January 6, 2009

Bill Keller
Executive Editor
The New York Times
620 Eighth Avenue
New York, NY 10018

Dear Mr. Keller:

Thank you for your gracious letter this morning apologizing for the headline and making the correction in your paper.

There are still some factual errors in the story, and in the correction that ran today. I want to outline them briefly, and hope you can correct them as soon as possible, as we continue together to set the record straight.

1. Discount Rate. The story says that "World Savings lending volume dipped again in 2006 shortly after the sale to Wachovia was initiated" and that this volume dip "prompted World Savings to attract more borrowers by" allowing customers to "make monthly payments based on an annual interest rate of just 1%."

In fact, the sale to Wachovia was initiated in April 2006 and closed in October 2006, while the discount rate was lowered to 1% by Wachovia in March 2007. We had nothing to do with this action, and had opposed such steps publicly as late as March 29, 2006 in correspondence with regulators (see below).

2. Prepayment Penalties. The article states that I "convinced" Mr. Eakes [at the Center for Responsible Lending] "to drop his opposition to prepayment penalties".

In fact, following a discussion we had, Mr. Eakes and the Center for Responsible Lending continue to oppose prepayment penalties on all subprime loans and only accept prepayment penalties on prime loans, and then only within certain specified limits. I support this position.

3. Letter to Regulators. The article characterizes my letter to regulators of March 2006 as "object[ing] to several aspects of [proposed] new rules".

In fact, our letter to the regulators quite explicitly encouraged greater oversight of mortgage lending, particularly with respect to deep payment discounts (which we referred to as "fool's gold") and securitization of Option ARMs, which we described as particularly vulnerable if default rates rose or in a "global financial crisis". With regard to stress simulations, our letter states that "lenders who originate alternative mortgage should run stress simulations to understand the relevant risks, including those relating to offering deep payment discounts and other structure features of the Option ARM loan, and they need to be prepared and able to take appropriate action to mitigate and address those risks." I implore you to review the letter we sent to the regulators, dated March 29, 2006, that is attached.

4. Broader Marketing. The article states that World Savings expanded marketing of the Option ARM to "a much broader audience" "in the recent housing boom", including to people with financial troubles.

This is not true. In fact, we had been offering the so-called Option ARM to the exact same types of borrowers since 1981. The only thing that changed, as noted in our letter to the regulators, was that a wider spectrum of lenders (including lenders who had little experience with the Option ARM product) began offering their versions of the Option ARM to a greater number of borrowers.

5. Today's Correction. Today's correction states that "World Savings Bank originated a type of adjustable-rate mortgage called Pick-a-Pay that has led to many foreclosures as the real estate market and the economy collapsed".

World Savings Bank did not originate, or invent, the negatively amortizing adjustable-rate mortgage. For years prior to 1981, a wide range of economists and industry leaders had been urging regulators to permit lenders to use adjustable-rate mortgages to avert problems that would inevitably result if only fixed-rate mortgage were permitted-- lenders that borrow short at high rates and lend long at low rates will inevitably run into problems. When such loans became permissible in 1981, the most significant banks to offer negatively amortizing adjustable-rate mortgages were Home Savings and Great Western Financial; World Savings was a small player by comparison.

The term Pick-a-Pay, which was a proprietary marketing term, was not used until 2002.

The Pick-a-Pay offered by World Savings has not caused, or "led to", many foreclosures. When housing values fall 50% and unemployment levels rise, a certain number of foreclosures will result regardless of whether the borrower has a fixed-rate loan or an adjustable-rate loan.

Thank you for you consideration.

Herb Sandler

WORLD SAVINGS

March 29, 2006

Office of Thrift Supervision
regs.comments@ots.treas.gov
Docket Number 2005-56

Re: Proposed Guidance Concerning Alternative Mortgage Products

Ladies and Gentlemen:

World Savings appreciates the opportunity to comment on the proposed guidance on alternative mortgage products. As discussed further below, we are in a rather unique position to offer a real-world perspective on these issues since we have had success and minimal risk originating adjustable rate mortgages with payment options (Option ARMs) for a quarter of a century. We hope that our perspective will be of value to the agencies as discussions about the guidance proceed.

