S. HRG. 109–1083

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

HEARING

BEFORE THE

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

AND THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE ISSUES SURROUNDING NON-TRADITIONAL MORTGAGES AND THEIR POSSIBLE IMPLICATIONS FOR CONSUMERS, FINANCIAL INSTITUTIONS, AND THE ECONOMY

WEDNESDAY, SEPTEMBER 20, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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C O N T E N T S

WEDNESDAY, SEPTEMBER 20, 2006

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

WEDNESDAY, SEPTEMBER 20, 2006

U.S. SENATE,
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittees met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Wayne Allard, and the Hon. Jim Bunning, Chairmen of the Subcommittees, presiding.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Chairman ALLARD. I am going to call the Committee to order.

This is a joint hearing of the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy. I will be joined this morning later on by Chairman Bunning on Economic Policy and minority side. I have a reputation of getting started on time. So I would like to get started on time, and my colleagues can drag in as they do.

We are going to run a pretty tight hearing today because we have lots of witnesses and we have a lot of time constraints. So I am going to enforce the 5-minute rule very strictly even on my colleagues. I think you would agree to that, Mr. Chairman, to make sure that we can stay within our time line.

Chairman Bunning, I have been informed that we have a vote, perhaps at eleven o'clock. So maybe you and I can switch off and keep the meeting going when we get to that point in time.

I would like to welcome everyone to the joint hearing of the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy. I was pleased to co-chair the hearing with Senator Bunning last week to examine developments in the housing markets, and at that time, we heard a great deal of discussion regarding non-traditional mortgage products, and Senator Bunning and I felt that the issue was of such importance that we should hold a second hearing to examine it in greater depth.

This is a topic that is not just inside the beltway conversation consideration. For example, *The Denver Post*, my State of Colorado, headlines last Sunday on "No Money Down, High-Risk Gamble". It is talking about home loans and whatnot. This is a topic which typical American families are following very closely, and the article raised many interesting points, and I would ask unanimous consent for the entire article to be entered into the record.

Without objection, that will be so ordered.

While these products may be considered non-traditional, they are certainly not new. Variations of interest only loans have existed at least since the 1930's and payment option mortgages have been in use since the 1980's, I understand. There has been a significant shift, however, in the consumer base for these mortgage products.

Over the previous two decades, non-traditional mortgages were primarily utilized by wealthy financially sophisticated individuals looking to manage cash-flow or maximize financial flexibility. However, following years of dramatic increases in houses prices, average consumers began taking non-traditional mortgages in order to make home ownership more affordable or to increase the amount of home that they could qualify to purchase.

Let us look at Chart 1. Non-traditional products have surged in popularity. According to the "First American Real Estate Solution", interest only and payment option loans comprised only 1.9 percent of the mortgage market in the year 2000. That is reflected in the chart that you see here on your left. However, their share of the mortgage, market expanded to 36.6 percent in 2005. That is reflected on the chart there on your right.

An interest only loan allows the consumer to make payments covering only the interest on the loan balance for a period of time, generally three to 10 years. At that time, the consumer must also begin making payments which cover the principal. Because the period in which the principal is repaid is compressed, payments can jump significantly.

I would like to go Chart No. 2, the payment shock chart. Payment option mortgages, which is the second type of mortgage we want to review today, offer consumers a choice of four different mortgage payments. There is a 15-year amortization payment, which is a traditional loan; a 30-year amortization payment, where you pay on the interest and you pay equity into the house, you pay down the house; a payment covering interest only or a minimum payment, which is the bottom line. Because consumers choosing the minimum payment are not even covering the interest on the loan, the loan balance actually increases, making the loan negatively amortizing. The loan balance can continue to increase until it reaches a preset cap at which point the loan resets and becomes fully amortizing. At this point, payments can jump significantly, sometimes double or more, which is referred to at times as just payment shock.

As we go to Chart No. 3, why have we seen such an upsurge in non-traditional mortgages recently? Well, quite simply, they can make homeownership more affordable by lowering payments and allowing homeowners to potentially qualify a larger mortgage. As part of the Mountain Census Region, my home State of Colorado has been part of the highest regional home price increases over the past year. It is no coincidence that the uptick in non-traditional mortgages parallels the uptick in home prices.

As this chart demonstrates, an interest only loan can allow a consumer to buy a 20 percent more expensive home. Non-traditional mortgages can also provide financial flexibility. For example, a buyer who doesn't intend to remain in a house for very long could buy more house because of initially loan low payments.

These mortgage products can also be helpful for people who desire temporary cash-flow for investments or to pay off other higher interest rates and those who expect a future increase in earnings. Payment option loans also provide flexibility for those with uneven income flows such as people who receive large bonuses or commissions. In utilizing a non-traditional mortgage, borrowers bet on the fact that mortgage rates will remain stable and home values will continue to rise. This is crucial for them to be able to refinance their loan before it resets and payment shock kicks in.

As we learned at the last hearing, though, the cyclical nature of markets dictates that past rates of appreciation and record low interest rates cannot continue indefinitely. If interest rates have increased, a consumer may not be able to qualify for or afford the refinancing alternatives. Similarly, if home values have been stagnant or decreased, homeowners may have difficulty refinancing or even selling their home as they can owe more than what it is worth.

This is exacerbated by situations in which the buyer made little or no down payment or used piggy-back mortgages. Homeowners with little or no equity have no cushion for financial hardships such as an illness, job loss, or divorce. It is no coincidence that recent Colorado home buyers have the Nation's lowest home equity rate and the State also has the highest foreclosure rate. According to "Business Week", nationwide, more than 20 percent of the option ARM loans in 2004 and 2005 are upside down, meaning the homes are worth less than their debt.

Non-traditional mortgages are not necessarily bad products as long as they are carefully utilized. In order for consumers to decide whether these products are appropriate for them, they must have adequate information. The information must also be clear and meaningful. Consumers should understand exactly what risks and benefits different products represent.

I commend the regulators for taking steps to improve consumer disclosure. No one should face the situation of Colorado's Lilly and India Hartz who thought they were refinancing with a 30-year fixed-rate mortgage, but instead got an option ARM.

Today, we will also explore the implications of non-traditional mortgages for financial institutions. Because these are risker products, it is even more important that they are underwritten with care. Additionally, financial institutions must take appropriate steps to manage that risk.

We have a distinguished lineup of witnesses today. While the witness list may be lengthy, each organization represented here today has an important perspective to share.

First, we will hear from Ms. Orice Williams, the managing director for the GAO study on alternative mortgage products. She and her team have done an excellent job of researching this issue, and I would like to commend them for their work. I know we are all looking forward to hearing more about the findings and recommendations of the report that GAO is releasing today.

The first panel will also include representatives from each of the four Federal financial regulators: Ms. Kathryn E. Dick, Deputy Comptroller for Credit and Market Risk at the OCC; Ms. Sandra F. Braunstein, Director of the Division of Consumer and Community Affairs at the Fed; Ms. Sandra Thompson, Director of Supervision and Consumer Protection at the FDIC; and Mr. Scott Albinson, Managing Director for Examinations, Supervision, and Consumer Protection at OTS.

In December 2005, the regulators issued draft interagency guidance regarding non-traditional mortgage products. Specifically, the guidance addressed the necessity for adequate and meaningful consumer disclosures. The guidance also addressed the need for financial institutions to properly manage the risks posed by the products. After receiving extensive comments, they are now working toward issuing final guidance. I commend them for taking up this issue and look forward to an update on their process as well as their ongoing individual agency efforts.

Our final witness on the panel will be Ms. Felecia A. Rotellini, the Superintendent of the Arizona Department of Financial Institutions. The Conference of State Bank Supervisors has also been looking at non-traditional mortgage products. In addition, they are developing a national licensing system for the residential mortgage industry. The system will provide a uniform application, allow access to a central repository of licensing and publicity and adjudicated enforcement actions. This will be incredibly helpful so for States like Colorado where mortgage fraud has been a problem, bad actors will no longer be able to simply move to another State and continue to perpetrate their fraudulent activities.

Our second panel will explore the perspectives of industry and consumer groups. Witnesses will include: Mr. Robert Broeksmit, Chairman of the Residential Board of Governors for the Mortgage Bankers Association; Mr. George Hanzimanolis, President-Elect of the National Association of Mortgage Brokers; Mr. William A. Simpson, Chairman, Republic Mortgage Insurance Company, on behalf of the mortgage insurance companies of America; Mr. Michael D. Calhoun, President, Center for Responsible Lending; and Mr. Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America.

You can tell from this list, we have many witnesses today. Therefore, I will ask our witnesses to be especially mindful of the 5-minute time limit. Similarly, I will also ask members to please respect the 5-minute time limit during the question and answer period. While I know that we all have many issues we wish to explore, Chairman Bunning and I want to ensure that all members and witnesses have an opportunity to be heard. We will leave the record open so that members have an additional opportunity to ask questions for which they may not have time at the hearing. I thank all of you for your cooperation.

Chairman ALLARD. Now I will turn to the ranking member, Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Chairman Allard and Chairman Bunning, for holding this hearing.

Homeownership has provided Americans with an avenue toward prosperity. Consumer Federation of America reports that home equity comprises 50 to 60 percent of an average American household's net wealth; however, homeownership has become elusive for many

Americans. The Joint Center for Housing Studies at Harvard reported, in their words, “Affordability pressures are now spreading with median house prices in a growing number of large metropolitan areas exceeding median household incomes by a factor of four or more”, proving that with the cooling real estate market, home prices in my State of Rhode Island are expected to jump an additional 6.3 percent this year.

As housing affordability has weakened, the mortgage industry has made available to the average home buyer non-traditional mortgage products that were historically designed for the high net worth and financially-savvy borrower. Two of the most commonly utilized non-traditional mortgage products are interest only and payment option loans. According to First American Real Solution, IO and payment option loans comprised only 1.9 percent of the mortgage market in 2000, but represent 36.6 percent of the market by 2005.

These loans pose significant dangers to the sustainability of homeownership for many American households. A recent “Business Week” article reported that 80 percent of the borrowers are making the minimum payment on their payment option loans, eroding their home equity with every payment. At a time where pricing are leveling or even decline in many parts of the country, many borrowers with option adjustable rate mortgages, ARMS, may soon be left with few options. Borrowers with other non-traditional product also may soon be facing significant higher payments in the near future, leading Goldman Sachs to estimate that non-traditional mortgage products are at a, quote, very high risk of default.

In fact, foreclosure rates are escalating. Indeed, non-traditional mortgages default at a higher rate than fixed-rate mortgages. In Rhode Island, for example, default on prime ARMs are 21 percent higher than prime fixed-rate loans. Subprime ARMs have almost a forty percent higher default rate than fixed-rate loans. As a result, according to “Fitch Ratings 2006 Finance Outlook”, mortgage delinquencies which increased by 53 percent over the last year are expected to rise by an additional 10 to 15 percent in 2006.

The Federal banking regulators issued proposed guidance in December 2005 that attempts to address the potential for heightened risk levels associated with non-traditional mortgage lending and recommended practices for communicating with and providing information to consumers. Guidance in this area is necessary to be finalized promptly to ensure that lenders and financial institutions take responsibility for the long-term sustainability of the loans they originate and ultimately to ensure safety and soundness of our financial system and protect consumers.

I look forward to the witnesses’ testimony. Thank you, Mr. Chairman.

I will call on Chairman Bunning for his opening statement.

OPENING STATEMENT OF CHAIRMAN JIM BUNNING

Chairman BUNNING. Thank you, Chairman Allard.

Last week, we had a very good hearing on the state of the housing market. I think everybody knows there are reasons to be concerned about the coming months in locations that have seen dramatic price increases over the last few years. Just yesterday, it was announced that housing starts declined another 6 percent in August for a total a 26.5 percent since the peak in January.

Other indicators are continuing to show a slow-down as well. Hopefully, we are just seeing a pull back to a more reasonable growth level and not a crash.

This week, we are going to examine non-traditional mortgages and how they have contributed to the housing boom. We are also going to look into risks posed by the popularity of these products over the last few years. The two mortgage products, as has been said before, are interest only and payment option adjustable rate mortgage loans. Those products were relatively rare. As Senator Reed said, only 1.9 percent of the mortgages in 2000 had those types of rates. Last year, they accounted for over 35 percent.

These products were first used by wealthy and sophisticated borrowers as a cash-flow management tool, but today, they are being marketed as an affordability product to ordinary and even subprime borrowers. Early reports for this year showed even further increases in the share of non-traditional mortgages being written.

These product have some benefits for consumers, such as a low initial payment, the ability to purchase more expensive homes, and more flexible repayment terms. Even Former Fed Chairman Greenspan suggested borrowers should get an adjustable rate mortgage. That is quite a few years back, and that was before he started raising interest rates at the Fed.

There are significant risks that come with those benefits and it is not clear that borrowers understand those risks. The prime risk to borrowers has been described as payment shock, as Senator Allard said, as payments reset to a higher level. Most borrowers have not yet experienced significant payment shock, but experts believe over $2 trillion of these mortgages will reset in the next 2 years, and because of rising interest rates, those payment increases could easily total 100 percent by the fifth year of the loan.

Financial institutions are at risk also. In order to write more loans, lenders have relaxed their underwriting standards. This is troubling because of payment resets. If the borrower is unable to make those new payments, they will have to refinance, sell, or default. Due to higher interest rates and a slow-down in the housing market, many borrowers may wind up with negative equity in their homes. If lenders are forced to foreclose, they could end up owning properties that are worth less than the outstanding loan value.

While regulators have stated that banks have taken steps to reduce their risks, they have issued draft guidance to Federally regulated institutions on how to better reduce that risk. Further steps may be necessary by Federal and State regulators to ensure borrowers understand what they are getting into when they sign up for one of these mortgages.

The GAO report being released at this hearing highlights these concerns, and I thank them for their work to raise awareness.

