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February 20, 2001

Chairman Donna Tanoue
c/o Robert E. Feldman
Executive Secretary
Attention: Comments/OES
The Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: FDIC Guidance Regarding Predatory Mortgage Loans

Dear Chairman Tanoue:

The Bond Market Association (the "Association")[1] is responding on behalf of its members to the Federal Deposit Insurance Corporation (the "FDIC") "Draft FDIC Staff Memorandum: How to Avoid Purchasing or Investing in Predatory Mortgage Loans" (the "Proposals") encouraging banks regulated by the FDIC to adopt certain steps aimed at curbing the purchase or funding by banks of predatory loans as well as investment by banks in securities backed by such loans. Given our members' prominent role in the secondary mortgage market, our objective is to provide the FDIC with a collective industry response to the Proposals.

The Association fully agrees with the FDIC that abusive and predatory lending practices have a detrimental effect on individuals and communities, and the Association supports thoughtful and effective initiatives to curb such practices. As discussed in further detail below, however, the Association believes that in several respects, the Proposals would impose subjective and unreasonable responsibilities on secondary market participants. Such measures would have a detrimental effect on legitimate subprime secondary market activity in which banks are broadly engaged, and would reduce the amount of legitimate and valuable credit available to subprime borrowers. The Association believes that further analysis and dialogue is necessary to develop feasible and practical approaches that will enable secondary market participants to assist in addressing these problems. We would look forward to working with the FDIC to craft such measures.

I. Executive Summary

The Association strongly agrees with the FDIC's objective of curbing improper lending practices. The Association also shares the FDIC's view that subprime lending programs "provide an important source of credit for borrowers whose credit history may not permit them to qualify for the conventional prime loan market." The subprime lending market makes much-needed financing available to millions of Americans who otherwise would be unable to obtain credit for purchasing homes, refinancing mortgage debt, consolidating credit card and other consumer debt and achieving other important and

socially desirable purposes. A robust secondary market for subprime loans is essential to ensure the necessary liquidity to reduce the cost and increase the availability of subprime loans. We appreciate the FDIC's concern that policies intended to curb predatory and abusive lending practices not do so at the expense of providing legitimate and necessary financing to traditionally underserved borrowers.

Without purporting to address all aspects of the Proposals, the Association addresses the following issues in this letter:

- There is no objective, accepted and standard definition of "predatory lending." The Proposals would require that financial institutions craft and apply their own individual definitions and make subjective determinations.
- The Proposals do not distinguish among the various capacities in which banks may act, each of which may suggest different types of appropriate due diligence or other review.
- The Proposals risk significantly increasing financial institutions' legal exposure, without the corresponding ability to manage and control it.
- Compliance with certain of the steps outlined in the Proposals would significantly increase the cost of doing business, thereby reducing the availability of legitimate credit to subprime borrowers.

II. There is no objective, accepted and standard definition of "predatory lending." The Proposals would require that financial institutions craft and apply their own individual definitions and make subjective determinations.

A. Regulatory agencies have not defined predatory lending and many of the practices characterized as evidencing predatory lending are permissible under federal law

At the outset, the Proposal states categorically that "[p]redatory loan characteristics and practices are well known." It then lists the following loan characteristics as examples (emphasis added):

- misleading or fraudulent marketing;
- loan fees and interest rates higher than necessary to cover profit and risk;
- excessively priced products, such as single premium credit life insurance;
- large prepayment penalties that make it difficult to refinance affordably;
- balloon payments likely to result in default;
- abusive collection and aggressive foreclosure practices; and
- mandatory arbitration provisions.

Although broadly discussed and generally described, predatory loan characteristics are not well defined. As noted by the Senate Committee on Banking, Housing and Urban Affairs, a study of key federal regulatory agencies found that none had developed a definition of predatory lending,[2] and state law and regulatory definitions vary widely. There has been much debate over the last several years on the relative merits and hardships of mortgage features including prepayment penalties, mandatory arbitration

clauses, balloon loans, refinancing terms and fees, and the financing of closing costs, among other items. Reasonable people repeatedly disagree on where the line should be drawn with respect to numerous variations of such features.