As you know, we have long supported a regulatory regime that encourages lenders to provide full and fair disclosures to customers and to prudently manage their lending practices. Given our reputation as a conservative residential mortgage portfolio lender, it should come as no surprise that we fully support the guidance insofar as it reminds banks and thrifts to:

- Maintain strong underwriting, appraisal, compliance and risk management functions;
- Actively measure, monitor, and control risks, including through the use of stress testing, early warning systems and appropriate loss mitigation strategies;
- Maintain appropriate capital levels and allowances for loan losses;
- Avoid diluting underwriting standards to stimulate volume or otherwise ceding underwriting standards to third parties;
- Avoid lending practices that could be predatory or abusive; and
- Provide consumers with clear and timely disclosures.

Of course these sound practices are relevant to any loan a bank might offer, whether it has a fixed or adjustable rate and whether it is for residential or commercial purposes. We certainly support the reemphasis of these principles in the proposed guidance.

We do offer a few suggestions based on our long experience with ARM lending. As discussed in greater detail below, in some instances we think the guidance may not have gone far enough in addressing recent practices in the industry, and in a few other areas we believe specific changes to the proposed guidance are warranted.

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About World Savings

World Savings is one of the nation's 15 largest financial institutions with $125 billion in assets, and we currently make residential loans in 39 states. Our parent company, Golden West Financial Corporation, was originally incorporated in 1963 to acquire a small, $34 million institution headquartered in Oakland, California. Golden West has been publicly held since 1969, and our earnings per share have compounded at 19% annually during the past 39 years, a record that, to the best of our knowledge, is unequalled by any other American company, with the possible exception of Berkshire Hathaway. For all that time, we have remained a residential mortgage portfolio lender and we engage in no other business activity. World Savings is also the only independent thrift that has ever been awarded a "Double A" rating from Moody's and S & P.

Much of our senior management has been in place for 25 years or more and has been actively involved in mortgage lending before, during and after the savings and loan debacle of the late 1970s and 1980s that resulted in the failure of thousands of institutions and cost taxpayers in excess of $150 billion before interest (and an estimated $500 billion-plus after interest). Both before and after that crisis, we spoke repeatedly with regulators, members of Congress and their staffs, Administration officials and others of the risks associated with borrowing short and lending long and the importance for banks to maintain sufficient capital. Working with other major portfolio lenders, we were instrumental in obtaining federal authority to make ARMs to protect against the systemic risks inherent in portfolio fixed-rate mortgage lending.

We are among the few management groups still around that has been originating, maintaining in portfolio, and servicing Option ARMs for the past 25 years. Option ARMs have been our core product ever since ARMs were first authorized in 1981, and they now comprise 99% of our portfolio. We have been originating these loans, and with extremely low losses, throughout interest rate cycles, recessions and home price declines. Our annual chargeoffs have averaged less than 5 basis points since 1981, which is lower than that of virtually every other depository institution of size, including institutions that have made only fixed-rate residential mortgage loans. We believe that our low chargeoff levels have been equal to or superior to that of Fannie Mae and Freddie Mac, even though our core product has been the Option ARM while the GSEs have essentially held fixed-rate loans and have had the benefit of being more widely diversified geographically.

During the past quarter century, we have not identified a single delinquent loan in our portfolio, much less a foreclosure or loss, due to the structure of our Option ARM product.

A Brief History of the Option ARM

We want to offer some additional background on the history of the Option ARM in the United States because it will help put our subsequent comments in context.

Late in the first phase of the savings and loan debacle in May 1981, Federal Home Loan Bank Board Chairman Richard Pratt authorized federal thrifts to originate a mortgage product other than a fixed-rate mortgage for the first time, namely the ARM. The decision was based on a desire to help lenders, most of which were portfolio lenders, avoid the significant interest rate risks associated with borrowing short and lending long. Indeed, in the wake of the savings and loan crisis, bank regulators aggressively discouraged fixed-rate lending and strongly encouraged the industry to shift to originating ARMs.

