

published: 3.13.01

March 13, 2001

The Honorable Alan G. Hevesi
Comptroller of the City of New York
Office of the New York City Comptroller
1 Centre Street, Room 517
New York, NY 10007

The Honorable H. Carl McCall
Comptroller of the State of New York
Office of the New York State Comptroller
Alfred E. Smith State Office Building
6th Floor
Albany, NY 12236

Dear Comptroller Hevesi and Comptroller McCall:

The Bond Market Association (the "Association")¹ is responding on behalf of its members to the request of the New York City Comptroller's Office and the New York State Comptroller's Office (collectively, the "Comptrollers") to review and comment upon the draft Predatory Lending Standards for the Secondary Market (the "Standards") proposed by the Association of Community Organizations for Reform Now ("ACORN").

Our objective is to provide the Comptrollers with a collective industry response to the Standards on behalf of the fixed income securities underwriting community.² We understand that some Association member firms may prepare separate, individual responses. Given our members' prominent role as underwriters of subprime and other mortgage-backed and asset-backed securities, we are well equipped to comment on proposed Standards applicable to the issuance of those securities.

The Association strongly supports the Comptrollers' policy goal of eliminating abusive and predatory subprime lending practices. We appreciate both the importance of this issue and the sincerity of purpose underlying the Comptrollers' initiative and ACORN'S proposed Standards. However, for the reasons discussed in greater detail below, the Association does not believe that the adoption or endorsement by securities underwriters of the specific Standards recommended by ACORN would be a feasible, effective or appropriate policy response to predatory lending practices in the subprime mortgage origination markets. We encourage the Comptrollers to reconsider the applicability of this approach to the underwriting community. We again extend our offer to work more closely with the Comptrollers in smaller, targeted working groups in connection with this important public policy issue.

In proposing the Standards for comment, the Comptrollers requested input on whether some method other than the adoption of the Standards would be a better approach. The

Association believes that other approaches are, in fact, preferable. We would like to explore these with you, along with other state and federal governmental agencies, mortgage originators and their industry trade organizations, community groups, and other market participants and interested parties.³

I. INTRODUCTION AND EXECUTIVE SUMMARY

Subprime lending serves important needs for low- and moderate-income borrowers with blemished credit histories. Without the availability of subprime financing, millions of Americans 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 provides liquidity that helps to reduce the cost and increase the availability of subprime loans. Nevertheless, the Association recognizes that some borrowers may fall victim to abusive or predatory mortgage loan origination practices and not realize the benefits that the subprime market can offer.

All levels of government have struggled in the last year to address the problem of predatory lending. There have been "white papers" published by the U.S. Department of Housing and the U.S. Department of Treasury. There has been "guidance" published by the Federal Financial Institutions Examination Council. There have been proposed regulations by the federal banking agencies. Members of Congress have introduced bills. State legislatures and executive agencies have proposed new laws and regulations, and local governments have proposed new ordinances. In some cases, these proposals have been enacted.⁴ Nevertheless, nationwide there exists no commonly accepted definition of a predatory loan. The Association and its members have participated in these public and private debates and share policy makers' frustrations in trying to resolve this important problem.

At the outset, however, it must be emphasized that underwriters that purchase or securitize subprime loans generally are far removed from the mortgage origination process. Their focus principally is on the integrity of the mortgage-backed securities underwriting process, to ensure full and fair disclosure to investors in the securities being offered and to promote efficient markets in which the mortgage-backed securities will be traded. Underwriters neither set the loan terms of individual mortgage loans nor engage in, sponsor or promote the sales practices that are characterized as predatory.