Against this backdrop, the Association does not believe the Proposals have set forth a definition of "predatory lending" which is reasonably capable of common and consistent application. There is no doubt that certain practices such as misleading or fraudulent marketing practices are improper; however, such practices are illegal whether or not they are characterized as "predatory." Other practices that the Proposal condemns as "predatory" not only are legal but have, in fact, been facilitated by federal law. For example:

- Federal law has preempted many state limits on interest rates and loan fees based on a recognition that (i) price controls can actually limit the supply of credit and, (ii) that in our economic system, it is the role of the market - not the government - to determine what prices are "necessary."
- Federal law has preempted certain limits on prepayment penalties based on a recognition that such penalties - which are fully disclosed and elected by borrowers - can facilitate consumer choice, add predictability to prepayment rates and therefore result in lower costs to consumers.[3]
- Federal law has preempted state limits on arbitration clauses based on a recognition that alternative dispute resolution provides a variety of benefits, and such preemption recently has been upheld by the U.S. Supreme Court.

B. The definition of predatory lending set forth in the Proposals is vague and subjective

Leaving aside the conflict with existing law and policy, the Proposals' definition of "predatory characteristics" is vague and subjective. Throughout, the Proposals would require that banks make highly subjective determinations. Banks are asked to decide whether marketing practices are misleading, loan fees and interest rates are higher than necessary, and prepayment penalties are so large that it would be difficult to refinance affordably. In purchasing loans, banks are encouraged to ask themselves whether "the [originator's] underwriting policies permit practices that raise "predatory lending red flags," but given the guidance provided by the Proposals, banks could do little more than draw subjective and arbitrary conclusions in determining whether such "red flags" exist. The Proposals themselves point out that "no individual characteristics clearly identify predatory loans." Particularly where particular practices are legal, it is hardly appropriate to ask banks to determine, based on subjective and vague criteria, whether such practices evidence predatory lending.

Moreover, the entities asked to make these subjective determinations often are not in a position to make them. Banks are often asked to substitute their judgment for that of originators - the parties which are closest to, and therefore better equipped to make such compliance determinations. For example, the Proposals recommend that in reviewing an originator's underwriting procedures, a bank "[e]nsure the collateral was appraised fairly and accurately." However, particularly when acting other than as an originator, a bank is

not equipped to determine the fairness or accuracy of an appraisal, particularly where it is being asked to draw that conclusion from a perspective other than its own. Similarly, underwriters would be asked to make such subjective determinations in connection with securities offerings. For example, the Proposals recommend that banks acting in an investor capacity ask underwriters "whether a review of [prepayment penalties evidenced in a loan pool] raised questions." An underwriter would first have to determine what constitutes a "question." An underwriter can only conduct due diligence from its own perspective, based on securities' legal and regulatory mandates and in light of its own business purpose. Therefore, what may constitute an issue or a question from a particular investor's perspective may not constitute an issue from an underwriter's perspective. Observing this recommendation would require that an underwriter place itself in the shoes of an investor-bank, and conduct investment-oriented due diligence accordingly.

As another example, based on the assumption that "the total amount of credit enhancement required by credit rating agencies is an indication of the risk associated with the underlying loans," the Proposals also recommend that banks ask underwriters to "compare the total credit enhancement required for the securitization to the amount of credit enhancement required in other sub-prime or similar securitizations. If disparities exist, ask the underwriter whether there is any likelihood the loans exhibit predatory characteristics." This recommendation raises several issues. First, the total level of credit enhancement is not necessarily an indication of the risk associated with the underlying loans. It is less a reflection of whether the borrowers will pay or have the ability to pay the underlying mortgage loans, and instead is more a reflection of the particular credit structure chosen by an issuer and underwriter to market various tranches of securities to investors. Second, no guidance is provided regarding what would constitute a "similar" securitization. Third, with respect to being asked whether "there is any likelihood the loans exhibit predatory characteristics," the underwriter is essentially being asked to make a representation regarding the presence of predatory loans. The underwriter would have no basis for doing so, given that underwriters do not test whether loans were originated in compliance with applicable laws.