For some time before 1981, we and other major financial institutions in California and throughout the country, together with trade groups and others, began to study the various forms of ARMs. The research took us to Great Britain and other parts of Europe where adjustable rate residential mortgages had been in use for many years. At the end of the day, there were essentially two alternate structures: the Option ARM that includes protections against payment shock such as annual payment caps and a borrower's ability to defer interest, and the "No Neg" ARM that is more likely to result in payment shock as interest rates rise.

Major U.S. financial institutions heavily involved in mortgage lending did an enormous amount of analysis and ran innumerable simulations. Our company alone ran several thousand simulations, analyzing the various alternative forms of ARMs under a large variety of stress situations. The No Neg ARM was adopted by many companies in the East, primarily smaller institutions. All the major thrifts on the West Coast, and various others throughout the country, chose the Option ARM. Our simulations demonstrated that the No Neg ARM posed significant concerns about early, and continuing, payment shock to the borrower as rates increase. Experienced lenders were concerned that by using the No Neg ARM, they might be exchanging interest rate risk protection for serious potential credit risk problems. Since we were all portfolio lenders – that is, we originated loans and held them in our portfolios – it was imperative that the loan work for borrowers and at the same time not present inappropriate risks to portfolio lenders.

For the first two-plus decades after the Option ARM was authorized, the loan was originated principally by portfolio lenders who needed a loan product they could keep in portfolio without significant interest rate or credit risk. During that time, the Option ARM had little appeal to lenders who were not going to hold it in portfolio because the Option ARM was only a small portion of the total mortgage market, and the loans required a significant investment in personnel and sophisticated systems to service the loans effectively. We and other portfolio lenders all understood the dangers of sacrificing quality for volume, and we knew that effective underwriting, appraisal and other risk management practices were critical to managing a portfolio of Option ARM loans.

The traditional Option ARM product is essentially unchanged since 1981. What has changed in the last few years, particularly since the emergence of a securitization market willing to acquire greater numbers of Option ARMs, are more aggressive practices by new Option ARM originators, many of whom lack a sophisticated understanding of the loan and appear focused principally on generating volume. These aggressive practices include deeper discounts between the loan's fully-indexed rate and the starting payment rate (referred to as the "payment discount"), diluted underwriting standards, and shortcut appraisal practices. It is these emerging practices that have increased the visibility, and we believe the risks, associated with the Option ARM product and that have lead, ultimately, to the proposed guidance.

Strengthening the Guidance

We applaud the regulators for issuing the proposed guidance to highlight practices that can be risky to both consumers and lenders. As discussed below, we think the guidance needs to more fully address the emerging practices referenced above, including in particular Option ARMs that are offered with deep payment discounts, which has been facilitated by a growing secondary market.

Deep Payment Discounts

Those of us experienced in Option ARM lending have long known that a critical issue, arguably *the* critical issue (assuming high-quality underwriting and appraisals), affecting the risk level of the Option ARM loan is the payment discount. As a result, we and other residential mortgage portfolio lenders traditionally limited the payment discount to a range of 150-300 basis points in a rising rate environment and 250-400 basis points in a declining rate environment. In recent years, however, some lenders have boosted their Option ARM production volumes by promoting very low initial payment rates, generally 1% or less. These lenders have maintained their low payment rates despite the 375 basis point increase in the Federal Funds rate since mid-2004, which has resulted in payment discounts of 550 basis points today. Simulations show that payment discounts at these high levels present greater risks than the lower payment discounts that had traditionally been used by portfolio lenders. We think the practice of deep payment discounts deserves greater regulatory scrutiny than the passing reference in the proposed guidance.