Well over half of the residential mortgage loans originated in this country come from mortgage brokers, which in turn place loans in process with mortgage lenders. In turn, many mortgage lenders sell closed loans to loan purchasers in the secondary market, which in turn may sell the loans again or cause them to be securitized. Reports of predatory lending have focused on abusive, deceptive or fraudulent acts perpetrated by mortgage originators, and on inappropriate, unethical or possibly illegal actions of mortgage originators regarding the suitability of loans for particular borrowers. The Association believes that initiatives designed to minimize or eliminate predatory lending practices should focus principally on the underlying consumer credit transactions, and the

parties who are directly involved in, and thus capable of exerting control over, the terms and dynamics of those transactions. This is the point at which direct interaction occurs between mortgage originators and borrowers, and where legal, ethical and appropriate business standards relating to the loan origination process may be best observed and enforced. The harmful conduct that often is cited in the debate on predatory lending occurs at the loan origination stage.

The Association is concerned that the voluntary adoption by underwriters of loan eligibility criteria of the type proposed by ACORN could impose on underwriters significant legal risks of private lawsuits and require them to enforce subjective judgments of suitability about which reasonable people can and do disagree. We believe that underwriters of mortgage-backed securities should assume only those duties and responsibilities that are consistent with their role in the securities markets. Underwriters are ill suited to play the role of private government regulators.

Finally, the Association is concerned about the proliferation of multiple and potentially conflicting predatory lending "best practices" recommended for underwriters and other secondary market participants. Such efforts are likely to result in fragmented, disjointed and potentially conflicting proposed standards of conduct, rather than uniform and commonly recognized and observed criteria. This outcome would be counterproductive to assuring that everyone connected to the process contributes, as much as they can given their role in the broader marketplace, to the objective of eliminating predatory lending.

Although we believe that there are useful steps that underwriters can take to address predatory lending problems, many of which are presently undertaken and supported by our members, as outlined further in this letter, we believe there are several key prerequisites to any broader and more comprehensive policy response to this issue. These include:

- Leadership from and coordination among state and federal legislative bodies and regulatory agencies in proposing and considering whether establishing objective criteria by which "predatory loans" and "predatory lending" activities can be defined and proscribed is in the interest of the subprime market, including the interests of borrowers;
- Input from all affected constituencies (including mortgage borrowers, lenders and brokers, government-sponsored housing agencies, securities underwriters and other secondary market participants, and the public at large) in the broader policy debate concerning how best to achieve balance between preventing predatory lending, on one hand, and preserving wide access to affordable credit by subprime and other borrowers, on the other. As noted above, mortgage originators, and not underwriters, are directly engaged in lending practices that are the subject of proposed reforms and, we believe, must be included in the Comptrollers' initiative; and
- The continuation and expansion of consumer information, education and counseling initiatives that, apart from governmental action or the adoption of industry standards of conduct, can provide the most direct and effective "front

line" defense that borrowers may assert against unscrupulous, abusive or predatory mortgage originators and origination practices.

II. TRADITIONAL ROLE OF UNDERWRITERS IN SECURITIZATION TRANSACTIONS

As we detail below, underwriters of mortgage-backed securities view their principal role as helping issuers to raise capital, by structuring and selling securities to investors. In carrying out this role, both in fulfillment of their securities law responsibilities but also to protect their own interests and those of securities holders, underwriters conduct due diligence on issuers. A natural consequence of this effort is to screen out lower quality or less reputable subprime mortgage loan originators. Underwriters do this to assure that investors are receiving the asset type and quality they expect. Underwriters do not see their role as defining for the broader marketplace whether otherwise lawful loan features and characteristics are suitable for individual borrowers. Further discussion and refinement of the due diligence process in the context of underwriting securities may be one way that the Association and its members may work with the Comptrollers on the issue of predatory lending.

A. Legal and Economic Incentives for Underwriter Due Diligence

There is ample incentive for market participants to conduct due diligence of issuers and their affiliates and the underlying pooled mortgage loans. In connection with an offering of mortgage-backed securities, the federal securities laws require underwriters to undertake a "reasonable investigation" to foster the accuracy of information contained in the disclosure documents with respect to those securities. Failure to fulfill these responsibilities can subject the underwriter to civil and criminal penalties and sanctions. Also, purchasers of mortgage loans are already subject to certain federal consumer credit laws, a material violation of which could result in monetary liability as well as, in certain cases, an impairment of the mortgage loan asset.