Moreover, the graduated, multi-step approach to conducting the inquiries outlined in the Proposals is not practical, as it too would require financial institutions to make highly subjective determinations at each step of the process. For example, if the inquiries made during Part-Two, Step-One (with respect to which banks would make inquiries about loan originators), raise concerns which "by [themselves do not] necessarily indicate predatory practices but may raise questions that warrant a closer view," banks are encouraged to conduct the underwriting and compliance program reviews recommended in Step-Two. For the reasons already stated, such parties are not positioned to determine what precisely would constitute a question that warrants further examination.

Accordingly, contrary to the assertions in the Proposals, it is not at all clear what practices are properly viewed as predatory, and the criteria provided by the Proposals are unduly subjective. The uncertainty thus created will only restrict the availability of credit to subprime borrowers and, as detailed below, will improperly expose lenders and others to liability.

III. The Proposals do not distinguish among the various capacities in which banks may act, each of which may suggest different types of appropriate due diligence or other review

In addition to focusing on "loan purchases and investments in securities," the Proposals state that "the underlying principles also apply to other ways banks may be involved in the mortgage market." In describing some of the ways in which banks can inadvertently become "associated with predatory lending," the Proposals list the purchase of loans through loan brokers, having lending subsidiaries, forming joint ventures with other lenders, providing warehouse lines of credit, performing loan servicing, or acting as trustees in securitizations. The Proposals consequently purport to apply to banks broadly and equally in all of these capacities. However, they do not adequately recognize that these functions encompass broadly different business purposes, resulting in different needs for, and access to, information concerning underlying mortgage loans to which those activities relate.[4]

Underwriters, servicers (particularly where the servicer has not also acted as the originator of the applicable loans) and trustees, all conduct different levels of underlying collateral review because of their broadly different duties, obligations and business purposes.

A. Underwriters

As applied to underwriters, the Proposals do not reflect the purpose for which underwriter due diligence is conducted. For example, the Proposals explain that they are in part designed to address "compliance concerns for financial institutions" and other risks which are presented by predatory loans. The Association believes it is inappropriate to seek to employ underwriter due diligence to minimize the risks to an originator which may result from predatory lending. The Association would nonetheless welcome the opportunity to identify other ways in which these concerns may be addressed.

The basic purpose of underwriter due diligence in the context of a securities offering is to enable an underwriter generally to familiarize itself with the business and activities of an issuer, to identify issues or problems with the issuer that may materially affect either the performance of the securities or the validity of the securities offering and, ultimately, to provide the underwriter with a reasonable basis for concluding that a registration statement or offering document is complete and accurate in all material respects. Such due diligence is performed with a view toward ensuring full and fair disclosure to the investors in the securities being offered, promoting efficiency and transparency of the markets in which the securities will be traded, preserving the underwriter's business reputation and customer relationships and shielding it from potential securities law liability. Finally, securities laws do not require that underwriter due diligence be conducted for purposes of providing customer protection or to police the activities of loan originators.

More specifically, virtually all underwriters already have developed and follow their own policies and procedures for conducting due diligence in connection with subprime and other securitization transactions. Due diligence practices encompass an evaluation of both the originators of loans as well as the characteristics of the assets that support payment on the related securities. This is not to say, however, that a common recognition of the need for due diligence equates to an industry-wide standard for conducting a due diligence investigation.

Many variables influence the nature and the scope of the due diligence that an underwriter will perform. One key factor is the type of credit enhancement that will support the securities, such as an insurance policy by an AAA rated bond insurer or over-collateralization through a senior/subordinate structure. Another essential element is the credit rating of the securities. In either case, the focus is on the stability of whether the securities will pay in accordance with their prescribed terms. Other relevant factors may include the nature and timing of the transaction; the nature and characteristics of the issuer and the assets included in the securitization; the degree of familiarity and previous experience the underwriter has with the particular asset type, and with the originator(s), servicer(s) and other participants involved in a particular transaction; the role of the underwriter as the sole or lead manager of the underwriting syndicate or as the co-manager; and a host of other situation-specific factors.