Thank you again, Mr. Chairman. I have enjoyed working with you on this set of hearings, and I look forward to hearing from our many witnesses.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. First of all, I want to commend the Chairman Allard and Chairman Bunning, respectively the heads of our Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy, and Ranking Members Reed and Schumer for holding this second hearing to examine the housing markets and the economy. Last week, we have a very good hearing that focused on the overall housing market. Today's hearing is designed to explore the challenges posed by new and highly complex mortgage products.

It is obvious, of course, that the mortgage market that a borrower confronts today is vastly different from the market that existed even five or 6 years ago. In 2000, 85 percent of all mortgages were fixed-rate obligations. Borrowers generally understood these mortgages and the risks, generally speaking, were transparent.

Today, just 6 years later, nearly half of all loans are adjustable rates mortgages, 46 percent. Moreover, about 37 percent of all loans originated in 2005, last year, are what many now call exotic mortgages, either interest only loans or option ARMs where the borrower has the option to make a payment that is not sufficient to cover even the interest due. Such loans, of course, result in negative amortization.

Now, the regulators tell us, and I am pleased to join the chairman in welcoming the representatives of the various regulatory agencies to this panel, tell us that these exotic mortgages were designed as niche products for wealthier borrowers. As such, they may, perhaps, have been appropriate; however, over the past 3 years, lenders and mortgage brokers have been selling these more complex loans to middle class and lower income borrowers as affordability products. In other words, they are being used to enable borrowers to deal with steadily escalating housing prices.

These mortgages are characterized by significant payment shocks that hit borrowers some years into the term of the loan. In my view, these new products may be helpful in expanding consumer choices and creating opportunities to create homeownership, but I think this is true only if they are used very judiciously. The loans must be underwritten so as to reasonably ensure that borrowers can afford the payments over the life of the loan, not just during the introductory period. Loans where there are new exotic programs, or a more traditional mortgage for that matter, should be underwritten with this in mind.

Unfortunately, evidence seems to indicate that this careful approach has not been followed in recent years. Too often, according to what the regulators tell us, loans have been made without the careful consideration as to the long-term sustainability of the mortgage. Loans are being made without the lender documenting that the borrower will be able to afford the loan after the expected payment shock hits without depending on rising incomes or increased appreciation.

We are seeing the consequences of this. The cover story of *Business Week* September 11th says that more of a fifth of option ARM loans in 2004 and 2005 are upside down, more than a fifth, meaning borrowers' homes are worth less than their debt. If home prices drop another 10 percent, which the realtors expect to happen, that number will double.

An economic report by Merrill Lynch entitled “House of Horrors”, September 18th, indicates that problems are already beginning to surface as some of the early option ARMs are being reset. Merrill Lynch, citing data from “Realty Track” notes that foreclosures nationwide surged 53 percent year on year in August and spiked 24 percent month over month. They go on to say the culprit is the resets on option ARMs. The report also notes a high concentration of delinquencies among subprime ARM borrowers in States that have both hot and flat housing markets.

The guidance proposed by the regulators, which requires that lenders carefully and fully analyze a borrower’s ability to repay the loan by final maturity based on the fully indexed rate assuming a fully amortized repayment schedule, should help to curb some of the abuses we are seeing. I strongly support this guidance as an important first step to setting in proper perspective what I perceive to some troubling aspects of the mortgage industry. It is not the final step, but it is a good start.

I also support the provisions of the proposed guidance that will require lenders to monitor third-party originators, such as mortgage brokers, to ensure that the loans they originate meet the standards of the guidance and of the regulated entity. These third parties originate as many as 80 percent of the mortgage loans made in this country. If they are not held to the same standard as regulated retail lenders, if that standard is not effectively enforced, the rules will not result in better outcomes for borrowers.

Likewise, we need to urge the States and the regulators to act to adopt consistent rules for unregulated lenders if they expect progress to be made in this area. This is particularly true in the subprime market. According to the 2004 HMDA data, 58 percent, 58 percent, of first lien subprime loans were made by unregulated lenders. These are the borrowers that are especially vulnerable and we need to address their situation.

Mr. Chairman, this is an important problem that you are addressing, and I want to thank the chairmen, in the plural. I want to thank both Senator Allard and Senator Bunning for scheduling this hearing. Thank you very much.

Senator Carper, do you have an opening comment?

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Just very briefly.

A couple of my colleagues have already spoken to this. When I read my briefing materials, I saw the number 1.9 percent of mortgage market in 2000 was interest only and payment option loans. Then I saw that it jumped to over a third in six short years. I said that is a pretty good reason for holding the hearing and I am very glad that we are doing that.

I have to go to another hearing. I apologize to the witnesses. I thank you for coming today, and I especially want to welcome one whose mother lives in Wilmington, Delaware, only a few blocks from where my family now wells.

Sandra, welcome. I am glad to hear from you and all these people who you brought with you. Thank you.

STATEMENT OF ORICE WILLIAMS, DIRECTOR, GOVERNMENT ACCOUNTABILITY OFFICE

Ms. WILLIAMS. Chairman Allard, Chairman Bunning, and Subcommittee Members, I am pleased to be here this morning to discuss the finding of our just released report on alternative mortgage products. As you well know, these products can offer benefits from a flexibility and affordability perspective. They also can pose significant risks for some borrowers because of the potential for large increases in monthly payments or payment shock and features such as negative amortization.

This morning, I will briefly discuss the findings from our report, specifically, trends in alternative mortgage products, the risks these products can pose to borrowers and lenders, current disclosure practices, and the actions of Federal and State regulator. While alternative mortgage products have been around for decades, interest only and payment option ARMs have only become part of the mainstream real estate lending landscape in the past few years.

For example, in 2003, interest only and payment option ARMs comprised about 10 percent of mortgages originated. Today, that number is over 30 percent, and in certain parts of the country, particularly on the east and west coast, this number can be even higher. As housing prices have increased, so has the demand for mortgage products that can make the dream of home ownership more affordable even if only temporarily. While once marketed to the wealthy and financially sophisticated, these products are now being mass marketed to a wider range of potential borrowers.

This change in focus poses risks that lenders must manage. In addition to the products being more complex than traditional mortgage products, some lenders are layering on additional risks by combining alternative mortgage products with underwriting practices such as low or no documentation loan features. Although banking regulators expressed some concerns about underwriting standards, they told us that they generally believe that federally-regulated institutions have generally managed these risks well through portfolio diversification, selling or securitizing these loans, and holding an adequate level of capital.

For borrowers, these products raise concerns about the extent that current borrowers fully understand the risks they may face such as payment shock and negative amortization. Although these products pose risks, they can also provide many borrowers with flexibility that they would not have had with more conventional products. Moreover, for borrowers that understand the risks and are able to refinance, sell, or absorb the higher payments, these products can be beneficial; however, for other less savvy and less informed borrowers, the experience can be very different.

Alternative mortgage products illustrate the importance of adequate disclosures to help borrowers understand the product's terms and risks. To gain some insight into the disclosures borrowers receive, we reviewed a sample of alternative mortgage products disclosures used by some of the largest federally-regulated lenders in this market. What we found was both troubling and revealing. While we found that these lenders generally complied with the letter of the law and that they provided the federally-required disclosures, most did not fully or clearly discuss the risks and the terms of these products.

Federal and State regulators have been and are focusing attention on these developments in the real estate lending market. Specifically, Federal banking regulators are in the process of finalizing interagency guidance, and individually they have taken a variety of other steps aimed at ensuring that lenders are acting responsibly. Likewise, State regulators have begun to focus on alternative mortgage products.

In closing, I would like to thank you for your attention to this issue. While we found no evidence of widespread problems to date, it is too soon to tell what the future holds for these borrowers and much will depend on a variety of economic factors. Finally, we would like to stress the importance of the interagency guidance being finalized by the bank regulators and hope that it is issued in the future.

Mr. Chairman, this concludes my oral statement and I will be happy to answer any questions.

Chairman ALLARD. Thank you.

Ms. Kathryn Dick, Deputy Comptroller of Credit and Market Risk in the Office of the Comptroller of the Currency.

STATEMENT OF KATHRYN E. DICK, DEPUTY COMPTROLLER FOR CREDIT AND MARKET RISK, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. DICK. Chairman Allard, Ranking Member Reed, Members of the Subcommittees, I appreciate the opportunity to appear before you today to discuss non-traditional mortgage products and the proposed interagency guidance on those products.

Mr. Chairman, thanks in part to the highly competitive and highly innovative mortgage market, we have achieved near record levels of homeownership across our country. Our goal as Federal regulators is to preserve and expand upon this important accomplishment while avoiding unwarranted risks to financial institutions and consumers.

In recent years, a combination of market forces, especially the rapid increase in housing prices, has led to the increased popularity of so-called non-traditional mortgages. This category includes interest-only mortgages, where a borrower makes no payment on principal for the first several years of the loan, and payment-option adjustable-rate mortgages, where a borrower has several payment options each month, including one with a potential for negative amortization, which occurs when a certain portion of the interest due is deferred and added back to the principal balance of the loan.

In addition, many non-traditional mortgages are made under relaxed underwriting standards—with less stringent income and asset verification requirements, and sometimes in combination with simultaneous second mortgage loans to reduce down payment requirements, frequently so that borrowers can dispense with private mortgage insurance.

Non-traditional mortgages have gained a prominent place in the marketplace. According to one trade publication, 30 percent of all mortgages originated in 2005 were interest-only or payment-option

ARMs. In the highest-price housing markets, the number was even higher.

Yet despite their popularity, these loans pose special risks to borrowers and to lenders. Payment-option ARMs expose borrowers to the likelihood of payment shock, which occurs when the payment deferral period ends, usually after 5 years, and the loan resets to the market rate of interest. At that point, the borrower must amortize the entire amount outstanding over the shorter remaining term of the loan. In the example that was attached to my written testimony, which assumes a modest 2 percent rise in interest rates, the monthly payment would double.

In an active real estate market characterized by rapid home price appreciation, such a mortgage can be refinanced and paid off by extracting the increased equity from the appreciated property. But what happens if interest rates rise or home prices fall, or both?

Evidence shows that these risks are often not adequately disclosed and less well understood in the wider population to which these products are increasingly marketed. Marketing materials we have reviewed emphasize the initial low monthly payment and gloss over the likelihood of the much higher payments later on.

Increasingly, when borrowers opt for a payment-option ARM, they aren't thinking about how much their payment will be 5 years down the road and whether they will be able to make that payment—or what will happen if they can't. But they should be thinking about it and lenders should be thinking about it, too. It is that kind of thinking that our proposed interagency guidance on nontraditional mortgages is designed to stimulate.

It does this by directing financial institutions to ensure that loan terms and underwriting standards are consistent with prudent lending practices, with particular attention to the borrower's repayment capacity. It requires that when banks rely on reduced documentation, particularly unverified income, they do so with caution. It requires that banks adopt vigorous risk management practices that provide early warning systems on potential or increasing risks. And it requires that consumers are provided with timely, clear, and balanced information about the relative benefits and risks of these products, sufficiently early in the process to enable them to make informed decisions.

It may be useful to think of a payment-option ARM as the functional equivalent of a loan coupled with a separate home equity line of credit, except that, instead of using a check to draw down the line of credit, the borrower does so by choosing the minimum payment option. The real difference, for our purposes, is in the underwriting. Whereas an applicant for a home equity line has to show adequate income to service the entire amount of the line, no similar qualification requirement is imposed on the payment option borrower for the additional debt that could be incurred by electing to make only the minimum monthly payment, and the minimum monthly payment is what most borrowers make.

Under the proposed guidance, lenders would be required to conduct a credible underwriting analysis of the borrower's capacity to repay the entire debt, including the potential amount of negative amortization that the loan structure and initial terms permit.

Chairman ALLARD. Ms. Dick, I must ask you to wrap up your comments, if you would, please.

Ms. DICK. Very good.

Chairman ALLARD. Thank you.

Ms. DICK. In proposing this guidance, Mr. Chairman, we had two goals in mind: One, to ensure that non-traditional mortgage products and the risks associated with them are managed properly in our institutions, and, the other, to ensure that consumers are provided the information they need, when they need it, to make informed decisions about these products.

Chairman ALLARD. Okay. Ms. Sandra Braunstein, Director of the Division of Consumer and Community Affairs, Federal Reserve.

STATEMENT OF SANDRA BRAUNSTEIN, DIRECTOR OF THE DIVISION OF CONSUMER AND COMMUNITY AFFAIRS, FEDERAL RESERVE

Ms. BRAUNSTEIN. Thank you.

Chairman Allard, Chairman Bunning, Senator Reed and Members of the Subcommittees.

Chairman BUNNING. Thank you for pulling your mike up.

Ms. BRAUNSTEIN. I appreciate the opportunity to appear today to discuss consumer issues related to non-traditional or alternative mortgage products. These products have increased the range of financing options available to consumers and have grown in popularity over the past few years. Some consumers benefit from these products and the more flexible payment options, but these loan products are not appropriate for everyone. Thus it is important that consumer have the information necessary to understand the features and risks associated with these types of mortgages.

The Federal Reserve engages in a variety of activities to ensure that consumers understand credit terms and the options available to them when they are shopping for mortgage credit. We have a role as a rule writer in which the Board issues regulations implementing the Truth-in-Lending Act, or TILA, and its required disclosures. TILA is the primary Federal law governing disclosures for consumer credit, including home mortgage loans.

TILA requires the uniform disclosure of costs and other terms to consumers at various stages of the mortgage transaction. This allows consumers to compare more readily the available terms and avoid the uninformed use of credit. The disclosures required by TILA and its implementing Regulation Z are discussed in greater detail in my written testimony.

We recognize that required disclosures alone cannot address these complex issues. Thus we engage in complementary activities to ensure that consumers understand credit terms and the options available to them when they are shopping for mortgage credit. I would like to highlight five significant activities that we currently have underway.

First, we have begun a comprehensive review of the Board's Regulation Z which implements TILA. A review of Regulation Z specifically focuses on improving the format, content, and timing of consumer disclosures. In considering how to improve disclosures for alternative mortgage products, in addition to soliciting public comments and engaging in outreach, we will conduct extensive consumer testing. This testing will help us to determine what information is most important to consumers, when that information is most useful, what wording and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload.