Some might claim we raise this point about payment discounts because we are concerned about competing against new Option ARM lenders. Our concern has nothing to do with remaining competitive, and we have long outlasted and outperformed past competitors who acted irrationally. We could certainly increase our Option ARM production, and short-term financial results, by offering deeply discounted loans with starting payment rates of 1% or lower. After all, our sales force and back-office support systems are oriented toward Option ARM production. The sole reason we have been willing to forego volume and raise our starting payment rates as market rates have increased is because Option ARMs with deep payment discounts present inappropriate levels of risks to borrowers and to lenders. We have been originating this loan long enough, and have run enough simulations, to recognize fool's gold when we see it. Our concern is that foolish lenders who eventually stumble under the weight of their missteps will bring down innocent borrowers with them and leave the rest of us to clean up the mess, as we have done before.

Given the importance of this issue, we suggest the agencies consider adding more discussion in the guidance of the risks of inappropriately steep payment discounts. One suggestion might be to add the following or similar language on page 19 of the proposed guidance, at the end of the subsection headed Introductory Interest Rates:[1]

> "Among other things, where discounted initial payments are offered, simulations should first be run that analyze the impact of various starting payment rates over the long term. Introductory payments that are deeply discounted are of particular supervisory concern, absent other mitigating factors such as lower LTV ratios."

Secondary Market Transactions

The other significant development in recent years is a growing secondary market for Option ARMs, which has facilitated, and even stimulated, the origination of Option ARMs with deep payment discounts. Greater volumes of Option ARM loans have been originated in the market in the past few years primarily by aggressively promoting loans with very low payment rates that lenders then pool into securities, slice into multiple tranches with varying risk characteristics, and sell to investors.

Lenders who sell Option ARMs in the secondary market typically either have a mortgage banking business model requiring the production and sale of a large volume of loans to generate sufficient income, or they are portfolio lenders who sell Option ARM loans because of capital or funding constraints. In either case, continued demand from the secondary market is critical for the business model to succeed, and the sellers' Option ARMs are often structured to the standards investors will accept, which may differ from the standards used by lenders who keep their Option ARM production in portfolio. Although the secondary market has been receptive in the last two years to securities collateralized by Option ARMs, investor interest could wane for reasons ranging from higher-than-expected default rates in Option ARM pools to a global financial crisis such as occurred in 1998 that depresses capital market funding and securitization activity and triggers a revaluation of collateral.

The proposed guidance appropriately cautions against other risks that also can occur with secondary market sales, including reputational risk and implicit recourse. Sellers into the secondary market are not immune from the risks of losses from loan delinquencies and foreclosures. If there are a large number of problem loans in a securitization structure, the originator may repurchase troubled loans for a variety of reasons, including the originator's reputation and franchise value, inaccurate disclosures or representations, or the constraints on being able to offer flexible loan workouts when the loans are in a trust. A repurchase would trigger a capital charge for the affected loans. In addition, under the

[1] The references to "introductory interest rates" on page 19 of the guidance should more accurately be referred to as "introductory payment discounts."

implicit recourse regulations, a bank could be required to hold capital on its entire sold portfolio or securitization if its repurchases expose the bank's earnings and capital to potential risk of loss, such as could occur if delinquent loans are repurchased at par (as is contemplated by most pooling and servicing agreements), even if the loans' fair value is less than par, or if the bank provides other support beyond its contractual obligations.

We do not mean to suggest that all securitizations of Option ARMs are problematic or that Option ARMs should only be made by portfolio lenders. However, portfolio lenders have very strong economic and reputational incentives to make high-quality loans and to manage credit risk through appropriate starting payment rates, underwriting and appraisal practices, and consumer disclosures. In addition, portfolio lenders are not dependent on the availability of the securitization market. Time will tell if new Option ARM lenders who hold minimal capital and rely on the secondary market fare as well when they sell pools of loans, including loans with deep payment discounts. We think the potential risks are certainly worthy of greater regulatory scrutiny.