Apart from legal and regulatory requirements, underwriters already have strong economic and commercial incentives to establish and preserve the integrity of securities offerings in which they are involved. High delinquency, default and prepayment rates on the pooled loans impact the subordination level, marketability and value of the related securities. Indeed, rating agencies have downgraded several securities backed by subprime mortgage pools for poor collateral performance. Poor underwriting standards at origination and weak appraisals were common in many of the downgraded pools.⁵ Underwriters who bring securities to market do not benefit from such a downgrading, whether this adverse performance results from the operation of natural market forces or the "unsuitable" nature of loans for affected borrowers. Accordingly, underwriters perform due diligence 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.

B. Description of Underwriter Due Diligence

All underwriters must have and follow their own policies and procedures for conducting due diligence in connection with securitization transactions. Due diligence practices encompass an evaluation of both the originators of mortgage loans as well as the characteristics of the assets that support payment on the related securities.

Many factors 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 factor is the credit rating of the securities. In either case, the focus is on the stability of the cash flow, not necessarily from the perspective of whether individual borrowers will pay or have the ability to pay the underlying mortgage loans, but instead whether the securities will pay in accordance with their prescribed terms.

Other relevant factors in the underwriter's due diligence 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 a co-manager; and a host of other situation-specific factors.

Based on the variables present in a securitization transaction, due diligence may encompass one or more of the following factors, among others:

- A determination that the issuers have sufficient experience, financial capacity and demonstrated expertise to produce mortgage loans that satisfy applicable eligibility criteria and fulfill the requirements of the securitization documents through various background checks such as of financial statements, references, credit reports and licenses.
- A determination that the issuers have policies and procedures in place to evaluate material conformity with eligibility criteria in originating, documenting and securitizing mortgage loans, which may include:
 - Underwriting policies and procedures, such as methods used to assess the value of assets/collateral and the credit standing and payment capacity of borrowers/obligors thereon;
 - Compliance policies and procedures pertaining to applicable federal and state laws and regulations, particularly with respect to legal violations that may affect the enforceability of the mortgage loans; and
 - Quality control processes to review mortgage loans purchased from originators.

- A review of the servicing policies and procedures of the servicer, including billing and collection methods, pursuit of delinquent accounts and realization on collateral.
- A review of internal systems and controls.
- A statistical review of objective performance standards in such areas as rejection rates, early payment defaults, delinquency and foreclosure rates, and loan repurchase requests.
- A general review of an issuer's implementation of its policies and procedures.

Ultimately, any or all of these variables may be relevant or irrelevant to the performance risk borne by the securities holders in a particular transaction. Even if a specific variable is relevant in a particular transaction, the variable is not necessarily material from a securities law perspective. High delinquency and default rates adversely affect the value and marketability of securities as well as the type and amount of collateral or credit enhancements backing the mortgage loan pools. Historically, underwriters have conducted meaningful due diligence in the manner they determined was appropriate, given the purposes for which it is conducted. Such due diligence complements the remedies available under the securitization documents for breaches of representations and warranties.

Moreover, underwriters conduct due diligence for a subprime mortgage loan securitization in the context of the statements made in the prospectus about compliance with applicable law. Typically, the prospectus for a subprime mortgage loan securitization will state:

- that the loan seller has represented and warranted that all loans were originated in compliance with applicable law,
- that the loan seller is required to repurchase any loan that breaches that representation and warranty if the breach materially adversely affects the investors,
- that risk factors include the fact that the loans are subject to consumer protection laws which, if violated, can result in losses, particularly with regard to HOEPA loans which may be subject to assignee liability, and
- that losses resulting from consumer protection law violations may be borne by investors, if the loan seller fails to comply with its repurchase obligations.

As suggested above, underwriters' due diligence generally focuses on matters such as the originator's general policies and procedures for underwriting, origination and quality control.