Furthermore, in reviewing the disclosure requirements, we will be mindful that future products might differ substantially from those we see today. Thus any new disclosure requirements must be sufficiently flexible to allow creditors to provide meaningful disclosures even if these products evolve over time.

Second, the Federal Reserve and the other bank and thrift regulators issued draft interagency guidance on alternative mortgage products at the end of last year which is currently being finalized.

Third, in conjunction with our Regulation Z review, the Federal Reserve recently held four public hearings on home equity lending. A significant portion of these hearings was devoted to discussing consumer issues regarding non-traditional mortgage products. Lenders testified that when loans are prudently underwritten, consumers are able to benefit from the flexibility these products provide without being at risk of default. On the other hand, consumer advocates and State officials testified that aggressive marketing and the complexity of these products put borrowers at additional risk for obtaining mortgages that they do not understand and may not be able to afford.

Fourth, since 1987, the "Consumer Handbook on Adjustable Rate Mortgages", or the CHARM booklet as we refer to it, a product of the Federal Reserve and the Office of Thrift Supervision, has been required by Regulation Z to be distributed by all creditors to consumers with each application for an ARM. Board staff is currently working with OTS staff to update the CHARM booklet to include additional information about non-traditional mortgage products. This revised CHARM booklet will be published later this year.

And fifth, the Federal Reserve will soon publish a consumer education brochure on these mortgage products, and we are developing an interactive mortgage calculator for the Internet. These items are designed to assist consumers who are shopping for a mortgage loan.

In conclusion, the Federal Reserve is actively engaged in trying to ensure that consumers understand the terms and features of non-traditional mortgage products. Improving federally required disclosures under TILA is an important aspect of this endeavor, but we are also pursuing other opportunities, for example, through consumer education and by issuing industry guidance. We expect the Board will continue these efforts over time as mortgage products evolve in response to consumers' changing needs.

Thank you very much.

Chairman ALLARD. Ms. Sandra Thompson, Director of Supervision and Consumer Protection, Federal Deposit Insurance Corporation.

STATEMENT OF SANDRA THOMPSON, DIRECTOR OF THE DIVISION OF SUPERVISION AND CONSUMER PROTECTION, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. THOMPSON. Chairman Allard, Chairman Bunning, Senator Reed, and Members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding the growth in non-traditional mortgage products and the Federal agencies' draft guidance to address this issue.

Non-traditional mortgage products have existed for many years; however, they were primarily a niche product used by financially sophisticated borrowers as a cash-flow management tool. Since 2003, there has been a growing use of non-traditional mortgage loans among a wide range of borrowers. Non-traditional mortgage products have been especially popular in States with strong home price growth. With the surge in home prices, non-traditional mortgage products have been marketed as an affordable loan product. Some borrowers, often first-time home buyers, use these products to purchase higher-priced homes than they could have qualified for using more traditional mortgage loans.

Consumers can benefit from the wide variety of financial products available in the marketplace; however, non-traditional mortgage products can present significant risks to borrowers because the product terms are complex and can be confusing. The primary risk to borrowers is payment shock, which may occur when a non-traditional mortgage loan is recast and the monthly payment increases significantly, sometimes doubling or tripling. The risk grows as interest rates rise and as home appreciation slows. This is especially true in the case of payment option ARMs where the loan negatively amortizes, sometime to the point of exceeding the value of the property.

Because of the potential impact on their payments, it is critical that borrowers fully understand both the risks and the benefits of the mortgage products they are considering. Current disclosure requirements were not designed to address the characteristics of non-traditional mortgage products. Some borrowers do not receive information regarding the risks of non-traditional products early enough in the loan shopping process to allow them to fully compare available products. In addition, marketing materials for these loans often emphasize their benefit and downplay or omit the risks. Once the loan is made, some of the loan payment statements encourage borrowers to make the minimum payment by highlighting only that option.

Borrowers will clearly benefit from receiving information with their payment materials that explains the various payment choices as well as the impact of those choices such as payment increases or negative amortization.

Non-traditional mortgage loans pose risks to lenders as well. As these products have become more common, there have been indications that competition is eroding underwriting standards. For products that permit negative amortization, some lenders fail to include the full amount of credit that may be extended when analyzing a borrower's repayment capacity. In addition, there is growing evidence of non-traditional mortgage products being made to borrowers with little or no documentation to verify income sources or financial assets. In effect, some institutions are relying on assumptions and unverifiable information to analyze the borrower's repayment capacity.

Financial institutions that effectively manage these risks do so by employing sensible underwriting standards and strong management information systems. Other institutions are managing risk by securitizing their non-traditional mortgage originations and spreading the risks of these products to investors. In light of the growing popularity of non-traditional mortgage products to a wider spectrum of borrowers, the agencies have crafted guidance to convey our expectations about how financial institutions should effectively address the risks associated with these loan products. We have been reviewing the comments and are near completion on the final guidance.

In conclusion, the FDIC will continue to monitor insured institutions with significant exposures to non-traditional mortgage products, and we will ensure that FDIC-supervised institutions follow the final guidances when they are issued. The FDIC expects institution to maintain qualification standards that include a credible analysis of a borrower's capacity to repay the loan and they should provide borrowers with clear, understandable information when they are making mortgage products and payment decisions.

Thank you for the opportunity to testify, and I am happy to answer questions.

Chairman ALLARD. Thank you.

Mr. Scott Albinson, Managing Director for Examinations, Supervision, and Consumer Protection, Office of Thrift Supervision.

STATEMENT OF SCOTT ALBINSON, MANAGING DIRECTOR FOR EXAMINATIONS, SUPERVISION, AND CONSUMER PROTECTION, OFFICE OF THRIFT SUPERVISION

Mr. ALBINSON. Good morning, Chairman Allard, Chairman Bunning, Senator Reed, and Members of the Subcommittees. Thank you for your continued leadership on issues affecting the mortgage markets and the important topic of non-traditional mortgage products. We appreciate the opportunity to discuss the views of the Office of Thrift Supervision on alternative mortgage products and the risks these products may present to consumers, financial institutions, and other financial intermediaries.

Consistent with market development and the expansion of these products in the mortgage marketplace, OTS has implemented a comprehensive supervisory approach that focuses on credit, compliance, legal operational, reputational, and market risks associated with offering alternative mortgage products to consumers. We pay careful attention to underwriting practices, internal controls, portfolio and risk management, marketing, consumer disclosure, loan servicing, and mortgage banking activities. Our examination staff is well-trained to monitor and adjust to trends in mortgage markets to identify and ensure weaknesses in underwriting and risk management are promptly corrected and to mine consumer complaint information and to prevent or end abusive lending practices.

We updated and reissued detailed examiner guidance on mortgage lending activities and mortgage banking operations in June 2005 and made it publicly available. To augment our existing guidance and to provide further clarity to thrift institutions in the broader mortgage markets, OTS has been actively engaged and fully supports recent interagency efforts to finalize and issue joint guidance addressing the range of safety and soundness and consumer protection concerns with respect to offering these products.

I believe concerns regarding alternative mortgage products generally fall into two broad categories. One is consumer confusion as to how the products are structured and how they function, and two, that the products are being used as affordability tools to enable borrowers to become overextended on their debts. OTS and interagency initiatives on a variety of areas are designed to specifically address these areas of concern.

To address the first broad area of concern, the problem of potentially inadequate information and consumer understanding of the risks of alternative mortgage products, OTS is active on several fronts. Together with the Federal Reserve, we are diligently working on updating the Consumer Handbook on Adjustable Rate Mortgages, the CHARM booklet, a disclosure that is made available to all borrowers seeking an adjustable rate mortgage. We feel efforts to communicate with and educate the consumer concerning the features, benefits, and risks are particularly important.

We are steadfastly working on proposed guidance with the other agencies regarding supplemental consumer disclosures for alternative mortgage products that include recommended narrative descriptions of the products as well as sample illustrations for use by lenders. Our objective is to stimulate clear, balanced, and conspicuous disclosure of the benefits and risks of alternative mortgage products at the time the borrower is considering loan options, at settlement, and on monthly borrower statements indicating the effects of any negative amortization and other key aspects of the mortgage instrument.

On a simultaneous and parallel track, we are participating with the other agencies in drafting a consumer information booklet specifically addressing features of interest only and pay option ARM loans. Furthermore, OTS will continue its efforts to promote awareness and understanding of alternative mortgages among consumers in a variety of venues.

To address the second broad area of concern, that some products are being inappropriately used as affordability mechanisms to stretch borrowers beyond their means, OTS is focused on loan underwriting and risk management among thrift institutions. We expect thrift institutions to implement a prudentially sound system of underwriting policies, standards, and practices that include qualifying borrower at the fully indexed, fully amortizing amount for option ARM loans. This helps insulate borrowers from the potential for payment shock as well as curbs the ability of institutions to use alternative mortgage products as affordability products, ensuring borrowers have the ability and capacity to prepay the loan, including principal, at the outset.

Lastly, the requisite infrastructure to support lending activities must be present within thrift institutions, including robust risk management practices and management information and reporting systems to screen loans and monitor portfolio conditions and originations made through third parties.

Chairman ALLARD. Mr. Albinson, I must ask your to wrap up your testimony, please.

Mr. ALBINSON. Thank you.

The potential risks of alternative mortgage product have in the past and can in the future be appropriately managed by informed consumers and well-run institutions. We do not want to stifle innovation or unjustifiably restrict the flow of credit, especially during the current challenged housing market. Promptly addressing problems and poor risk management practices will ensure a steady flow of credit to deserving borrowers in the future.

Thank you.

Chairman ALLARD. Ms. Rotellini, you are next. You are with States. You are the Superintendent, Arizona Department of Financial Institutions, and you are here on behalf of the Conference of State Bank Supervisors.

STATEMENT OF FELECIA A. ROTELLINI, SUPERINTENDENT, ARIZONA DEPARTMENT OF FINANCIAL INSTITUTIONS

Ms. ROTELLINI. Yes, Mr. Chairman. Thank you.

Good morning to both Chairman Allard and to Chairman Bunning, Ranking Member Senator Reed, and to the Members of the Committee.

Like most of my State counterparts, in addition to supervising banks, I am also responsible for the regulation of State-licensed mortgage brokers and lenders. In fact, 49 States plus the District of Columbia currently provide regulatory oversight of the mortgage industry. Under State jurisdiction, there are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.

In recent years, CSBS has been working with the American Association of Residential Mortgage Regulators, known as ARMOR, of which I am a member of the board of directors, to improve State supervision of the mortgage industry. Regulation of the mortgage industry originated at the State level, and while the industry has changed dramatically, State supervisors maintain a predominant changing role. Because of the nature of the industry, effective supervision now requires an unprecedented level of State and Federal coordination.

State supervision of the residential mortgage industry is rapidly evolving to keep pace with the changes occurring in the marketplace. State standards for licensure are quickly improving and adapting. Through CSBS and ARMOR, the States are working together to improve coordination of State supervision as well as to provide best practices and more uniformity.

The residential mortgage industry has changed dramatically over the past two decades. The majority of residential mortgages are no longer originated in Federal- and State-regulated savings and loans, but by mortgage brokers and State-licensed lenders. Risk-based pricing has allowed more consumers than ever to qualify for home financing by trading a lower credit score or down payment for a higher rate.

Mortgage lenders have developed a number of products, including the non-traditional mortgage products that are the subject of today's hearing, that offer home buyers a wide and ever-expanding variety of loan choices. Increasingly, many of these products are quite complex, providing both opportunities and perils for consumers. The sophisticated nature of these products requires an elevated level of professionalism in mortgage originators and robust oversight of the companies and the people offering such products.

The increasing role that brokers play in the residential mortgage process, concerns about predatory lending, the explosion of product choices offered by the private sector, and the realignment of the Federal role in housing finance has required the States to develop new tools to protect consumers and to ensure that mortgage markets operate in a fair and level manner. It is within this context that my fellow State regulators and I find ourselves compelled to develop policies and initiatives that raise professionalism and increase coordination.

In order to do so, CSBS and ARMOR have created a residential mortgage licensing initiative designed to create uniform national mortgage broker and lender licensing applications in a centralized data base to house this information. The uniform applications will significantly streamline processing of licenses at the State level. The national data base will contain licensing information, final outcomes of enforcement actions, and background data for every State-licensed mortgage broker, mortgage lender, control person, branch location, and loan originator.

The CSBS–ARMOR residential mortgage licensing initiative is the cornerstone for a new generation of coordination, cooperation, and effective supervision in the State system. The changes in the mortgage industry over the past 20 years require this robust licensing system. Given the changes in mortgage products and the increased role of broker, CSBS believes it is in the regulators', consumers, and mortgage industry's best interest to move to the coordinated oversight the CSBS–ARMOR licensing system and data base will provide.

CSBS commends the Federal regulators for drafting guidance on non-traditional products. This guidance has done much to draw attention to the threats these products may pose to consumers, especially if the underwriting is done improperly or the consumer does not understand product. When the guidance is implemented, however, it will not apply to the majority of mortgage providers in the country. Therefore, CSBS and ARMOR are developing parallel model guidance for the State to apply to State-licensed residential brokers and lenders. The parallel guidance is intended to hold State-licensed mortgage brokers and lenders to effectively the same standards developed by the Federal regulators.

Finally, the States have proactively worked to increase the expertise and knowledge of our examiners. It is critical for our examiners to understand the function of the mortgage market and its various products. These examiners are the individuals who will see firsthand and who do see firsthand the practices of the industry and its impact on consumers and have the opportunity to counsel and advise these companies.

I commend the subcommittees for addressing this matter. On behalf of CSBS, I thank you for the opportunity to testify, and I look forward to any questions you may have.

Chairman ALLARD. We will now move into the question and response period. I am going to try to enforce the 5-minute rule, for the Member's benefit, very strictly. And my plan is I will have my 5 minutes. I should get down there to vote 5 minutes before the vote comes up. It is scheduled for 11:15. Then I will have Senator Bunning run the committee, and I will get back and other members can go vote whenever it is convenient for them.

