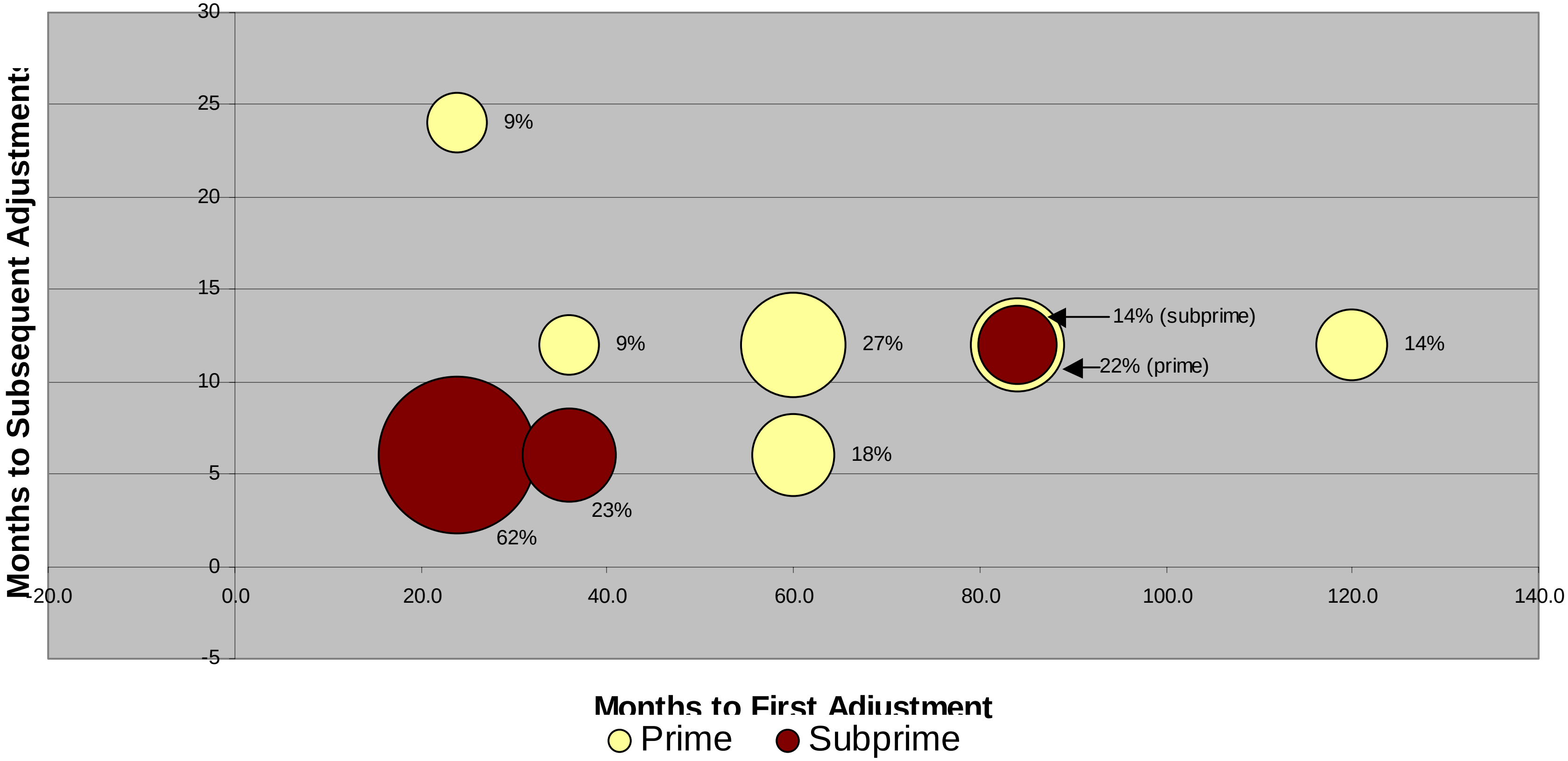
Table 5: Lower, Slower, Later—Payment Shocks on Prime ARMs