C. Protective Steps that Underwriters Can and Do Take

While underwriters are leery of adopting a voluntary code of eligibility criteria, they do conduct due diligence that is designed to provide reasonable assurance that, among other things, their customers engage in responsible lending. Presently, there is a wide range of guidance available to the lending and underwriting industry from government agencies,

government-sponsored enterprises and industry trade organizations concerning due diligence practices in the residential mortgage financing sector. With respect to federal consumer credit law compliance, for example, the respective banking agencies have prepared, regularly update and publicly distribute handbooks used by bank examiners to audit the regulatory compliance operations of the lenders they supervise. These manuals include detailed checklists for compliance with the Real Estate Settlement Procedures Act, the Truth in Lending Act, the Equal Credit Opportunity Act and the Fair Housing Act, among other laws.

Freddie Mac makes available on its website voluminous "Best Practices" procedures that it recommends for use by its sellers, including, without limitation, (i) Wholesale Originations Best Practices, which, among other items, provides guidance on how to evaluate the viability of mortgage brokers and loan correspondents and the quality of mortgages, (ii) Quality Control Best Practices and (iii) Fraud Prevention Best Practices. HUD also has issued a detailed guide on how to establish and implement a meaningful quality control program to test for compliance with the requirements of the Federal Housing Administration ("FHA") for FHA-insured loans, which is a useful guide for all types of residential mortgage loans. The Mortgage Bankers Association of America, a leading trade group for the mortgage lending industry, recently issued its own recommended "best practices" for mortgage lenders. There exist in the marketplace sophisticated audit tools produced by federal agencies and instrumentalities to facilitate a lender's compliance with legal and contractual requirements of mortgage loan originations in accordance with prescribed eligibility criteria. Underwriters consult with these valuable resource tools to comfort themselves that their customers are conducting their business appropriately.

The Association and its members have recently engaged in extensive discussions concerning the appropriate role and scope of due diligence in connection with the securitization of subprime residential mortgage loans. We would be pleased to discuss ways that underwriters could "fine-tune" their due diligence procedures to address the Comptrollers' concerns, consistent with the purposes for which underwriters perform such due diligence. In any event, the Association's members have been and continue to be strongly committed to undertaking commercially reasonable due diligence investigations of subprime loan issuers, consistent with their existing legal and regulatory responsibilities, and legal standards of fair and ethical business conduct, as well as to protect the economic interests of bondholders and ultimately the underwriters themselves.

III. REVIEW OF THE STANDARDS

A. Use of Objective Standards

The Standards principally take the form of objective eligibility criteria that would guide whether an underwriter would purchase a loan.⁶ If a loan possessed one or more of the so-called "predatory characteristics," the loan would be ineligible for purchase or securitization. ACORN's Standards starkly portray the difficulty confronted by the Association and its members concerning this issue.

On one hand, it is virtually impossible to operate a large-scale business based on subjective standards as to which reasonable people can disagree-particularly where those subjective standards are proposed as a means of defining or limiting acceptable conduct. Indeed, as noted below, virtually all who have studied the issue of "predatory lending" have grappled unsuccessfully with the definitional issue of what is a predatory loan and instead have retreated to proscriptions based on qualitative terms (e.g., a prohibition on "oppressive" arbitration agreements, or charging "excessive" interest, points and fees). Indeed, there has been no consensus within and among the various branches of the government at a federal, state and local level to define with specificity what constitutes "predatory" lending. That is why the financial community has advocated that any new laws and regulations in this area be objective and capable of administratively feasible and commercially reasonable implementation. Generally, the Standards provide objective eligibility criteria that would not appear to be difficult to apply on a loan level basis. On the other hand, as a set of voluntary guidelines, these objective criteria do not appear to further any traditional business purpose, raise certain risks for private participants in the secondary mortgage market and, quite frankly, favor assumptions and value judgments as to which reasonable people can and do disagree.