Within this context, therefore, underwriters are not positioned to access the type of information regarding borrowers, brokers and originators required by the Proposals. It would be difficult, if not impossible, for underwriters to discern whether loan pools present predatory lending issues. For example, underwriters are not positioned to, nor is underwriter due diligence designed to, facilitate a determination of the business purpose for which loans are originated. However, the Proposals encourage banks to determine "loan purpose[s]" by "asking the underwriter to explain" in the event that "there is a high percentage of refinanced loans" in a loan pool to determine whether such refinancings evidence predatory loan flipping. By requiring an underwriter to explain whether, or the extent to which, such refinancings are predatory in nature, the underwriter is being placed in the position of discerning the intent of one or more parties to which it is not related. The brokers and originators of such loans are best positioned to explain the business purpose behind multiple refinancings.

As another example, the Proposals recommend that banks turn to underwriters to "assess the extent to which the originator relies on mortgage brokers." Underwriters cannot reasonably make such an assessment. First, originators, not underwriters, have a direct relationship with mortgage brokers. Further, in many cases, underwriters will not even have direct access to or even a direct relationship with the originators of the underlying mortgages, particularly where the assets have been purchased as part of a pool of mortgages in the secondary trading markets. A pool of mortgage loans involving a single issuer, for example, may involve many third party originators with whom the underwriters have absolutely no relationship. Not only would assessing the originators' reliance on brokers fall outside of the underwriters' business purpose, but making such an assessment could not be undertaken in a commercially reasonable manner.

B. Trustees and Servicers

Banks would face similar challenges in applying the Proposals when acting in some of their other capacities. For example, a servicer's role is to collect monthly loan payments, manage escrow accounts, and monitor and address delinquencies. Servicers manage payments on the underlying loans. They are neither legally nor contractually obligated to review the collateral underlying the loan. Nor are they engaged to re-underwrite the underlying loans. Such activities would fall outside of the scope of a servicer's business purpose. Trustees in securitizations are passive entities that are engaged to hold the underlying collateral for the benefit of the applicable certificate holders and to perform a variety of administrative duties on behalf of the trust. A trustee's obligations and responsibilities are set forth contractually in the applicable pooling and servicing agreement, and it is granted little, if any, discretion in its duties.

The Proposals recommend that banks conduct loan level reviews for "refinanced loans and loans with excessively high interest rates, points, and fees." Not only would this type of inquiry fall outside of trustees' and servicers' scope of responsibilities and business purposes, but it would be unreasonable to require banks acting in these capacities to make the subjective determination of what might constitute "excessively high interest rates." Further, it would be commercially unreasonable for financial institutions acting as servicers or trustees to, as part of those services, be asked to begin conducting loan level file reviews.

The Proposals also recommend that banks familiarize themselves with loan originators by investigating their marketing tactics, their use of brokers and complaints and lawsuits filed against them. This is another example of how a bank's ability to observe the Proposals would be affected based on its particular business function. Neither a trustee nor a servicer would have cause, as a business matter, to investigate each originator's marketing tactics or use of brokers. Also, loan pools can contain loans originated by scores of originators, making it practically impossible for a servicer or trustee to investigate these parties. Finally, the loans would have been originated several steps before even reaching the servicer and trustee.

IV. The Proposals risk significantly increasing financial institutions' legal exposure, without the corresponding ability to manage and control it

The Association appreciates that the Proposals are intended to provide helpful guidance by the FDIC; however, the Association is concerned that the Proposals may be cited as evidencing legally required standards of conduct. Thus, rather than minimizing legal exposure to banks as intended, such exposure might instead be elevated, particularly in circumstances where the Proposals are not capable of being strictly or comprehensively observed. As described above, the Proposals require that banks make highly subjective determinations at every step and in all cases, regardless of their role and whether they are positioned to or legally or contractually required to make the inquiries on which they would base such determinations. Also, particularly given the proliferation of similar local, state and federal recommended practices aimed at the secondary markets, the

Association is very concerned that conflicting standards will emerge, making it difficult for financial institutions to conduct business without inevitably violating one, if not multiple, sets of standards.