In light of these concerns, we suggest that the agencies consider adding the following or similar language on page 25 of the proposed guidance, at the end of the subsection headed Secondary Market Activity:

> "In cases where there have been secondary market sales of alternative mortgages, examiners will review the quality of the collateral and the terms of the pooling and servicing agreements, including representations and warranties and other provisions allowing or requiring repurchases of loans. Examiners will also evaluate if repurchases are likely in order to facilitate loan workouts, preserve reputation and franchise value, and address similar issues. Examiners will review the institution's servicing practices and ensure that the institution has adequate capital and other resources to handle potential repurchases and workouts, including capital levels required under implicit recourse regulations."

Suggestions for Specific Revisions to the Guidance

There are a few other specific areas where we suggest the guidance should be revised to more accurately reflect the history of the Option ARM loan.

Alternative Mortgages

We submit that "alternative" is a more accurate term to describe these loan products than "nontraditional." Although the guidance states that these loans are "often referred to as nontraditional mortgage loans," (pp. 8, 13) the first time we ever heard the term "nontraditional" was in the proposed guidance itself. Congress used the term "alternative" mortgages when it passed the Alternative Mortgage Transactions Parity Act of 1982 in response to the crisis caused largely by the interest rate risk of "traditional" fixed-rate lending, and "alternative" is also the term currently used by several banking agencies in existing regulations governing these exact types of loans. We are not aware of any historical basis for the term "nontraditional," and it strikes us as having a misleading and inappropriately pejorative connotation given the country's successful 25-year history with ARM lending and the recurring problems associated with portfolios of fixed-rate loans.

Option ARMs *Are* Stress Tested

The guidance inaccurately states that alternative mortgages are "untested in a stress environment" (pp. 14 and 20) and that "the limited performance history of these products, particularly in a stressed environment, increases performance uncertainty" (p. 26). In fact, we have run literally thousands of scenarios to test for potential risks associated with individual Option ARM loans or a portfolio of Option ARM loans, and other experienced lenders have similarly run their own simulations.

Moreover, since we and other lenders have been originating Option ARMs, there have been periods in which the mortgage market has experienced extreme stress. As an example, Southern California went through a severe and sustained real estate depression in the late 1980s and early 1990s, caused largely by deep cutbacks in the defense industry. This real estate depression followed several years of extremely rapid price appreciation and, even worse, was accompanied by unemployment between 9% and 10%, a concurrent decline in real estate prices of approximately 20%, and a 300 basis point increase in interest rates. A perfect storm. In the worst year in our Company's history, 1994, which coincided with the worst point in the Southern California real estate depression, we experienced only 18 basis points of chargeoffs.

We think it would be more appropriate for the guidance to emphasize that lenders who originate alternative mortgages should run stress simulations to understand the relevant risks, including those related to offering deep payment discounts and other structural features of the Option ARM loan, and they need to be prepared and able to take appropriate action to mitigate and address those risks.

Concentrations Are Not Inherently Risky

As our 25-year history with Option ARMs shows, a conservative lender can achieve outstanding returns and have very low losses even when fully concentrated in Option ARM loans. It bears repeating that we have not identified a single delinquent loan in our portfolio, much less a foreclosure or loss, due to the structure of the Option ARM product.

That is not to say that managing a portfolio of Option ARMs is easy; it can be very complicated, and it is ultimately what we as a company have been focused on every day for decades. In many ways, our concentration in Option ARMs has been a source of great strength because we have been able to mitigate interest rate risk and also control credit risk by focusing management and Company resources on developing personnel and systems that are attuned to the specific needs of managing an Option ARM portfolio. Servicing Option ARMs involves various skills, which lenders who are new to the product may have a tendency to underestimate.

We suggest that the discussion of "concentrations" in the guidance (pp. 21-22) should recognize there are a number of traditional mortgage portfolio lenders who have been making alternative mortgage loans since 1981, and that a concentration in these loans is not *per se* of supervisory concern. At least for thrifts, the Congressionally-imposed QTL ("qualified thrift lender") tests mandate these concentrations. As we have noted, 99% of our portfolio consists of ARMs, and a similar focus on ARMs exists at other traditional mortgage portfolio institutions. Other depository institutions specialize exclusively or nearly exclusively in credit cards, trusts and other bank products and services. They, too, are able to achieve efficiency and develop customer service expertise while still assuring high safety and soundness.