Lender	Loan Amount	Term (Mos)	Initial Rate (%)	Initial Principal & Interest Payment	Fully Indexed Rate (%)	Fully-Indexed Principal & Interest Payment	Scheduled Payment Shock	Years to Scheduled Fully-Indexed Payment	Interest Only or Negative Amortiz-ation Feature
Abn Amro Mortgage Group, Inc.	$ 209,200	360	5.250	$ 1,155	7.580	$ 1,563	35.3%	5	IO
Mortgage Servicing, Inc.	$ 234,850	360	5.375	$ 1,315	7.580	$ 1,755	33.4%	5	IO
Wells Fargo Bank, NA	$ 309,384	360	6.250	$ 1,905	7.760	$ 2,540	33.3%	10	IO
Homebanc Mortgage Corporation	$ 236,000	360	5.750	$ 1,377	7.580	$ 1,816	31.8%	7	IO
Cartus Home Loans f/k/a Cendant Mortgage	$ 215,600	360	5.250	$ 1,191	7.580	$ 1,484	24.7%	5	None
Wells Fargo Bank, NA	$ 130,800	360	6.125	$ 795	7.760	$ 988	24.3%	5	IO
Homebanc Mortgage Corporation	$ 216,000	360	6.500	$ 1,365	7.580	$ 1,662	21.7%	7	IO
American Brokers Conduit	$ 135,450	360	6.250	$ 834	7.630	$ 1,012	21.3%	5	IO
Bank of America, NA	$ 168,000	360	5.500	$ 954	7.580	$ 1,148	20.3%	7	None
State Employees Credit Union	$ 228,000	360	6.250	$ 1,404	8.010	$ 1,661	18.3%	2	None
State Employees Credit Union	$ 172,000	360	6.250	$ 1,059	8.010	$ 1,253	18.3%	2	None
Countrywide Home Loans, Inc	$ 288,610	360	5.875	$ 1,707	7.580	$ 2,003	17.3%	5	None
Ohio Savings Bank	$ 128,000	360	6.375	$ 799	7.580	$ 933	16.9%	3	IO
1st Charter Bank	$ 210,000	360	6.500	$ 1,327	7.580	$ 1,531	15.3%	3	IO
First Horizon Home Loan Corp	$ 560,000	360	6.375	$ 3,494	7.760	$ 3,928	12.4%	7	None
Suntrust Mortgage, Inc.	$ 112,000	360	6.375	$ 699	7.580	$ 777	11.3%	7	None
Wachovia Bank, NA	$ 275,200	360	6.375	$ 1,717	7.580	$ 1,891	10.2%	10	None
Universal American Mortgage Company LLC	$ 231,950	360	6.625	$ 1,485	7.580	$ 1,625	9.4%	5	None
Bank of America, NA	$ 110,816	360	6.750	$ 719	7.580	$ 769	7.0%	10	None
Lehman Brothers Bank	$ 185,000	360	7.500	$ 1,294	7.630	$ 1,308	1.1%	5	None
Lehman Brothers Nank, FSB	$ 96,000	360	8.025	$ 706	8.130	$ 712	0.9%	5	None
The Mortgage Store Financial, Inc.	$ 168,000	360	8.125	$ 1,247	7.630	$ 1,195	-4.2%	5	Both
Median	$ 209,600	360	6.313	$ 1,270	7.580	$ 1,508	17.8%	5.0	NA