B. Rationale for the Standards

1. The Lack of a Traditional Business Justification

Private conduits and government-sponsored enterprises long have established and maintained detailed, objective eligibility criteria governing the purchase and securitization of loans. Similarly, both private and governmental mortgage insurers have promulgated eligibility standards. In each case the standards are tied to a business justification. For example, Fannie Mae and Freddie Mac may not purchase loans in excess of a certain original principal amount based on statutory limitations. Both governmental entities and private conduits maintain established underwriting guidelines pertaining to such items as debt-to-income ratios, principally based on their modeling of the risk of loss from defaults and foreclosures. The private conduits may require or permit prepayment penalties to lessen the reinvestment risk associated with mortgage prepayments and make mortgage-backed securities more attractive investments in comparison to other forms of financial instruments. In general, the primary purpose of promulgating these eligibility criteria is to protect and enhance the business of the entity and the marketability of the securities at competitive prices.

Fannie Mae, Freddie Mac, FHA and VA have a dual mission. Their principal mission, rooted in their respective authorizing statutes, is to increase home ownership by providing liquidity to the mortgage market. This public policy objective is complemented by the goal of balancing the needs of individual consumers and businesses that participate in the mortgage market. Each entity goes beyond the explicit provisions of applicable law by requiring that certain disclosures be given to applicants and borrowers and imposing certain substantive practice requirements on lenders and servicers to try to protect the interests of borrowers. This aspect of their mission is the direct result of their governmental or quasi-governmental status.

Individual companies may elect to promote practices that protect borrowers either because of their own moral judgments of where they want to fit in the marketplace or because they believe it is good business. Where, however, reasonable people disagree as to whether such "protections" are appropriate, private enterprise tends to look to the government to prescribe the requisite code of conduct for the marketplace. The Standards should be viewed as one organization's attempt to establish a voluntary code of conduct, in the absence of governmental intervention and without general agreement among the participants in the mortgage markets as to where "the lines should be drawn" between permissible and impermissible conduct.

2. Indirect Responsibilities for Abusive Mortgage Origination Practices

Imposing the Standards on the underwriting community to seek to eradicate abuses at the mortgage origination level suggests a belief that somehow the capital markets cause, and thus are responsible for eliminating, abusive mortgage origination practices in the primary mortgage market simply because the capital markets provide the working capital with which subprime originators operate their businesses. We disagree.

While, as noted above, there is no commonly accepted definition of a "predatory loan," the most salient characteristics are alleged fraud and deception by the originator of the mortgage loan, coupled with loan terms that are perceived to be inappropriate or unsuitable for the borrower. The allegations of fraud and deception go to sales and marketing practices about which underwriters have no knowledge and over which they exercise no control. Unsuitable features include price and the size or term of the mortgage loan. In some cases, it is believed that the borrower did not understand the terms of the loan, irrespective of the several disclosures required by law, and that he or she would have been better off if the loan had not been obtained at all. It is not appropriate for underwriters to make these value judgment of wrongful lending; historically it has been the failure to make or purchase mortgage loans that has resulted in criticism being leveled at the secondary market. In any event, these origination-type determinations are far removed from the purview of the capital markets. Underwriters do not participate in the primary mortgage market where the deceptive sales practices may occur and individual judgments of suitability are made.

Although underwriters share the Comptrollers' desire to eliminate unfair marketing practices by mortgage originators who may take advantage of unsophisticated borrowers (including those who may lack the ability to engage in meaningful comparison shopping), underwriters have no way of knowing whether a mortgage originator has made an incorrect judgment regarding a borrower's need for a mortgage loan, or the propriety of the terms and conditions of the mortgage loan. Generally making capital available to the subprime primary mortgage loan market to operate is insufficient to impute responsibility to underwriters for the terms of the individual mortgage loan that, in hindsight, may not have been the best deal for the borrower.