Okay. To the Federal regulators, the question is what do you expect to issue the final guidance on non-traditional mortgage products?

Yes, Ms. Thompson.

Ms. THOMPSON. It is my understanding our principals met earlier this week and they are very close to finalizing it. I am hopeful that we will finalize it in the very near term.

Ms. DICK. I would just echo the comments of my colleague at the FDIC. My understanding is we will have the guidance issued in a matter of weeks, not months.

Chairman ALLARD. OK.

Senator SARBANES. How about the other two?

Chairman ALLARD. Federal regulators?

Ms. BRAUNSTEIN. I concur with what Ms. Dick said.

Mr. ALBINSON. I concur as well.

Chairman ALLARD. Nothing too specific for the committee. We were hoping for something more specific.

Consumer groups and others have questioned the extent to which guidance as opposed to a law or regulation can be enforced to truly protect consumers and bring about changes to non-traditional mortgage lending. What can Federal regulators do to ensure lenders follow guidance principles? I would like to have the regulators respond again.

Yes, Ms. Thompson.

Ms. THOMPSON. Our institutions are used to guidance because that establishes what the regulators' expectation are. When our examiners go in to examine for safety and soundness or consumer protection issues, guidance has been very effective over the years in providing a specific road map as to what we are going to examine these institutions for.

With regard to non-traditional mortgage loans and the guidance that will be issued, we will certainly issue examiner guidance that will be distributed to our institutions so that they have a very clear expectation of what we are looking for in our examination process.

Chairman ALLARD. So we are putting discretion in the examiner in your case. We feel certain that the examiner will treat these guidance principles almost as a regulation. Is that right?

Ms. THOMPSON. Well, these guidance procedures are used to establish what our expectations are, and we do have regulations that they have to adhere to, but it is very useful for the examiners and the institutions to quickly understand what our expectations are in this area.

Chairman ALLARD. Others regulators?

Ms. BRAUNSTEIN. Yes. We think guidance can be a very effective starting place for having conversations on examinations about these issues. It is there, as Ms. Thompson said, to give some guidance, some direction to the financial institutions, and also to our examiners, in addition to the examiner guidance that we will develop. And that it is a very good place for us to have conversations about these issues and to see what the institutions are doing.

Chairman ALLARD. Ms. Dick.

Ms. DICK. I would supplement the comments of my colleagues by first echoing the fact that at the OCC, we also use guidance to make our supervisory expectations very clear. However, certainly, if we have a situation where we believe abusive practices are taking place with respect to consumer lending, we do have a full menu of regulations and, laws that we can bring into play. An arsenal, if you will, to take forward an enforcement action. So we have safety and soundness standards and other directives, regulations, and laws that we can use to carry things forward in an enforcement capacity, if necessary.

Chairman ALLARD. Mr. Albinson.

Mr. ALBINSON. I would agree with everything my colleagues have said. The guidance establishes a baseline of supervisory expectations. We have a very intensive supervisory process that includes annual on site examinations at thrift institutions. Our examiners by virtue of that on-site examination process get to see a wide range of practice, and over time, as you might expect, the markets innovate. They evolve as well as institutions. Risk management practices evolve, and the examiners can take that and communicate the range of practice they see as well as leading and best practices within institutions.

We also have internal processes within our organizations to be able to receive that data and assimilate it within the organization and update our examination guidance and the other supporting infrastructure that exists behind the guidance that we will issue on an interagency basis.

Chairman ALLARD. The way I understand guidance, it is a warning, that you are concerned about certain practices and whatnot. If they don't follow the guidance, the industry meets certain thresholds and it could be looking at rules and regulations, basically. Is that the approach? Where is that threshold?

Mr. ALBINSON. I think it would depend on the individual institutions as to what—we look in a holistic fashion at the risk management practices.

Chairman ALLARD. Yes, but a rule and regulation is for all the institutions under your purview. So I don't hear a threshold number. I think you need to think a little bit about that. I don't expect anybody can answer that.

My time has run out, but I do think you need to think about where that threshold is and what is going to create that threshold.

I will yield to Senator Reed, and Chairman Bunning will now run the committee.

Senator REED. Well, thank you very much, Chairman Allard.

First let me thank Ms. Williams for the GAO report, which is very insightful, and then ask the regulators each a general question. To what extent are these loans securitized to a secondary market so they are not getting held by the financial institutions, in a way mitigating the risk? Ms. Dick, do you have an idea?

Ms. DICK. Actually, my understanding is a large number of the non-traditional mortgages are, in fact, delivered into the securitization market. Much of that takes place through what we call private label securitizations, which are packages put together by investment firms and other dealers.

Senator REED. So, in effect, in this case, the bank, the financial institution, regulating institution, is taken out of the risk as soon as they sell into the secondary market. Is that accurate?

Ms. DICK. The securitization market is used, really, as a liquidity vehicle for large financial institutions to sell assets and provide additional credit. There are risks that are retained by financial institutions that securitize assets.

Senator REED. Right. Sometimes they have these puts. People can put back the security.

Ms. DICK. Reps and warranties, exactly, as well as reputational risk associated with it. A borrower generally is going to remember who they got the loan from, not the fact that that loan has been sold into a secondary market.

Senator REED. Right. And you are also looking systemically at these reserve risks that the institutions might hold even if they securitize?

Ms. DICK. Absolutely.

Senator REED. Ms. Braunstein, can you comment on that same question?

Ms. BRAUNSTEIN. I concur with what Ms. Dick said. We don't have data on how much of it is going into the secondary marks, but our understanding is that a large part of it is.

Senator REED. Ms. Thompson.

Ms. THOMPSON. Yes. We do know that some of these institutions are securitizing the mortgages, which means that the loans are off the books and that they are placed into the securities and then sold to investors. So the risk is dispersed.

We are also concerned about the amount of these types of securitizations that banks hold. It hasn't been that much, but this is something that we are looking at.

Senator REED. The other side is they are actually buying into these pools of securitized mortgages.

Ms. THOMPSON. They have the ability to, yes, sir.

Senator REED. And you are going to pay attention to that?

Ms. THOMPSON. Absolutely.

Senator REED. Thank you.

Mr. Albinson.

Mr. ALBINSON. Likewise, we not only look at purchases of tranches of CMO instruments that our institutions may put into their portfolios, but we also look for those that do securitize, at their retained risks, and we do have rules, specific rules, requiring a careful analysis by the institution, including an analysis of the capital adequacy and support needed behind that retained risk; and, of course, as Ms. Dick indicated, the reputational risk is not insignificant for these institutions too.

Senator REED. Thank you.

Ms. Rotellini, from the perspective of a State regulator, do you have more of a problem with State institutions holding these themselves? Is that something or can you comment upon this line of questioning?

Ms. ROTELLINI. Senator Reed, most of our mortgage brokers would not be holding onto them. The mortgage lenders, many of them are using wholesale lines and do not hold onto those mortgages either.

Senator REED. Very good.

You have issued at least preliminary guidance and you are finalizing it. There are, I think, several areas which are critical, if you want to quickly each comment upon it. How do you treat negative amortization, reduced documentation, and then the layering of the secondary loans or special sort of combinations of lending, risk layering in general? And Ms. Dick, again, if we could go just go down. What is your advice right now, even though it is not is formalized, to institutions about these factors?

Ms. DICK. With respect to the negative amortization, we have tried to make clear that the standard in the industry needs to be changed such that the economic equivalent of a line of credit is included in the analysis that is done at underwriting, so the borrower understands the full amount of the debt they will owe and the borrower's repayment capacity is analyzed by the financial institution.

Reduced documentation loans, again, introduce an element of risk to the financial institutions. We have provided our supervisory expectations in the guidance and want to make sure that the regulated institutions use strategies such as reduced documentation in underwriting in a very clear and thoughtful manner.

As to the layering of risk, that is a practice that we are very concerned about, and certainly one that is associated with some of these non-traditional mortgages, because it reduces, potentially eliminates, the amount of equity a borrower has in their home. We don't do anyone any favors—not banks, not consumers, not our communities—if we have situations where 5 years down the line, there is no equity left in the home and the borrower has excessive payments.

Senator REED. Well, my time has expired, and I would ask for a nod of the head if you agree with Ms. Dick's comment.

I would note one other point, Ms. Thompson, is we are lucky in our office to have Ken Kilber, your colleague as a fellow. Thank you for that.

Thank you.

Chairman BUNNING. Thank you, Senator Reed. I am going to ask my questions for 5 minutes and then yield to my colleague, the ranking member of the full committee.

It seems to me there has been a race to the bottom with underwriting standards for non-traditional mortgages over the last few years. Lenders have granted larger loans to borrowers who are less able to afford them and based on less documentation. I would like to ask each of you to answer this question quickly, if you can.

Over the past two or 3 years, have lenders used adequate underwriting standards or did they get so loose with their money that significant numbers of borrowers are going to default unless they can refinance or sell in the current climate, rising interest rates, less equity in their homes?

Ms. BRAUNSTEIN. I can start and just say that at this point in time, we have not seen any specific signs that lead us to conclude that there will be huge numbers of defaults. Of course, a number of these loans still have not recast, and we will be watching very carefully in the next few years as they recast to see what happens.

Chairman BUNNING.

Ms. THOMPSON. I would say that we have been looking at some of the more vintage loans that have been originated in 2004 and 2005, because this is when the payment option and interest only ARMs were prevalent in the market, and we have noticed that some of these loans are becoming more delinquent than the traditional mortgage loans. Even though the payments haven't reset and we don't have a real good understanding yet, we have noticed an increase.

Chairman BUNNING. Some of the ARMs have not reached their expiration?

Ms. THOMPSON. That is exactly right, but we have noticed an increase in the delinquencies, very slight, in the loans that were originated in 2004 and 2005, and we are keeping our eye on them.

Chairman BUNNING. Ms. Dick, do you have anything to add to that?

Ms. DICK. We have a process at the OCC of looking at underwriting standards more generally, and, certainly in the last few years, we have been seeing an easing in underwriting standards. Part of the responsibility of our examiners, then, is to go in on a case-by-case basis at the large lenders and look at how those underwriting standards have evolved and whether or not there are any supervisory concerns.

Chairman BUNNING. With interest rates rising as they have in 17 out of the last 18 meetings of the FOMC and ARMs not reaching their maturity yet, the three- to five-year ARM in most of the mortgages, you wouldn't possibly see a great acceleration, but what happens when it hits? That is what I am interested in. What happens when the interest only and the ARMs hit and borrowers have to ante up and they don't enough equity and they surely weren't anticipating the huge increase in the interest rate of the original loan?

Ms. DICK. Chairman Bunning, I would just say, from our standpoint, that is exactly why we issued this guidance and are working diligently to get it in final form. Right now, this is a very small part of the mortgage market, but it clearly has been the area that has been growing.

Chairman BUNNING. Mr. Albinson.

Mr. ALBINSON. I concur with my colleagues. The numbers as far as delinquencies and defaults for this product are rather low even compared to fixed-rate 30-year amortizing mortgages at this point in time, but one would expect that. These loans are relatively unseasoned. They have been originated in 2004 and 2005, and when you look at those cohorts and begin to plot them out on a graph, the trajectory is a little bit higher than other cohorts or other vintages that we have looked at.

The question will be based on a combination of factors as these loans begin to recast in the coming years. It will be partly dependant on where interest rates are as well as macroeconomics factors, employment statistics, and real estate values, of course, as well.

Senator BUNNING. I have a question for the Federal Reserve. Ms. Braunstein, in your testimony, you indicated the Fed is going to update the Truth-in-Lending Disclosure Regulation Z to address newer non-traditional mortgages once you have complete revision for credit cards. If I am correct, that process started in December of 2004 and is still not done. Can you give us a realistic expectation when the Fed is going to act on these mortgages?

Ms. BRAUNSTEIN. Well, we have already started the process, Senator Bunning.

Senator BUNNING. I know you have started, in 2004, but when are you going to finish?

Ms. BRAUNSTEIN. I don't have an exact date for you, but I can tell you that it is a very time-consuming process. First of all, when TILA was issued and passed by the Congress, these kind of products were not envisioned, and we did choose some years ago to add disclosures for adjustable rate mortgages. We are looking at those in light of today's marketplace, and one of the big things that we have to do with these is to try to minimize burden to the industry, while at the same time making sure that new disclosures are effective for consumers, because the worst thing we could do is to issue something that is not useful.

So in order to feel comfortable we are doing that, we are engaging in pretty extensive consumer testing in focus groups to make sure that what we actually issue, consumers understand and can digest and utilize.

Senator BUNNING. We surely don't want to hurt the consumer with a regulation that is after the fact.

Ms. BRAUNSTEIN. No. I understand that. It is a lengthy process, and that is one of the reasons why we are doing some other things. Issuing the new CHARM booklet is part of the TILA review. That is required by Regulation Z, and that will be out before the end of year.

Senator BUNNING. And?

Ms. BRAUNSTEIN. We also held hearings on these, as I mentioned, this summer and have gathered that information. I don't have an exact date for you.

Senator BUNNING. Thank you very much.

Ms. ROTELLINI. Chairman Bunning, may I respond to those questions as well from the State's perspective?

Senator BUNNING. Yes, but I want to make sure that my colleague from Maryland gets his time in too.

Ms. ROTELLINI. First, with respect to the scenario you described, the States are very concerned that default will increase and that the train has left the station with respect to many of the types of loan that are on the books right now.

Secondly, with respect to State regulation, there are many States, including Arizona, that have prohibitions on the books right now that State-licensed brokers and lenders cannot misrepresent, cannot engage in deceptive practices, and State-licensed brokers and lenders are subject to State consumer laws, and those laws have been enforced in the past in situations such as Ameriquest and Household where the State Attorney Generals and regulators have looked at these very types of non-disclosures.

Senator BUNNING. Senator Sarbanes, go right ahead.

Senator SARBANES. Thank you very much. I am going to put one question to the regulators, and then I am going to have to depart for the vote, but I do want to thank you all for your testimony and also that of the second panel.