<u>There is a Not a Wider Spectrum of Option ARM Borrowers</u>

In a few places (pp. 8 and 13), the proposed guidance states that Option ARM products are only recently "being offered to a wider spectrum of borrowers." In fact, the Option ARM has been offered since 1981 to a full spectrum of borrowers seeking low-cost and flexible financing. Contrary to some beliefs, the Option ARM loan was never offered only to high income, wealthy professionals. We and other residential mortgage portfolio lenders have been offering the Option ARM since 1981 to the exact same types of borrowers to whom we were offering fixed-rate mortgages prior to 1981.

What has changed in recent years is that the Option ARM is being offered to a greater *number of borrowers* and by a much *wider spectrum of lenders.* The greater volume of Option ARMs has been facilitated by the new securitization market and technological developments, including automated underwriting systems, automated appraisal valuation models, and credit scoring methods. These new technological tools may not be fully tested, especially with alternative mortgages. As our prior discussion notes, many new lenders may not fully appreciate the history of the Option ARM loan or the critical role that underwriting, appraisals, disclosures and other mortgage practices play in mitigating risks. In addition, as we have already noted, some lenders appear to be generating greater volumes of loans by continuing to offer very low initial payment rates despite the red flag of ever deeper payment discounts.

<u>Qualification Standards</u>

The proposed guidance asks for specific comments on appropriate qualification standards. Our practice has always been to require borrowers to qualify at the fully-indexed rate, rather than only the loan's starting payment rate. We believe the fully-indexed rate is the appropriate standard. We would caution against being overly prescriptive in the guidance with specific qualification criteria. Instead, we suggest that the guidance reiterate the importance of maintaining appropriate underwriting practices and remind lenders that these practices, including those that are automated, will be closely reviewed during supervisory examinations. Underwriting of Option ARMs with deep payment discounts should be subject to close regulatory scrutiny, particularly since these loans are totally untested in stress scenarios and, as simulations demonstrate, could have a greater potential for payment shock, particularly if interest rates rise.

The guidance also asks for specific comments on the use of "stated income." We share many of the agencies' concerns about relying exclusively on stated income to determine a borrower's ability to pay. On a related note, we agree with the statement in the guidance that "the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process" (p. 17). Credit scores have been used broadly for mortgages only during the last decade or so, which has been a benign economic period with strong housing price appreciation and low consumer credit losses. Credit scoring methods have therefore not been tested in a stressed mortgage environment. More important, credit scores can change quickly, and they differ widely from one credit agency to the next, in many cases by as much as 100 points or more.

Conclusion

We commend the agencies for the time and attention they have devoted to the proposed guidance. We support the inter-agency effort to remind lenders about sound mortgage lending practices, and we hope that the background and comments we have offered in this letter will be of value.

As stated above, we have had great success with the Option ARM product for 25 years. It is an outstanding loan for both borrowers and lenders when properly underwritten, appraised and managed. Borrowers benefit from payment flexibility, and Option ARM portfolio lenders avoid the interest rate risks associated with fixed-rate portfolios.

While guidance geared toward specific products is sometimes appropriate, we think it is also important to remind all banks about prudent lending practices for all products. In our experience, it is the <u>quality</u> of the loan that matters more than the <u>type</u> of loan. In other words, whether lenders allow borrowers to manage and access their home equity through Option ARMs, equity lines of credit or other products is ultimately less important than the strength of the lender's culture, underwriting, risk management, disclosure and other lending practices.

Few if any products are inherently bad, nor are concentrations in these products inherently risky. Rather, it is a combination of multiple factors that could be inappropriate for particular borrowers and/or lenders. Assuring that consumers can choose among competitive and suitable alternatives, while avoiding transactions that are likely to harm consumers and financial institutions, presents challenges. The proposed guidance is designed to achieve that objective, and with modifications along the lines set forth in this letter, we believe the agencies will help address potential problems.

Sincerely,

Herbert M. Sandler
Chairman and Chief Executive Officer