The capital markets fund, at some level, virtually every industry sector in the country, providing the essential capital needed to finance and operate these businesses. However,

we are unaware of any other industry sector where responsibility is imputed to the capital markets for the imprudent, inappropriate or even illegal practices of the underlying businesses. The fact of funding alone does not mean that underwriters act to perpetuate abusive lending practices by their customers, and mere funding imposes no special duty or responsibility on capital market participants to assure that their customers businesses comply with current social standards.⁷ Underwriters should not be asked to serve as private attorneys general with responsibility to police the practices of their institutional clients and question the subjective judgments they make. That role is better left to the government. Accordingly, we reject the notion that underwriters are responsible for the perceived abuses in the subprime mortgage origination market. We appreciate, however, that the underwriting community may be part of the solution.

C. Efforts to be Part of the Solution

The Association appreciates the desire of the Comptrollers to expedite efforts to address predatory lending, and to look instead to a voluntary code of conduct within the underwriting community to attempt to eliminate abusive lending practices, in advance of legal and regulatory initiatives. As we detail below, however, the underwriting community is constrained in its ability to work together to adopt and implement the proposed Standards. These constraints are based upon several factors: a real fear of lawsuits; a sincere belief that reasonable people will disagree on whether the Standards identify abusive loan features and lending practices that should be uniformly prohibited; a reluctance, given the limited role of underwriters, to attempt to define the boundaries of acceptable conduct by mortgage originators; and a concern about the adverse effects of a proliferation of multiple and potentially conflicting predatory lending standards. These factors are discussed below.

1. Anti-Trust Concerns

Federal and state anti-trust laws generally prohibit restraints of trade or commerce and unfair competition, including those achieved through price fixing, standard setting, boycotts or refusals to deal. It is not necessary that there be an express written or oral agreement in order to violate these prohibitions; agreements to fix prices, set standards or boycott companies may be inferred from informal conversations coupled with a common course of conduct afterwards. An explicit exemption from this rule is recognized to lobby the government with respect to proposed laws or regulations. No such exemption, however, exists to negotiate voluntary standards proposed by community groups. Criminal and civil penalties are onerous for violations of the anti-trust law, including treble damages. In addition to administrative enforcement, private lawsuits brought by businesses that are harmed by restraints of trade and unfair competition are plentiful. Moreover, it is not relevant under the anti-trust laws whether the motives of the participants are good or evil; instead, courts look solely to the anti-competitive effects of the actions.

The Standards would require signatories to refuse to purchase loans with certain "predatory characteristics." Among other terms, the criteria relate directly to price (e.g.,

number of points and prepayment penalties) and standard terms and conditions (e.g., debt-to-income ratios, balloon payments, single premium insurance). These criteria may have little or nothing to do with the experience of the Association's members with the loans they previously have purchased in terms of delinquencies, defaults and losses, or the marketability or liquidity of mortgage-backed securities supported by mortgage loans possessing these characteristics. Rather, ACORN is asking the Association and its members not to do business with lenders and financial intermediaries that make or sell loans on lawful terms and conditions based on subjective value judgments that such terms and conditions are harmful to borrowers.

The Association and its members are not in a position to determine whether ACORN's assumptions or value judgments are correct, although we clearly are sympathetic to ACORN's concerns about abusive lending practices. Uniform adoption of these eligibility criteria, however, could put some mortgage originators out of business, materially impair their profitability and/or restrict their access to the capital markets. If any of these results were to occur, Association members may not be able to invoke any business justification for their actions, because these eligibility criteria would have been adopted in large measure without regard to either legal requirements or internal determinations that such criteria are necessary to reduce losses, improve profits, promote market efficiency or otherwise further an articulated business purpose. Aggrieved lenders may look to the parallel conduct of the underwriters and the concomitant absence of a traditional business rationale in determining whether to blame their business losses on potential anti-trust violations. We are concerned that these significant legal risks may prevent the Association and its individual members from engaging in any group discussion of certain proposed criteria embodied in the Standards.