In looking through the proposed guidance as well as the witness' testimony from the second panel this morning and the background material, it seems to me that the very fundamental issue here is that each lender must ensure that a borrower has the ability to repay the mortgage when it first underwrites the loan at the fully indexed rate assuming a fully amortizing repayment schedule. In other words, you have to look at the process and ensure its sustainability.

This is important to maintain safe and sound operations at the financial institutions, although someone noted they are selling these things off, and it is important for the borrowers that their ability to repay the mortgage and keep their home should not turn on what amounts to a throw of the dice. If we do finalize this guidance, in particular requirements to establish the ability of the borrowers to fully repay the mortgages, we are in effect inviting lenders and mortgage brokers to make collateral-based loans, a practice which the guidance calls unsafe and unsound.

In fact, let me quote from Ms. Dick's testimony here this morning, quote: Underwriting standards that do not include a credible analysis of a borrower's capacity to repay their entire debt violate a principle of sound lending and elevate risks to both the lender and the borrower, end of the quote.

I want to ask each of you, therefore, if you agree that it is essential to move forward with a provision of the guidance requiring lenders to establish a borrower's long-term ability to pay the mortgage. Ms. Dick, why don't we start with you and come right across, and if you can give succinct answers, it would be helpful in this circumstance.

Ms. DICK. Yes, Senator Sarbanes, I agree with your statement. It is important both for the borrower and the financial institution that the repayment capacity be considered based on the full amount that that borrower will be expected to repay.

Senator SARBANES. Ms. Braunstein.

Ms. BRAUNSTEIN. Yes. I concur with that also, and say that that is a critical part of the guidance, but other things in the guidance are also critical and it is important to move forward with the guidance in general.

Senator SARBANES. I didn't mean to suggest they weren't. I was just focusing on that.

Ms. Thompson.

Ms. THOMPSON. Yes, Senator. That is a critical part of the guidance, to qualify the borrower at the fully indexed rate and at a fully amortized payment schedule. We want borrowers to not only get their homes, we want them to stay there.

Senator SARBANES. Mr. Albinson.

Mr. ALBINSON. Yes. I concur with the prior statements of my colleagues. That is a critical component of the guidance.

Senator SARBANES. And, Ms. Rotellini, you are not a Federal regulator, but I am told or we have reports that you are a very good State regulator. What is your view on this issue?

Ms. ROTELLINI. Thank you, Senator Sarbanes. The States are looking at this guidance and wanting to continue to make the playing field and the markets level, and we too are considering the same guidance and issuing something similar.

Senator SARBANES. I have a quick moment here. I am going to pop another question. Thank you all for that answer.

The issue has been raised regarding the fact that the proposed guidance applies to federally regulated institutions only, obviously. Many have pointed out there are many lenders and other originators who are not federally regulated, particularly in the subprime market. So let me ask the regulators if they agree that the proposed guidance will be more effective if the States adopt similar rules.

We will go right across.

Ms. DICK. Again, I agree with that statement. We applaud the efforts of the CSBS in attempting to do exactly that, take the principles of this guidance and make them into something that the States can use as well.

Senator SARBANES. Ms. Braunstein.

Ms. BRAUNSTEIN. Yes. I concur and would just add that our data shows that even though it won't cover all regulators in terms of dollar amount, it will cover about 70 percent of the market.

Ms. THOMPSON. Yes, Senator, and you know we work very closely with the State regulators in our examination program.

Senator SARBANES. Mr. Albinson.

Mr. ALBINSON. Yes. We welcome CSBS's participation in this effort and continuing enforcement of the principles that are ultimately espoused in the final guidance.

Senator SARBANES. And, Ms. Rotellini, what is your view about the States upgrading the standard to jibe with the Federal standards in this area?

Ms. ROTELLINI. Senator, the States are doing that. They are committed to professionalism and ethics and a lending community under State regulation that considers the borrower's repayment ability as well as all of the other concerns about disclosure.

Senator SARBANES. Well, I thank the panel very much.

Thank you.

Chairman ALLARD. Thank you, Senator Sarbanes, and I want to also thank the panel. I know it is not always easy to get away from your jobs to testify, but it is important to support the issue. Thank you for taking the time to be here.

We will go now to panel two: Mr. Robert Broeksmit, when you are ready, we will proceed, Chairman of the Residential Board of Governors, Mortgage Bankers Association.

We are sticking to the 5-minute rule, gentlemen.

STATEMENT OF ROBERT BROEKSMIT, CHAIRMAN OF THE RESIDENTIAL BOARD OF GOVERNORS, MORTGAGE BANKERS ASSOCIATION

Mr. BROEKSMIT. Thank you, Chairman Allard and Members of the Committee. My name is Robert Broeksmit. I am the President and Chief Operating Officer of B.F. Saul Mortgage Company, a subsidiary of Chevy Chase Bank in Bethesda, Maryland. I also serve as the Chairman of the Mortgage Bankers Association's Residential Board of Governors and I am pleased to be here today on their behalf, testifying before you.

The term “non-traditional mortgage products” encompasses a variety of financing options developed by the industry to increase the ability of borrowers to manage their own money and wealth. Borrowers have used these products to tap their home’s increased equity to meet an array of needs ranging from education to health care to home improvement and to purchase homes in markets where home prices have quickly appreciated.

While these products have often been characterized as new, many of them actually predate long-term fixed-rate mortgages. The market’s success in making these products available is a positive development, although these products have been used to finance a relatively small portion of the Nation’s housing, they offer useful choices for borrowers who can benefit from them.

As with all mortgage products, they must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. It is equally important that lenders provide consumers with adequate explanations of the loans and their terms so that borrowers can make an informed choice about whether these products match their needs.

I would like to put the market’s use of non-traditional products into perspective. More than a third of homeowners, approximately 34 percent, own their homes free and clear. Of the 66 percent of remaining homeowners, three-quarters have fixed-rate mortgages and only one-quarter, or 16 and a half percent, have adjustable rate mortgages. Many of the borrowers with adjustable rate loans have jumbo loans and many have extended fixed-rate periods, such as five, seven, and 10/1 ARMs.

You know, it wasn’t all that long ago that our industry was addressing concerns about the availability of credit to all borrowers. It seems we are victims of our own success to a degree as the discussion now concerns whether some of the many credit options available to borrowers are appropriate for them. Some have even suggested that the industry should take on an undefined responsibility to determine the suitability of products for particularly borrowers, a very difficult and dangerous undertaking at best.

We as lenders know how to determine a borrower’s eligibility for a loan. Limiting choices to borrowers we would deem eligible but not suitable would not serve borrowers well, would increase lenders’ liability, and would raise all borrowers’ costs. Lenders have successfully offered these products for decades and should continue to do so.

MBA and our members strongly believe that sound underwriting, risk management, and consumer information are essential for the public interest. It is equally critical to assure a regulatory environment that encourages rather than hinders innovation in the industry. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain, and, as needed, draw equity from their homes to meet their financial needs. While expectations should be articulated, the details need not be proscribed, and any requirements in this area must balance all of these imperatives to truly serve the public interest.

I can assure you the marketplace still works. Mortgage lenders want to lend money to those borrowers who are willing and able to pay the loan back. When a homeowner goes to foreclosure, everybody loses: The consumer, the community, the lender, and the investor. We all win when the right loan keeps a family in its home.

The mortgage market works and the data demonstrate that fact. The market is serving more borrowers who are benefiting today from unparalleled choices and competition, resulting in lower prices and greater opportunities than ever before to build the wealth and well-being that homeownership brings to their families and communities. The market must be permitted to continue to do so. Any consideration of new requirements in this area must be judicious and any requirements very carefully conceived.

We must also do our best to assure that borrowers fully understand and can take advantage of the choices available to them.

MBA stands ready to work with you on this important topic, and I look forward to answering your questions.

Chairman ALLARD. Mr. Hanzimanolis, you are next. You are NAMB President-Elect and with Bankers First Mortgage, Incorporated.

STATEMENT OF GEORGE HANZIMANOLIS, NAMB PRESIDENT-ELECT, BANKERS FIRST MORTGAGE, INC.

Mr. HANZIMANOLIS. Good morning, Chairman Allard. I am George Hanzimanolis, President-Elect of the National Association of Mortgage Brokers. I commend the subcommittees for holding this important hearing to address the concerns and practices relating to non-traditional mortgage products. Thank you for inviting us here today.

As you just heard from the first panel, approximately 85 percent of mortgage loans are brokered loans. With respect to the topic, there are a few critical points I would like to make.

Today, non-traditional mortgage products can be effective financing tools, affording consumers the flexibility to invest, manage their wealth, and manage uneven income flows. We appreciate the concerns raised by this topic, such as risk layering and borrower knowledge, and welcome the opportunity to discuss and comment on these issues.

Next, all mortgage originators should be knowledgeable about the benefits and the risks of the products they offer. Our lending industry has experienced significant growth, expanding product choice and distribution channels, adding robust competition, and great pricing options. In order for originators to keep pace with this growth, every originator should complete both pre-employment and continuing education requirements. We must also ensure that all the originators submit to a criminal background check so that bad actors are not able to move freely from one distribution channel to another.

In support of this effort, NAMB has urged the States to implement minimum standards that call for licensing and education requirements for all mortgage originators. NAMB has taken steps to develop education courses for mortgage originators that focus solely on non-traditional mortgage products.

While these initiatives have been largely successful in increasing professional standards for mortgage brokers, they have not increased standards for officers of banks and lenders who continue to be exempt from any State licensing and consumer protection laws, which brings me to an important point. Consumers don't know the difference between a broker, a bank, or a lender, or even a depository institution. When it comes to originating a mortgage, there is little difference between them. The large majority of loans today can be considered brokered loans, which includes brokers, correspondent lenders, and any lender that does not service a loan for a period longer than 3 months. In the end, they are all competing distribution channels, which means one channel should not be exempt from these important standards.

Second is financial literacy. Regardless of how knowledgeable a mortgage originator is or becomes, educated consumers are always in a better position to make informed decisions when choosing a loan. NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school level so that consumers are educated about the financial decisions they make and retain the decisionmaking ability throughout their life. The consumer, not the government and not the mortgage originator, is the best decisionmaker.

The role of the consumer is to acquire the financial acumen needed to take advantage of the competitive marketplace. Shop, compare, ask questions, and expect answers. Consumer demand has driven the use of these loan products. These products can be an effective and useful financing tool that affords consumers flexibility; however, as with any loan, there is risk involved for both the consumer and the market.

As a decisionmaker, the consumer decides where risk is appropriate and when it is not. Just as a mortgage originator cannot forecast the future or cannot anticipate when the Federal Reserve Board will raise interest rates 17 times, the mortgage originator cannot decide for the consumer what loan product is best.

Third, to facilitate meaningful comparison shopping, disclosures should impart information that is useful and does not otherwise mislead or deceive the consumer. NAMB supports clear and concise consumer-tested disclosures that are accurate and uniform across all distribution channels. We look forward to working with the Federal Reserve Board to re-evaluate the current disclosure scheme to make it more useful for consumers, especially for non-traditional mortgage products.

Last, it is also important that the government enforce existing laws to effectively eliminate deceptive or misleading marketing practices and communications with consumers with respect to any loan product type, traditional or non-traditional. We must protect the consumer choice by maintaining a competitive marketplace. We should not ban products from the market. Rather, it should be left to market forces, simple supply and demand, to determine the utility and longevity of any loan product.

Again, thank you for the opportunity to appear before this joint subcommittee today to discuss this timely issue, and I am happy to answer any questions you may have.

Chairman ALLARD. Thank you.

Mr. Simpson, you are Chairman, Republic Mortgage Insurance Company.

STATEMENT OF WILLIAM SIMPSON, CHAIRMAN, REPUBLIC MORTGAGE INSURANCE COMPANY

Mr. SIMPSON. Yes, and I am currently serving as Vice President of the Mortgage Insurance Companies of America, and we are pleased to be here today. Thank you.

Chairman ALLARD. It is good to have you.

Mr. SIMPSON. Let me start by first asserting that mortgage insurers play an important role in the home mortgage market. We cover the first tier of loss on defaulted home mortgage loans for lenders and investors such as Fannie Mae and Freddie Mac. Because of the high capital requirements and stringent regulation imposed on mortgage insurers, the industry is well-positioned to take on this risk.

Currently, the members of MICA have $635 billion of insurance in force and approximately $17 billion in capital. Since the industry was founded in 1957, we have helped over 25 million families become homeowners usually when they could not otherwise afford a 20 percent down payment.

We take a conservative view of mortgage risk because of our first-loss exposure and because of our unique historical perspective. We were there when some regional markets in this country were in chaos during the mid-1980's and early 1990's and we covered losses for mortgage investors, paying out approximately $15 billion in claims.

Data that we have on the size characteristics and rate of growth in the non-traditional market while somewhat sparse is also alarming. For example, one industry publication recently estimated that in the first half of 2006, non-traditional mortgages represented 37 percent of all home mortgage originations, up from being almost nonexistent a few years ago.

Second, the FDIC estimated in its testimony last week that interest only mortgages and option ARMs together made up as 40 to 50 percent of all loans securitized by private issuers of mortgage-backed securities during 2004 and 2005. SMR, a private research firm, found that piggy-back mortgages comprise 48 percent of all purchase money mortgages originated in the first half of 2005 and that 38 percent of those loans had a combined loan-to-value ratio in excess of 95 percent. By piggy-back mortgage, we are referring to a structure where a first mortgage is usually made at about 80 percent of the value of the property and then a 10 percent, up to a 20 percent, second mortgage is made on top of the first.

One that should cause concern for the mortgage industry and policymakers is the combination of the size of the non-traditional mortgage market and the concentrated positions taken on these loans by some lenders such as the banks with holdings of piggy-back seconds and/or option ARMs. Introducing the inherent risk of non-traditional mortgages into a soft housing market could be a recipe for another housing debacle as occurred in the eighties and early nineties. Certainly, concentrations should be avoided in lieu of such a scenario.