V. Compliance with the steps outlined in the Proposals would significantly increase the cost of doing business, thereby reducing the availability of legitimate credit to subprime borrowers

Even assuming banks were able to comply with the Proposals by providing the requested information and drawing the requested conclusions, the cost of providing such assurances and information would be substantial. Particularly where banks are not positioned - given their business purpose - to access or provide certain information, the level of inquiry that would be required before such financial institutions might obtain the comfort sufficient to make such determinations would far exceed the level of review currently conducted. For example, the level of investigation which servicers and trustees would have to undertake in order to conduct the originator and loan level reviews sufficient to make the determinations called for in the Proposals would be substantial.

These increased costs would necessarily be factored and priced into new securitization and loan purchase/servicing transactions. Loan originators seeking to recoup losses would inevitably charge borrowers higher fees and interest rates, and less credit would ultimately be available.

As a related matter, the Association is concerned that those institutions which agree to observe the Proposals would be placed at competitive disadvantage with respect to entities not regulated by the FDIC which would not be obligated to observe the Proposals, or incur the costs related thereto.

VI. Conclusion

The Association appreciates the opportunity to share its thoughts and concerns regarding the Proposals. As described above, the Association is concerned that the highly subjective determinations a financial institution would necessarily have to make if it were to observe the Proposals might expose the institution to serious legal liability. Also, because such determinations would be so subjective, and institution-specific, the Proposals would not have the intended effect of filtering predatory loans out of the secondary marketplace.

Notwithstanding our specific concerns, the Association believes there are ways in which our members can join efforts to curb predatory lending, provided that such efforts recognize the diverse functions our members play. Any such efforts should be designed to preserve the ability of firms to exercise their business judgment and not be so specific or inflexible as to adversely affect legitimate business activity. Also, any such guidance should be crafted recognizing the type of information to which financial institutions have access, in light of their business purpose.

Once again, the Association appreciates the opportunity to comment on the FDIC's Proposals. Should you have questions or wish to discuss any of the matters addressed herein in greater detail, please do not hesitate to contact the undersigned at 212.440.9400.

Sincerely,

/s/
George P. Miller
Senior Vice President,
Deputy General Counsel

/s/
Laura C. González
Assistant General Counsel

FOOTNOTES

1. The Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. Among other roles, the Association's members act as issuers, underwriters and dealers of mortgage and asset-backed securities, including the securitization of subprime mortgage loans. The views expressed in this letter are based upon input received from a broad range of Association members active in these markets, including members of the Mortgage and Asset-Backed Securities Division, and that Division's Subprime Lending Practices Task Force. More information about the Association, its members and activities may be obtained from the Association's website at www.bondmarkets.com .
2. Report of the Staff to Chairman Phil Gramm, Committee on Banking, Housing and Urban Affairs, "Predatory Lending Practices: Staff Analysis of Regulators' Responses," August 23, 2000.
3. Prepayment penalties are designed to make it difficult to refinance and there is nothing nefarious about this. Expectations about prepayment speeds heavily influence prices paid by investors for loans. Lower prepayment speeds can translate to lower prices for consumers and consumers are free, of course, to obtain loans without prepayment penalties.

   Also, on Wednesday, February 7, the United States Court of Appeals for the Fourth Circuit held in National Home Equity Mortgage Ass'n v. Face, No. 99-2331, 99-2386 2001 U.S. App. LEXIS 1735 (4th Cir. February 7, 2001) that a non-federally chartered housing creditor may charge prepayment fees despite any limitation imposed by the Virginia Code, provided the creditor is in compliance with federal law.

4. Further, the Association notes that there already exists a broad range of explicit federal regulatory guidance to address the risks to which banks may be exposed in connection with asset securitization activities, including that which relates specifically to subprime lending and securitization activities. See Federal Financial Institutions Examination Council, "Expanded Guidance for Subprime Lending Programs" (January 31, 2001); Board of Governors of the Federal Reserve System, "Risk Management and CapitalAdequacy of Exposures Arising from Secondary Market Credit Activities" (July 11, 1997); Federal Financial Institutions Examination Council, "Supervisory Statement on Investment Securities and End-User Derivatives Activities" (April 23, 1998); Federal Financial Institutions Examination Council, "Interagency Guidance on Asset Securitization Activities" (December 13, 1999); Comptroller of the Currency, "Asset Securitization: Comptroller's Handbook" (November 1997); and Board of Governors of the Federal Reserve System, "Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities" (July 11, 1997).