2. Legal Liability for Voluntary Standards

The Association's members have another concern about the legal consequence of adopting the Standards. Should these Standards be adopted as proposed, they are likely to be characterized (by plaintiffs, in hindsight) as accepted industry custom and practice, and thus as legally required standards of conduct in all situations. Merely stressing that the practices are non-binding, and should not be construed as a recitation of existing law or as imposing any legal obligation on secondary market participants, may be insufficient to avoid this result.

Moreover, our members also are concerned that adoption of the Standards could lead to discrimination claims. The Fair Housing Act applies with equal force to the making and purchase of residential mortgage loans. Using purchase criteria that may disproportionately limit credit, or the terms and conditions of credit, to minority borrowers could be the foundation of a discrimination claim. Where the justification for the purchase criteria is not required by law or other traditional business factors such as profit and loss, underwriters may have a difficult time defending their case. It is quite likely that a defense based on a subjective value judgment of what is right for the borrower would not satisfy a defendant's burden of proof. This is why these types of subjective value judgments are more properly made by the government after suitable

deliberation and public debate. One private person's view of suitability could be another's view of paternalism and discrimination.

3. Disagreement Regarding Predatory Loan Features

Even if Association member firms were willing to take the risk of potential anti-trust and fair lending claims, underwriters that adopt a voluntary code of conduct would want to be sure that the standards they adopt clearly differentiate acceptable and unacceptable behavior. The Standards promote this goal, as noted above, because they essentially rely on objective criteria. The question is whether they adopt the *right* objective criteria.

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 workable definition of predatory lending,⁸ and state 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, flexible underwriting, and the financing of closing costs. Reasonable people repeatedly disagree on where the line should be drawn with regard to particular mortgage features.

Against this backdrop, ACORN has not made a compelling case that the Standards represent a consensus view-within government or the private marketplace-concerning what loan features should universally be considered abusive or predatory. There is no doubt that certain practices - such as unfair and deceptive practices - are improper. They also are illegal whether or not they are characterized as "predatory." Other practices that the proposed Standards condemn 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) in our economic system, it is the role of the market-not the government-to determine what prices are appropriate or excessive.
- Federal law has preempted certain limits on prepayment penalties based on a recognition that such penalties, which are fully disclosed, can add predictability to prepayment rates and therefore result in lower costs to consumers.⁹
- 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.

Presumably, federal law recognizes that these loan terms in fact may be beneficial to borrowers as long as the terms are fully disclosed. Moreover, there continue to be good faith disagreements between and among consumer groups, the financial industry and governmental entities regarding whether certain lending practices should be permitted and perhaps encouraged because of the benefits to consumers and, in other cases, restricted or prohibited because of the detriment to consumers. The underwriting community has no unique capability or expertise to determine what is best for borrowers, and there is a concern that merely taking the side of an articulate, well intentioned and

assertive public interest group may not produce a result that properly balances the competing legitimate concerns of the participants in the primary or secondary mortgage market.

4. Patchwork of Conflicting Standards

The Association is also concerned that, should the Comptrollers articulate a set of Standards for underwriters to follow, each state and city may follow the Comptrollers' lead and articulate its own set of "ethical" standards, leaving underwriters in the untenable position of choosing which of the many potential standards they should follow under any given set of circumstances. 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 continue to emerge, making it increasingly difficult for financial institutions to conduct business without inevitably violating one, if not multiple sets of standards.

IV. CONCLUSION AND RECOMMENDATIONS

The Association requests that the Comptrollers seriously reconsider the concept of recommended Standards to be adopted by underwriters. Simply put, underwriters are not in a position to determine the appropriateness of ACORN's value judgments requiring the elimination of lawful lending practices. For the reasons outlined above, our members are concerned that the Standards articulated by ACORN are neither appropriate nor the relevant standard for the purpose for which our members establish eligibility criteria--namely, to protect against the risk of loss, to enhance the value, performance and marketability of mortgage-backed securities and to preserve their business reputation and customer relationships.