Having witnessed these cross currents of risky mortgage instruments coupled with a retracting housing market, MICA supports the work being done by the bank regulatory agencies to set prudential standards for non-traditional mortgages. We urge that these standards be finalized quickly and that they be backed by effective enforcement. We also hope that the FTC acts quickly to issue rules comparable to the banking agencies to ensure that all mortgage originators are required to operate under similar standards and thereby leveling the playing field.

In addition, MICA supports the standards the banking agencies are setting for consumer disclosures. Vulnerable consumers may not know the real terms of their increasingly complex mortgage loans. This fact can lead to foreclosures which not only displace families and damage their credit, but also result in blighted neighborhoods with the foreclosed homes for sale.

Mortgage insurers will continue to play the same role in the non-traditional market they have always played in the overall mortgage market. We are a highly capitalized, well-regulated intermediary who balances the interests of the lenders and borrowers. Mortgage insurers with capital at risk will continue to insert a critical underwriting discipline into many mortgage lending decisions, providing a safeguard against excessive foreclosures and evictions of sometimes innocent homeowners.

Thank you for listening to our views, and I will be happy to answer any questions.

Chairman ALLARD. Thank you.

Mr. Calhoun, President, Center for Responsible Lending.

STATEMENT OF MICHAEL CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Thank you, Chairman Allard, and thank you also, Chairman Bunning, for holding this hearing and allowing us to testify.

I appear on behalf of the Center for Responsible Lending, which is a non-profit, non-partisan research and public policy center dedicated to supporting responsible lending and preventing predatory lending. We are an affiliate of Self-Help, which is a community development lender which has provided over $5 billion for first-time home financing to Americans across the country. We operate presently in 48 States.

We do this lending because homeownership has been the traditional ladder to the middle class for Americans. We are concerned, though, that the development of many of these non-traditional mortgages has created a trap door to financial ruin for these families.

Much of the discussion about non-traditional mortgages is focused on the prime market; however, today in the subprime market, which is nearly one-fourth of the overall mortgage market, the dominant product in that market is the non-traditional product, and it will inflict, in our view, far more harm than the other types of non-traditional mortgages that you have heard about today. These so-called subprime hybrid ARMs with low teaser rates are the leading product in the subprime market, and that is where I will direct my testimony today. I am going to first describe the nature of this product, then the impact that we see in the market and on the borrowers, and then add our policy recommendations.

A subprime hybrid ARM has an initial short fixed-rate period. The typical one is 2 years, and then the remaining 30 years of the mortgage, it is an adjustable rate. So they are often called 2–28 mortgages. The key factor is that the initial payment is set far below the fully indexed payment. To give you an example of what typical rates would be in the market today, the initial payment would be based on an interest rate of maybe seven and a half or 8 percent; however, after the end of that initial 2-year fixed-rate period, the fully adjusted rate would be in the range of 11 and a half to 12 percent even with interest rates remaining the same, the market rates remaining the same.

This produces a payment shock typically of 40 to 50 percent for the borrower, and perhaps it is most dramatic that even if you take a very favorable scenario, if interest rates are reduced, market rates, by 200 basis points, these borrowers still would typically face a 20 to 25 percent payment shock.

I would think the testimony today is that one of the common themes of the risk of the non-traditional mortgage has been payment shock and how most families are very ill-equipped to handle that. In the subprime market, this payment shock is exacerbated by several factors. First of all, the underwriting on these loans is done at a very high debt ratio, up to 50 to 55 percent, which means that that mortgage payment can be 50 to 55 percent the total debt of the borrowers, 50 to 55 percent of the borrowers' gross income, before tax income.

Second, the standard underwriting practice in the subprime market is to underwrite only to the initial payment. So they allow the initial payment to be 50 or 55 percent of the borrowers' income. When you had add a payment shock of 20 or 40 percent, you end up with loans where the mortgage burden is more than the borrowers' take-home pay.

Third, in the subprime market, the practice is in the majority of the loans not to escrow for insurance and taxes, and the reason for that is it is a way to artificially depress that monthly payment, make it look lower, but you leave another financial shock out there for these borrowers.

The impact of this is that many borrowers are threatened with losing their homes, and this impact is especially felt in minority communities. Recent HMDA data showed that the majority of African Americans have high interest subprime loans. More than a third of Hispanic borrowers have high interest subprime loans.

My time is running out. So let me give you very quickly our policy recommendations. First, we support the guidelines of the joint agencies. We would emphasize in the subprime market, nearly 60 percent of these are originated by non-regulated entities. There is already underway, though, the means to cover those entities. Both the FTC and the Federal Reserve held hearings this summer to address non-traditional mortgages. They both have existing authority to apply the joint guidance to the entire mortgage market under both the Homeownership Equity Protection Act and under the FTC Act.

In conclusion, I want to thank you again for the opportunity to testify. We look forward to working with the committee on this important problem.

Chairman ALLARD. Thank you. Mr. Fishbein.

Mr. Fishbein, I see you are the Director of Housing Policy, Consumer Federation of America. Thank you for being here.

STATEMENT OF ALLEN FISHBEIN, DIRECTOR OF HOUSING POLICY, CONSUMER FEDERATION OF AMERICA

Mr. FISHBEIN. Good morning, Chairman Allard and Chairman Bunning. We appreciate the fact that you have held these hearings on this important and timely subject. My testimony today is on behalf of Consumer Federation of America and also the National Consumer Law Center. We appreciate the opportunity to present our views.

The purpose of today's hearing is to assess the impact of non-traditional mortgage products on borrowers and the housing market. A sampling of the news stories from the past few weeks conveys a very disquieting picture. There is a "Business Week" article that referred to "How Toxic Is Your Mortgage?" 9/11/06, a Bloomberg article from earlier this week that the "U.S. Housing Slump May Lead to First Drop Since 1930" 9/11/06, a "USA Today" article from last week, "More Fall Behind on Mortgages" 9/14/06. According to the story, many homeowners with shaky credit are falling behind on their mortgage payments, especially in such States as Ohio, Alabama, Tennessee, Michigan, and West Virginia, and the "New York Times" editorial from earlier this week, "Who Bears the Risk" 9/17/06, all of these are commenting on developments in the mortgage market.

Non-traditional mortgages are complex loan products that have enabled lenders to maintain high numbers of loan originations even in a rising rate environment. Admittedly, this has helped additional borrowers qualify for home purchase in the face of rising home prices in certain areas. These loans, it should be indicated, also are used to refinance existing loans particularly in the subprime market.

The initial low monthly payments are attractive to borrowers who want to leverage their purchasing power in a rapidly appreciating market. Unfortunately, many borrowers do not fully understand the changing payment schedules, especially the sharp monthly payment increases that are common with non-traditional mortgages.

Federal banking regulators, consumer advocates, and increasing segments of the industry all have expressed concerns that non-mortgages, or exotic mortgages as they are known, may be too exotic for many that have taken them out. The delinquencies and foreclosures that result from the unsustainable loans will have extremely negative implications on the credit ratings of borrowers that could prevent or make refinancing of a subsequent home purchase prohibitively expensive.

Although these products have been around, what has changed in today's market is that they are aggressively mass-marketed to a much broader spectrum of borrowers. These borrowers could be vulnerable to payment shock and rising loan balances, making their homes suddenly unaffordable and potentially ruining their finances.

My written testimony goes into detail on this, but I do want to point out a few things. One, indications are of higher problem loans stemming from the recent lending boom. The rise in non-traditional and hybrid adjustable rate mortgages may increase defaults and foreclosures over the next few years. Some in the industry already are predicting that higher monthly payments resulting from these resets are to mean that one in eight or more of these loans will end up in default.

There was a lot of talk this morning about numbers. At CFA and NCLC, we care also about the homeowners and the families behind these numbers. A recent study by First American Real Estate Solutions has reported that $368 billion in adjustable rate mortgages originated in 2004 and 2005 are sensitive to interest rate adjustments that would lead to default, and $110 billion of these are expected to go into foreclosure. Now, this translates into 1.8 million families at risk as a result of the possibility of default, with half million of these likely to go into foreclosure. So the numbers are quite large.

Second, indications are that many borrowers may be more vulnerable to payment shock resulting from non-traditional mortgages though often portrayed. Research cited in my testimony indicates that a significant percentage of people taking out interest only mortgages and option ARMs have credit scores below the median and incomes at the median or below.

Third, it appears that many consumers do not fully understand the risks associated with non-traditional mortgage products. This is understandable given the dizzying array of products that are available in the marketplace. My testimony discusses research indicating that many borrowers who have taken out these loans do not fully appreciate the payment adjustments and the potential of payment shock that could occur.

Since my time is nearing an end, let me say, in conclusion, we believe that more needs to be done to ensure that consumers are adequately aware of financial risks associated with these complex and potentially risky products. Yet the plain fact is that exotic mortgages products simply may not be appropriate for all borrowers who receive them. In my written testimony I offer a number of specific policy recommendations to address this problem. This quick adoption of the proposed Federal interagency guidance on non-traditional mortgage products and also the establishment of suitability standards to ensure that borrowers receive loans that are truly appropriate for them.

I would be glad to answer any questions that you may have.

Chairman ALLARD. I want to thank all of you for your testimony.

I think at least a lot of the consumers that take these exotic-type loans in order to avoid the payment shock try to refinance that loan before they hit the adjustment or reset period. According to "The Denver Post" article, this can be an expensive proposition. For example, the couple that I mentioned in my opening comments, Lilly and India Hartz, they have an option, an ARM, with a growing balance. They would like to refinance the loan, but face a prepayment penalty of $11,000.

The question is this: What percentage of non-traditional mortgages include a prepayment penalty? And to follow up on that, what is the range and average amount of such a penalty and what are the terms?

Mr. Broeksmit.

Mr. BROEKSMIT. I don't have a percentage for you. I can say that I know the terms of most prepayment penalties are a couple of varieties. One is a 1-year prepayment penalty that is often 2 percent of the loan's principal, and there are 3-year prepayment penalties that are typically on a sliding scale of 3 percent, 2 percent, 1 percent. So the penalty recedes as the loan stays on the books. There is another variant.

Chairman ALLARD. Up to the preset date?

Mr. BROEKSMIT. It expires in the thirty-seventh month. It is a 3-year penalty.

Chairman ALLARD. I see. Okay.

Mr. BROEKSMIT. There are other penalties where the penalty is constant for the term of the penalty. A common one is 6 months interest on 80 percent of the principal.

So there are different flavors, and some State regulations affect what is given State by State. I don't have a percentage for you in terms of the percentage of non-traditional loans that have a penalty.

Chairman ALLARD. Mr. Hanzimanolis.

Mr. HANZIMANOLIS. I do not have a percentage for you either, unfortunately, but I can tell you my experience. I have seen most common prepayment penalties as probably a 3-year with 3–2–1. Each year, it will decrease. Also keep in mind that there is also the option of no prepayment penalty. So the prepayment penalty is put out there for the consumer and they will have a cheaper interest rate or the margin may be cheaper if they have a prepayment penalty in place to ensure that the lender is receiving the compensation that they need, but there is always the option to not choose a prepayment penalty.

Chairman ALLARD. Can you give a guess on what percentage in your experience have a prepayment penalty? It is 90 percent?

Mr. HANZIMANOLIS. I couldn't even guess. I know in my daily business, if I offer a product that has a prepayment penalty, I will also offer the option of no prepayment penalty, depending on the customer's feeling of where they expect to be in the next year, 2 years, or 3 years. They may opt to take that. So across the board, I think it is probably a 50–50 percentage is what I see.

Chairman ALLARD. Mr. Calhoun, can you cite some numbers for us?

Mr. CALHOUN. Yes. There is a great disparity between the prime and subprime market. In the prime market, less than 10 percent of loans have prepayment penalties, and part of that is because of historically, Fannie and Freddie didn't buy traditional loans with prepayment penalties, and that has carried on some. We are seeing increasing prepayment penalties with the non-traditional mortgage.

In the subprime market, it is totally flipped. Over 80 percent of those loans have prepayment penalties, and industry studies show that the majority of borrowers with prepayment penalties end up paying the penalty, and I think you really hit the nail on the head with how these loans really work. They essentially are forced flippings. The 2–28 loans that I described, almost all end up operating as 2-year balloon loans because no one can afford to make the payment when the reset happens.

It is very, very difficult for a borrower to avoid the prepayment penalty, because to avoid the prepayment penalty and not get caught in the higher mortgage payment, you have to refinance in that 30-day period after the lower payment ends. If you finance it before that, if you are proactive, then you get the prepayment penalty, and to finance it later than that, you somehow had to be able to make the mortgage payments that have increased so dramatically.

These loans put consumers in a real bind both with the payment shock and sort of the double whammy of these prepayment penalties.

Chairman ALLARD. What cost is the prepayment penalty supposed to cover? Is it the re-processing of the loan or are there other factors that go into that prepayment penalty?

Mr. CALHOUN. There are several factors. Initially, it was supposed to be an alternative way to cover the cost of originating the loan. Increasingly in today's market, it is another fee. It adds more revenue to the whole loan package, and our organization did research looking at subprime loans throughout the country, using the largest industry data base, to see if consumers were getting a promised lower interest rate in exchange for the prepayment penalty, and our study which we made available to Federal regulators and everyone else found that in practice, they didn't, that the prepayment penalty did not actually lower it. It tended to be an additional expense for them.

Chairman ALLARD. Mr. Fishbein.

Mr. FISHBEIN. Well, I would concur with what Mike has said. We certainly hear of stories of prepayment penalties that exceed the initial preset period, particularly for loans in the subprime market. I do not know whether that is standard practice, but certainly it appears some lenders are doing this.

Chairman ALLARD. Now just one last question: How common are other types of refinancing penalties? For example, Monique and Anthony Amijo of Colorado have a mortgage that contains a $20,000 penalty if they refinance with anyone other than one particular broker. Is that common among brokers, Mr. Hanzimanolis?

Mr. HANZIMANOLIS. I have never heard of that before, sir. I can absolutely say it is not commonplace.

Chairman ALLARD. Would everybody else on the panel agree with that?