Trimmed Mean	$ 201,300	360	6.313	$	1,255	7.588	$ 1,461	17.8%	5.0	NA
Median Excluding IO/Neg. Am.	$ 200,300	360	6.375	$	1,242	7.580	$ 1,396	11.8%	5.0	NA
Trimmed Mean Excluding IO/Neg. Am.	$ 200,150	360	6.344	$	1,237	7.593	$ 1,418	12.8%	5.5	NA
Median IO/Neg. Am. Only	$ 209,600	360	6.250	$	1,281	7.580	$ 1,547	23.0%	5.0	NA
Trimmed Mean IO/Neg. Am. Only	$ 209,600	360	6.250	$	1,281	7.580	$ 1,547	23.0%	5.0	NA

Notes: Trimmed means use the middle 80% of measurements to provide a mean value that excludes potential outliers.
Payment shock calculations for the single loan with negative amortization features neglect the potential increase that could result from full exploitation of the negative amortization limit since our purpose here was to present only scheduled payment shocks.

Subprime Hybrid ARMs Adjust More Quickly and More Often



4. Is the guidance's definition of non-traditional mortgage loans appropriate? Are there other similar loan products that pose similar risks that should be included in this guidance?

The dominant product in the subprime market is the 2/28 hybrid ARM, which effectively operates as a two-year balloon. Sometimes referred to as "exploding ARMs" due to the significant increase in the monthly payment after an introductory period with an artificially low payment, hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector."[27] The recent growth of exploding ARMs is remarkable. In 2004 2/28s and 3/27s constituted an astonishing 72% of all subprime originations.[28] Through the second quarter of 2006, 80.7% of subprime loans were adjustable rate loans, predominantly 2/28s.[29] 2/28s include an initial short-term fixed rate for two years, followed by rate adjustments, generally in six-month increments for the remainder of the term of the loan.[30] 3/27s work the same way, except that the first rate adjustment comes at the end of the third year.

While interest-only loans are clearly of concern, representing one in four subprime loans nationwide,[31] the even more common 2/28 subprime mortgages themselves pose a significant risk to families and the industry as a whole. The low start rate virtually assures the payment will rise significantly when the rate resets, even if interest rates remain constant and do not rise at all. Of course, if interest rates rise, the payment shock will rise as well. See answer to question 3 above for details about the severity of payment shock.

Lenders and brokers who push 2/28s and 3/27s often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate and monthly payment will rise significantly. For example, as recently as 2005, a prospectus shows that a large subprime lender, Option One, was underwriting to *the lesser of* the fully indexed rate or one percentage point over the start rate.[32] For a loan with a typical 2/28 structure, the latter would always apply. This practice means that at the end of the introductory teaser rate on an ARM, borrowers face a shocking increase in monthly payment even if interest rates remain constant. Similarly,

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[27] Mike Hudson and E. Scott Reckard, More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans, L.A. Times, p. A-1 (October 24, 2005).
[28] Cause for Alarm?, A comprehensive tool for Understanding the recent development of the Adjustable Rate Mortgage and determining the implications on credit risk of its growing popularity, Figure 9 on p9lehman Brothers Global Equity Research, June 15, 2005

[29] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, see INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.
[30] See, e.g. *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 2.
[31] *Id.*
[32] See Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

as summarized in a November 2006 release, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. Other borrowers have their ability to repay screened at the initial interest rate. As the following chart demonstrates, Option One and other large subprime lenders are qualifying borrowers using underwriting standards that do not adequately address the built-in payment shock of these loans.

North Carolina
Top Rate-Spread Mortgage Lenders
Underwriting Rules For Adjustable Rate Mortgages[33]

LENDER	UNDERWRITING RULE
OPTION ONE MORTGAGE CORP	Qualified at initial monthly payment
FREMONT INVESTMENT & LOAN	Ability to repay based on initial payments due in the year of origination.
NEW CENTURY	Generally qualified at initial interest rate. Loans to borrowers with FICO scores under 580 and loan-to-value ratios of more than 80% are qualified at fully indexed rate minus 100 basis points