We would like to assist the efforts of the Comptrollers and other state and federal regulatory bodies to combat abusive subprime lending practices that may harm borrowers, as well as the economic and reputational interests of primary and secondary market participants. However, for all of the foregoing reasons, we do not believe that the proposed Standards constitute a desirable, appropriate or effective mechanism for achieving this goal.

The Association and its members would like to work with the Comptrollers to identify other, more appropriate measures to counteract subprime lending abuses. The Association, of course, supports vigorous enforcement of existing laws and regulations governing the conduct of mortgage originators and the observance of lending laws and regulations. As noted above, however, since many loan features associated with "predatory" loans are lawful, such enforcement actions at present appear to be limited to responding to allegations of deceptive or fraudulent conduct, which are actionable whether or not the context is "predatory" lending.

The key issue is whether (and if so, what types of) new laws and regulations are needed to define with greater precision and objectivity specific loan features and characteristics

that are "predatory," and which, therefore, should be universally proscribed. Here, we believe that there is no substitute for governmental leadership-effected, for example, through the promulgation of specific subprime loan origination legislative or regulatory standards, with sufficient notice and opportunity to be heard by all affected constituencies. Of course, one also must determine which legislative and regulatory bodies should enact these new standards so that the financial industry does not get caught in the "crossfire" of conflicting governmental initiatives. Given reasonable differences of opinion among market participants and the specialized business role occupied by underwriters, we do not favor the adoption or endorsement of private sector standards that would seek instead to define acceptable loan origination activities by limiting the types of loans that may be underwritten in the secondary markets.

Whether or not legislative or regulatory bodies respond in the manner outlined above, the Association believes that perhaps the most effective and constructive step that market participants can take lies in providing better and more accessible consumer information, education and credit counseling throughout the loan origination process. The Association is willing to work with the Comptrollers and to support the initiatives of other regulators and lending industry organizations in this regard.

The Association appreciates the opportunity to respond to on the Comptrollers' request. We look forward to follow-up discussions, where we would expect to articulate the views expressed in this letter in more detail. In the meantime, should you have questions concerning any of the matters addressed herein, please do not hesitate to contact me at 212.440.9403.

Sincerely,

/s/

George P. Miller
Senior Vice President,
Deputy General Counsel

cc: Denise Pease, *Office of the New York City Comptroller*
Thomas Sanzillo, *Office of the New York State Comptroller*

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 underwrite and trade mortgage- and asset-backed securities, including those backed by subprime residential mortgage loans. The views expressed in this letter are based upon input received from a broad range of Association members who are active in these markets. More information about the Association, its members and activities may be obtained from the Association's website at www.bondmarkets.com.

2. Some members of the Association have mortgage lending affiliates that originate prime and subprime residential mortgage loans. However, the Association does not represent its members or their affiliates with respect to their mortgage loan origination activities.
3. The Association is strongly of the view that mortgage originators and their respective trade organizations must be meaningfully involved in any follow-up dialogue that the Comptrollers may organize, given that loan originators' lending and business practices are directly implicated by the proposed Standards.
4. Indeed, the New York State Department of Banking has promulgated extensive regulations intended to redress perceived predatory lending abuses. See, N.Y. Com. Codes R. and Regs. 41, Sections 41.1 et seq.
5. Moody's, 1999 Year in Review and Outlook for 2000 Home Equity Asset-Backed Securities: The Market for Home Equity Residential Mortgage Proves Resilient, 5 (2000).
6. There are nevertheless several proposed Standards that are framed in qualitative terms, such as those which would prohibit loan purchases or funding unless a lender "fairly and fully" informs borrowers of loan terms and conditions, or where a lender "steers" borrowers inappropriately to higher priced credit.
7. We would also note that the issuance of mortgage-backed securities is not the only financing option available to mortgage loan originators who, similar to other businesses, may also rely on straight debt or equity financing, bank loans, or other funding sources.
8. 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.
9. 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 should be free, of course, to obtain loans without prepayment penalties. Also, the United States Court of Appeals for the Fourth Circuit recently 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.