Mr. CALHOUN. I will disagree. Most lenders have a practice of waiving prepayment penalties if you refinance with them. That is the common practice in the industry. A prepayment penalty of the size that you describe is not at all atypical. As described by our first witness, if you have a half-year's interest on a loan, that that is your prepayment penalty, most of your mortgage payment goes to interest, particularly in the early years, and it is very easy for that prepayment penalty to be tens of thousands of dollars, and we find and the realtors have found that borrowers are trapped where they can't sell the house because when you add on the prepayment penalty, the loan is upside down. They own more than what they can sell the house for, and so it is a concern there as well.

Chairman ALLARD. Any other comments from the panel on that last question?

Mr. BROEKSMIT. I would just say that it is highly unusual that a mortgage broker can say there is a penalty by not coming back to me. The mortgage broker doesn't even control the Note, and the prepayment penalty is an addendum to the Note. So there is something unusual about that circumstance.

Chairman ALLARD. We will have our staff follow up on that.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and thank you again for having this hearing on an issue of great concern to me, and I apologize. It is a busy time, but I want to thank you and Senator Bunning and Senator Reed.

I have been troubled by alternative mortgages, which are often a synonym for risky mortgages, for quite a while. The saddest part of these mortgages is that the borrower usually doesn't know what hit them. I have heard this from people. They feel like a ton of bricks have fallen on their head, and then they look up at the roof and it is still there, but their life is shattered in a million pieces because they can't pay.

I understand the need for these products and I understand when used in a responsible way, these products will help bring mortgages to people who don't need them, but we all know what is going on. Too many people who sell these mortgages are not looking out for the well-being of the mortgagee. They are looking out, rather, for just selling as many as possible, and then those mortgages are gone and gone far away, and it is really, really troubling.

The plethora of new products that flood the housing market, mainly the interest only loans and the payment option adjustable mortgages and the 2–28 ARMs, are destroying the lives of a whole lot of people whose lives didn't have to be destroyed. In the old days, these type of loans were distinctly for either high net worth or sophisticated home buyers. What has happened is they have devolved and they are sold to people or the least experienced and the most vulnerable.

So "Business Week" referred to these things on its September 11th cover as "Nightmare Mortgages", and that is what they have done. Middle income people, lower income people are accessing complex and risky mortgages in the name of affordability, but they are often mortgages that they can't afford.

We also have a particular issue with young minorities being preyed upon. I have been involved with this issue in New York for a long time, and we even have some people who are radiologists who made $200,000 a year, but who didn't believe that a bank would give them a loan, going with these products and paying far too high a rate, and I have worked in New York on trying to solve this problem by having our prime rate banks reach out to churches and other institutions to let people come in, but as I said, I have been really, really troubled.

Here is the problem: You can get a mortgage without showing the ability to pay for it. When the loans are issued, they don't look at when the rate bumps up, whether the family can afford it. They rely on some ridiculous projection that they are going to be making a whole lot more money before, and people just don't know what they are doing.

So is the explosion of these exotic mortgages especially to borrowers who can't demonstrate their ability to sustain their mortgage payments through the payment shock period at least in part the result of overly aggressive selling by brokers whose compensation is not tied to the successful outcome, but merely to the closing of the loan?

Mr. HANZIMANOLIS. Well, let me first say that mortgage brokers for the most part are small business people. We live in the same communities where we originate loans. We shop at the same stores. We go to the same churches. We have the same scout troop and school functions. In order for us to be successful in business we have to reach out to our community and be fair in our lending.

I can't imagine anybody would be successful being the——

Senator SCHUMER. Sir, I am sorry to interrupt you.

Chairman ALLARD. Let me interrupt both of you here. I am running a pretty tight time line on the members of this committee on their 5-minute limit. I would suggest that we go to—your time has expired. I would suggest that we go to Senator Bunning. We will get in his 5 minutes and come back to you.

Senator SCHUMER. OK. I will just submit questions in the record. All I was saying, Mr. Chairman, is that may be true in a small town. In a borough like Queens or Brooklyn, that is not true at all. I will be happy to submit questions in writing.

Chairman ALLARD. I have been treating all the members the same way.

Senator SCHUMER. I appreciate that. Thank you, Mr. Chairman, and I apologize for coming and running.

Chairman ALLARD. Thank you.

Chairman Bunning.

Chairman BUNNING. Mr. Simpson, mortgage insurers have an interest in seeing that lenders do not write loans that are too risky, I hope.

Mr. SIMPSON. Yes, sir.

Chairman BUNNING. Over the last 3 years, do you think that the relaxation of underwriting standards has been too risky or are the risks manageable?

Mr. SIMPSON. Well, on your first question, yes, we have seen some deterioration in the underwriting criteria for these non-traditional mortgages.

Chairman BUNNING. That is what we are talking about.

Mr. SIMPSON. Many people have testified, and years ago, an option ARM was for a very high-quality borrower. Today, there are less than high-quality borrowers taking out these loans.

Chairman BUNNING. So when the Federal Reserve Chairman is recommending that people look at this as a prime option—and he did exactly that before the Banking Committee. He said, If I were going to get a mortgage, I would get an ARM, because, you know, the interest rates at the time, the prime was 4 percent, and the short-term interest rates were much shorter, much lower than the long, and now, obviously, they have reversed.

Mr. SIMPSON. Yes.

Chairman BUNNING. So now I am talking about the risks at this time.

Mr. SIMPSON. Yes, sir. Well, I think that depends upon your forecast of interest rates. If you think interest rates are going down, you might want to get an ARM; but having been in this business all these years, I still think a six and a quarter 30-year fixed-rate loan is a mighty good loan. I fail to understand the wisdom of most people who don't take that option rather than an option ARM.

Chairman BUNNING. Well, most people that can do that would take that option.

Mr. SIMPSON. Correct.

Chairman BUNNING. But we are talking about people who want more for less.

Mr. SIMPSON. But if we are qualifying people on an option ARM today, that rate would be very close to the six and a quarter 30-year fixed-rate payment.

Chairman BUNNING. I understand that.

Mr. SIMPSON. OK. The other thing I would like to point out that purveys all of this discussion is housing appreciation, and as long as homes are going up in value in your neighborhood or any neighborhood, you can probably get by with some relaxed underwriting, and that is what this mortgage finance system is this country tends to do. It gets more aggressive as homes are going up in value, but let me tell you. Today, they are not all going up in value. In fact, there are parts of the country where they are going down, and the overall rates have really subsided. We are looking now at 4 percent annual appreciation rates, not 13.

Therefore, it only makes sense for the Federal regulators to come out with some reins and some tightening on the underwriting criteria.

Chairman BUNNING. I would hope so.

Mr. SIMPSON. We don't have the appreciation to bail out mistakes.

Chairman BUNNING. OK. Let me ask—I can't pronounce your name. I am sorry.

Mr. HANZIMANOLIS. That is quite all right.

Chairman ALLARD. Mr. Hanzimanolis.

Chairman BUNNING. Thank you.

In your written statement, you emphasize consumer education, and certainly that is an area for improvement. Before we see results in improvement in consumer education efforts, there will be a period when brokers will still be dealing with what many people have classified as an overwhelmed consumer, a confused borrower. Brokers share little of that risk, that borrowers and lenders assume. In fact, many have a financial interest in getting the borrower into a loan regardless of whether the borrower can afford it or not, as Senator Schumer has said.

Under current laws and regulations, are there strong enough protections for consumers and lenders?

Mr. HANZIMANOLIS. I believe that the protections are in place. Keep in mind, as a mortgage broker, when I originate a loan, it still has to go to the mortgage lender who is going to fund it. That lender does a very detailed underwriting job at looking at that. So we have qualified and processed that loan application to their guidelines, and they review it intently to make sure that everything have been gone through properly for that customer to be able to qualify.

Chairman BUNNING. I just am worried that the consumer doesn't really fully realize if they are in a sophisticated mortgage like we are talking about. It is easy to understand if it is a four and a half percent or a six and a half percent 30-year loan. You know what your payments are going to be and you know what they are going to be for 30 years, but if you get into a 3-year ARM or a 3–2–1 with a penalty, it is very difficult for some people to realize and grasp what happens at the end of the third year.

Mr. HANZIMANOLIS. I agree, and as you know from my written testimony, NAMB has always suggested that we have clearer, more concise disclosures, disclosures where, in fact, as the originator sits down and explains everything to the customer, both the originator and the customer would initial at each section there.

Chairman BUNNING. Yes, sir. I just recently refinanced. There were, I think, 36 pages, 36 documents that I had to either have my wife or myself initial. Now, how many people understand, unless there is a lawyer present, what the heck are they doing?

Mr. HANZIMANOLIS. I think any good originator, be it a broker or a bank, lender, anyone, would sit down with the customer and explain each form in detail.

Senator SCHUMER. It didn't happen to me.

Chairman BUNNING. It happened to me because I had a lawyer sitting right next to me, and he made sure when the paper was handed to me for a signature, that he said, OK, you can initial, OK, you can initial, because he understood. He had sat in on a lot of closings. So I felt very comfortable in doing that, but how many people do that?

Mr. HANZIMANOLIS. It is always the customer's right to bring an attorney.

Chairman BUNNING. I understand that, but how many people do that?

Chairman ALLARD. Chairman Bunning, I need to go to Senator Schumer.

Chairman BUNNING. Go ahead. Thank you.

Senator SCHUMER. I want to go back to Mr. Hanzimanolis. You know, you paint this apple pie picture of the mortgage broker who lives in the community and runs the Boy Scout Troop, goes to the same church. That may be true in Small Town America where there is one or two mortgage brokers for a thousand people. In the New York metropolitan area of 20 million people, that doesn't happen. People don't go to the same church as their mortgage broker 98 percent of the time or have the kid in the Boy Scout Troop, and we have lots of unscrupulous people here.

Do you understand that we should be regulating not the best who don't it, but for the worst who rip people off, and have you heard of instances of mortgage brokers ripping people off?

Mr. HANZIMANOLIS. I have heard of every business out there.

Senator SCHUMER. No. I didn't ask you that. Sir, have you heard of mortgage brokers ripping people off?

Mr. HANZIMANOLIS. Yes, I have.

Senator SCHUMER. Have you heard of it rarely? Frequently?

Mr. HANZIMANOLIS. I believe it is a small case, but it is something that happens. You hear about it.

Senator SCHUMER. Let me tell you I hear about it frequently. OK? And I am a Senator and my job is to get to know all of my constituents. We all hear of it frequently. Do you think we should do more than simply rely on consumer education for those mortgage brokers, however there are, and you are going to have to take my word for it there are too many of them, who have no interest once the loan is closed in seeing whether the customer can pay back? Do you think we need to do more than customer education?

Mr. HANZIMANOLIS. I think customer education is a wonderful start. I think helping educate the lenders regardless of the distribution channel——

Senator SCHUMER. How about some regulations of unscrupulous brokers; you don't think there should be any?

Mr. HANZIMANOLIS. I hope there are laws on the books already.

Senator SCHUMER. Do you think they are adequate on the books?

Mr. HANZIMANOLIS. I think we can always improve. It has always been NAMB's position that if there is anyone out there doing anything that is illegal——

Senator SCHUMER. I can tell you that there are lots of people who do this and they prey on the people who know the least, and it would protect good brokers to have the other ones better regulated. So I would ask you to go back to your organization and tell them that there is a lot of upsetness here on both sides of the aisle about what is going on now, and a lot of it, I have found in my explorations.

I used to think banks discriminated, but they don't. It is much more the mortgage brokers who go into these areas and sign people up without telling them the whole consequences. I shouldn't say the banks don't. I should say the biggest problem we face in New York City, why so many say minority areas are subprime and areas that actually the same income level that are only a mile away, but are white, are prime is the mortgage brokers, not the banks.

I will tell you, in my view, Mr. Chairman, we need a whole lot more attention here, and we have gotten very little because the industry is grown up quicker, because more people are getting homes, thank God, etc.

Here is my next question: OK. I am asking everybody here. How would underwriting loans to the fully indexed—wouldn't it be a good idea to underwrite loans to the fully indexed rate to make sure if the initial rate is 6 percent, but the rate 2 years later will be 9 percent, that at the time the customer signs up, that we are sure that they could pay at the 9 percent rate, and wouldn't that help people keep people in their homes, particularly, as Mr. Simpson mentioned, in this uncertain time when housing values might be going down?

Mr. BROEKSMIT. Senator Schumer, we make a lot of option ARM loans. We underwrite borrowers to the fully indexed rate at a fully amortizing payment.

Senator SCHUMER. Right.

Mr. BROEKSMIT. We think that is a smart idea, and we quibble with the guidance in some aspects of this because it runs the products together, and there are some interest only loans where I don't believe you need to qualify somebody at the fully amortizing payment on a 10/1 ARM. If you have got an interest only option for 10 years, the average life of the loan is probably five. We quibble, but generally speaking, that is a very sound practice.

Senator SCHUMER. Right. What do you think, Mr. Hanzimanolis?

Mr. HANZIMANOLIS. I think two things: One, better disclosures for the customers so they understand where the payment could possibly go; and two, you will be happy to hear that many of the lenders that I do business with are already asking the people to or requiring the people to underwrite that to the fully indexed and fully amortized payment.

Senator SCHUMER. What about those who don't; should we do more from a governmental point of view to make sure that happens?

Mr. HANZIMANOLIS. I think that we, obviously, know listening today and before coming here today that this is an issue, and if it is an issue, we want to protect people with better disclosures and underwriting to that.

Senator SCHUMER. What about beyond disclosure? Disclosure for many people doesn't work, as we have all tried to make the point clear here. Caveat Emptor is a good concept, and about in 1890, the country realized it was in some areas not sufficient.

Mr. HANZIMANOLIS. I think you are going to see more and more lenders going to that, and eventually that will——

Senator SCHUMER. Do you think we should regulate it or not?

Mr. HANZIMANOLIS. I don't know if a regulation is required. I think that we will see the market is going that way on its own.

Senator SCHUMER. Mr. Simpson.