To illustrate the unfortunate realities of inappropriate and unaffordable 2/28 adjustable rate mortgages (ARMs), the North Carolina Justice Center informally contacted a few practicing attorneys in North Carolina to provide examples from their cases. In very little time (less than 48 hours), they received a number of responses, including these described below. The following brief synopses of actual cases—certainly a very small sample of the destruction caused by 2/28s on subprime loans in North Carolina—illustrate how these loans undermine the benefits of homeownership:

1. **<u>From affordable loan to escalating ARM .</u>**
   Through a local affordable housing program, a homeowner had a 7% fixed-rate, 30-year mortgage. A mortgage broker told the homeowner he could get a new loan at a rate "a lot" lower. Broker originated a 2/28 ARM with a starting rate of 6.75%, but told borrower that it was a fixed-rate, 30-year mortgage. At the 24th

[33] These 3 lenders are prominent national lenders and make up 9.5% of the NC subprime market, a market where no single lender has more than a 6% market share. *See* Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) available at: http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm; Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm ; Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007) available at: http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm; *Best Practices Won't Kill Production at New Century*, p. 3 Inside B&C Lending (November 24, 2006)

month, the loan went up to 9.75%, following the loan's formula of LIBOR plus 5.125% and a first-change cap maximum of 9.75%. Loan can go up to a maximum of one point every six months, with a 12.75% total cap. Now borrower cannot afford the loan and faces foreclosure.

2. **Temporary lower payments—a prelude to shock.**
   Homeowner refinanced out of a fixed-rate mortgage because she wanted a lower monthly payment. The homeowner expressly requested lower monthly payments that included escrow for insurance and taxes. Mortgage broker assured her that he would abide by her wishes. Borrower ended up in a $72,000 2/28 ARM loan with first two years monthly payments of $560.00 at a rate of 8.625%. This initial payment was lower than her fixed-rate mortgage, but it did not include escrowed insurance and taxes. After two years, loan payments increased every six months at a maximum one percent with a cap of 14.625%. At the time of foreclosure, the interest rate had climbed to 13.375% with a monthly payment $808.75. If the loan had reached its maximum interest rate, the estimated monthly payment would be close to $900.00.

3. **Unaffordable from the start.**
   Homeowner had a monthly payment of $625 and sought help from a mortgage broker to lower monthly payment. Broker initially said he could lower the payment, but before closing said the best he could do was roughly $800. He assured borrower that he could refinance her to a loan with a better payment in six months. Previously he had advised homeowner not to pay her current mortgage payment because the new loan would close before the next payment due date. In fact, closing occurred after the payment was due, and borrower felt she had to close. Loan was a 2/28 ARM with an initial interest rate of 11% and a ceiling of 18% at an initial monthly payment of $921. Interest at first change date is calculated at LIBOR plus 7%, with a 12.5% cap and a 1.5% allowable increase/decrease at each 6-month change date. First change date is June 1, 2008. By approximately the third payment, however, borrower could not afford mortgage payments and is now in default.

Conclusion and Recommendations

Many have portrayed nontraditional and 2/28 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 ill-conceived notion of affordability is dangerously short-sighted if borrowers cannot sustain payment after adjustment, and results in loans that leave borrowers worse off financially than they would be had they never owned a home. This stands on its head the traditional American experience of home ownership as a path to greater long-term financial security. Regulators must make it clear that abusive and destructive lending practices such as these will not be tolerated.

CRL applauds NCCOB for its proposed guidance, and makes the following recommendations:

- Make the guidance applicable to subprime hybrid 2/28 and 3/27ARMs as well as other, non-traditional mortgage products.
- Include in the guidance the requirement that lenders escrow for property taxes and insurance, and include these payments in the calculation of the borrower's ability to repay the loan.
- Put mortgage lenders and brokers on notice that failure to follow the guidance will be deemed a violation of the Mortgage Lending Act (NCGS 53-243.11 and, as applicable, NCGS 53-243.10), and will result in disciplinary action under the Act (NCGS 53-243.12) and other enforcement measures by NCCOB.

Sincerely,

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Center for Responsible Lending

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