Mr. SIMPSON. I definitely think we should underwrite to the fully indexed accrual rate, and I do think there is more enforcement needed to assure that that happens. I would also, as an insurer, say that loan should be underwritten as having an additional layer of risk as a result of the uncertainty of the structure of loan, as we do.

Senator SCHUMER. All right. Mr. Calhoun.

Mr. CALHOUN. Yes, and I am glad to hear the widespread agreement, but I think, more importantly, is what you have addressed, is how do you make that apply to the market. If it is just this advice, it doesn't work, because if the good brokers or lenders are underwriting that way, they have to compete with the ones who aren't. It gives the bad apples an unfair competitive advantage.

Senator SCHUMER. That is exactly right.

Mr. CALHOUN. That hurts both the borrowers and the industry, because in the lenders, if a broker comes to them with a loan not fully unwritten, if the lender says I don't want it, the broker says, Well, this person down the street will buy it. See, you have got to make it apply to the whole market.

Senator SCHUMER. Agreed. I agree with you.

Mr. Fishbein.

Mr. FISHBEIN. Certainly underwriting to the fully indexed rate is necessary, but in some cases, for some types of loans, it may not be sufficient. We know that the LIBOR rate, which is an index that is used for many subprime loans has been adjusting upward every month for the past 2 years. So if you had just underwritten a loan in a subprime market to the fully indexed rate, it would not necessarily mean that the borrower 6 months or 2 years later would be in a position to be able to pay that loan.

Senator SCHUMER. But, Mr. Fishbein, the jumps that most people get far exceed the change in LIBOR over the period of time they get the jump. Isn't that true?

Mr. FISHBEIN. Well, the point——

Senator SCHUMER. The early teaser rates that come in early, and then when it goes up to the full rate, that is usually far more than the LIBOR increase.

Mr. FISHBEIN. That is certainly a significant part of the problem, and that is why I say I agree with underwriting to the fully-indexed. However, underwriting should also take into account the full extent that negative amortization is permitted. I would also say that, particularly in connection with more modest income people, it is important that underwriting also consider residual income, in other words, whether people when they pay all their debts still have income, regardless of how the percentages look, to be able to make the payments. This also should include taking into account taxes and insurance borrowers and be required to pay which some lenders do not do when deciding whether a loan is affordable to a borrower.

Senator SCHUMER. Thank you, Mr. Chairman.

Thank you. I thank the whole panel.

Chairman ALLARD. Thank you, Senator Schumer. In fairness, I have given everybody their questions.

Senator SCHUMER. You have been extremely fair, Mr. Chairman. I have no complaints with you, and we don't need any regulation to make you a better chairman.

Chairman ALLARD. Thank you, Senator.

Okay. I just have one question, and then we will let you go. During the last several years, we have seen a dramatic rise in the number of inter only loans and payment option ARMs. Have these products peaked out in being offered to consumers, or do you think they will continue to popular, and can we expect increases in these non-traditional type of loans, and if they are discontinuing, do you see them being replaced by some other type of non-traditional loan? What can we expect in the future?

Mr. BROEKSMIT. I would not expect them to—I don't believe they have run their course. I believe they are a good product for a large segment of the population, but you will continue to see evolution. For instance, the option ARM has typically had four payment options, but the underlying interest rate adjusts. There is recently, within the past 6 months, introduced a product that continues to have different payment options, but the rate behind the scenes is fixed for 5 years. So it appeals to a borrower who likes the certainty of a period of fixed rates, but also likes the ability to match the mortgage payment with a fluctuating income and make a lower payment when that is convenient for them and then have the option to catch up later.

So you will see an evolution, but I think we have seen a structural shift in consumer behavior where people don't expect to live in the home for 30 years. Why pay a 30-year fixed-rate rate when you expect to move or refinance within three or 5 years?

So the notion that people want to borrower on the short end of the yield curve to match the length they really expect to have the loan versus paying the premium for a 30-year rate, I will continue, and the notion that you are going to pay off your mortgage by a certain point in your life, I believe in my generation and younger generations is a much less prevalent one than it was among the older generations.

Chairman ALLARD. Do you want to look in the future, Mr. Hanzimanolis?

Mr. HANZIMANOLIS. Well, I agree with Mr. Broeksmit. I don't think it has peaked. I believe that there are still benefits to these programs. They have benefits in the right situations, and will other products develop? Absolutely. The needs of the consumer drive the market, and that is why we see the development of these new products. So I anticipate that we will see new products developing constantly.

Chairman ALLARD. Mr. Simpson.

Mr. SIMPSON. History shows that in the eighties when we had 17 percent mortgage rates, that the mortgage market was very creative in trying to find solutions to that problem. When the houses depreciated in the oil patch and we had massive foreclosures, most of those experimental non-traditional mortgages of those days disappeared, and we went back to the fixed rate loans. Now we are back experimenting again, and I think essentially because houses have gotten so expensive and they have also appreciated so consistently that we are now seeing people take these non-traditional mortgages based on the past.

But as I have said today and I will say it again, I think the past is the past. I don't see housing appreciation in the next 5 years anywhere near the kind of rates we have seen. So a lot of these structures don't make sense, but we will see experimentation, and as Bob was saying, I think you will see more flexibility in how the borrower interacts with their mortgage. I just hope that that is confined to people of means and we don't put people in houses who can't stay there.

Chairman ALLARD. Mr. Calhoun.

Mr. CALHOUN. Very quickly, I think these mortgages were developed for people, largely, to get into houses, and now we see once you are in one of these mortgages, it is very hard to get out, that as has been mentioned today, when you refinance, you typically incur significant additional expenses, both upfront fees and often the prepayment penalty, and just the financial truth is for far too many families, they cannot convert to a standard fixed mortgage at this point because if you underwrite—that is, in effect, underwriting to fully indexed, and if they didn't qualify for that when they got the mortgage a couple years ago, they are probably not going to qualify for it now.

I think it is incumbent on industry here to work with borrowers on a widespread basis for loan modifications and workouts that make the loans sustainable and do not extract additional fees which simply increase the debt load of American families.

Chairman ALLARD. Mr. Fishbein.

Mr. FISHBEIN. We have been surprised that the market appetite has continued for non-traditional mortgages products in the face of cooling house prices. As I point out in my written testimony, the growth of these products has contributed to the housing boom. Home price appreciation has continued because these loan products enable borrowers to stretch further and further. In essence, the growth of exotic mortgages has created a chicken and egg situation, which in turn, has contributed to the problem.

And as Mike pointed out, and I think it is a very important point, many who get into these highly leveraged loans wind up on a treadmill in which they get into progressively more costly loans, until their remaining home equity loans are refinanced in which they take equity out of home equity loans home as long as they have equity to continue with that.

So I suspect we will continue to see variations of these products. This is all the more reason to take a hard look at developing a comprehensive approach to protecting consumers. This should include, certainly, improved disclosures. However, it also should include suitability standards requiring that mortgage brokers and loan originators place people into loans they can afford. Such a standard is necessary to discourage bad practices in the marketplace.

Chairman ALLARD. Well, I would like to thank all of our witnesses again for testifying. We have heard a great deal of testimony from both panels, and Chairman Bunning and myself will both be watching this issue pretty closely in the following months.

The record will remain open for 10 days. Should members wish to submit any additional questions to the witnesses, we would appreciate your prompt response to the question and would ask you to please respond to them within 10 days. I have some questions additionally that I will be submitting.

I thank everyone for attending this joint hearing of the Housing and Transportation Subcommittee and Economic Policy Subcommittee. The hearing is adjourned.

[Whereupon, at 12:38 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

STATEMENT OF SENATOR CARPER

Thank you, Chairman Shelby and Ranking Member Sarbanes for holding this important hearing.

Homeownership is a top priority for me. When people own their home, they are often healthier, more involved in their communities, and have children who do better in school.

However, the process of buying a home can be daunting. Obtaining a loan is an intimidating and confusing process for the vast majority of people who participate in it. Today, there are many financing options for potential homebuyers. In our hearing today, the witnesses will comment on non-traditional mortgage products. While all of these products have helped to increase the national homeownership rate, they come with risks.

While I am encouraged by increased homeownership rates, I want to ensure that financing options that get people into a home are not counterproductive. I want to see more Americans own their own homes, but I also want to make sure they can *stay* in their homes.

An important component of increasing Americans' homeownership is financial literacy. We must empower consumers with the knowledge they need to successfully purchase a home. The state of financial literacy in our country is terribly low. We need to educate our children and young adults on basic skills, such as personal budgeting, balancing a check book and checking their credit score. Increasing financial literacy will go a long way to protecting Americans from finding themselves in a financial situation they cannot afford.

Mr. Chairman, I greatly appreciate that we are holding this hearing today, but I hope that next year, this Committee will turn its attention to the broader issues of predatory lending and financial literacy.

Thank you.

United States Government Accountability Office

GAO

Report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

September 2006

ALTERNATIVE MORTGAGE PRODUCTS

Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved

GAO

Accountability * Integrity * Reliability

GAO-06-1021

September 2006

ALTERNATIVE MORTGAGE PRODUCTS

Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-06-1021, a report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

Alternative mortgage products (AMPs) can make homes more affordable by allowing borrowers to defer repayment of principal or part of the interest for the first few years of the mortgage. Recent growth in AMP lending has heightened the importance of borrowers' understanding and lenders' management of AMP risks. This report discusses the (1) recent trends in the AMP market, (2) potential AMP risks for borrowers and lenders, (3) extent to which mortgage disclosures discuss AMP risks, and (4) federal and selected state regulatory response to AMP risks. To address these objectives, GAO used regulatory and industry data to analyze changes in AMP monthly payments; reviewed available studies; and interviewed relevant federal and state regulators and mortgage industry groups, and consumer groups.

What GAO Recommends

As the Federal Reserve Board reviews existing disclosure standards, GAO recommends that it considers revising federal requirements for mortgage disclosures to improve the clarity and comprehensiveness of AMP disclosures. In response, the Federal Reserve noted that it will conduct consumer testing to determine appropriate content and formats and will use design consultants to develop model disclosure forms intended to better communicate information.

www.gao.gov/cgi-bin/getrpt?GAO-06-1021.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

From 2003 through 2005, AMP originations, comprising mostly interest-only and payment-option adjustable-rate mortgages, grew from less than 10 percent of residential mortgage originations to about 30 percent. They were highly concentrated on the East and West Coasts, especially in California. Federally and state-regulated banks and independent mortgage lenders and brokers market AMPs, which have been used for years as a financial management tool by wealthy and financially sophisticated borrowers. In recent years, however, AMPs have been marketed as an "affordability" product to allow borrowers to purchase homes they otherwise might not be able to afford with a conventional fixed-rate mortgage.

Because AMP borrowers can defer repayment of principal, and sometimes part of the interest, for several years, they may eventually face payment increases large enough to be described as "payment shock." Mortgage statistics show that lenders offered AMPs to less creditworthy and less wealthy borrowers than in the past. Some of these recent borrowers may have more difficulty refinancing or selling their homes to avoid higher monthly payments, particularly if interest rates have risen or if the equity in their homes fell because they were making only minimum monthly payments or home values did not increase. As a result, delinquencies and defaults could rise. Officials from the federal banking regulators stated that most banks appeared to be managing their credit risk by diversifying their portfolios or through loan sales or securitizations. However, because the monthly payments for most AMPs originated between 2003 and 2005 have not reset to cover both interest and principal, it is too soon to tell to what extent payment shocks would result in increased delinquencies or foreclosures for borrowers and in losses for banks and other lenders.

Regulators and others are concerned that borrowers may not be well-informed about the risks of AMPs, due to their complexity and because promotional materials by some lenders and brokers do not provide balanced information on AMPs benefits and risks. Although lenders and certain brokers are required to provide borrowers with written disclosures at loan application and closing, federal standards on these disclosures do not currently require specific information on AMPs that could better help borrowers understand key terms and risks.

In December 2005, federal banking regulators issued draft interagency guidance on AMP lending that discussed prudent underwriting, portfolio and risk management, and consumer disclosure practices. Some lenders commented that the recommendations were too prescriptive and could limit consumer choices of mortgages. Consumer advocates expressed concerns about the enforceability of these recommendations because they are presented in guidance and not in regulation. State regulators GAO contacted generally relied on existing regulatory structure of licensing and examining independent mortgage lenders and brokers to oversee AMP lending.

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Abbreviations

AARMR	American Association of Residential Mortgage Regulators
AMP	alternative mortgage product
APR	annual percentage rate
ARM	adjustable-rate mortgage
CLTV	combined loan-to-value
COFI	Federal Home Loan Bank of San Francisco Cost of Funds Index
CSBS	Conference of State Bank Supervisors
DTI	debt-to-income
FDIC	Federal Deposit Insurance Corporation
FICO	Fair Isaac and Company
FRM	fixed-rate mortgage
FTC	Federal Trade Commission
GSE	government-sponsored enterprise
HOEPA	Home Ownership and Equity Protection Act
LTV	loan-to-value
MBS	mortgage backed securities
NAR	National Association of Realtors®
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
TILA	Truth in Lending Act

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

September 19, 2006

The Honorable Wayne Allard
Chairman
Subcommittee on Housing and Transportation
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

In recent years, the residential real estate sector experienced sustained growth in both volume and price. The National Association of Realtors® (NAR) reported record growth in sales of existing homes from 2003 to 2005, from 6.2 to 7.1 million homes annually. During this same period, median existing home prices increased an average of 10.9 percent a year, from $178,800 to $219,600. Further, NAR reported double-digit percentage increases in existing home prices in 72 metropolitan areas in 2005. To purchase homes they might not be able to afford with a conventional fixed-rate mortgage, an increasing number of borrowers turned to alternative mortgage products (AMPs), which offer comparatively lower and more flexible monthly mortgage payments for an initial period.

Two recently popular types of AMPs—interest-only and payment-option adjustable-rate mortgages (ARMs)—allow borrowers to defer repayment of principal and possibly part of the interest for the first few years of the mortgage. Interest-only mortgages allow borrowers to defer principal payments for typically the first 3 to 10 years of the mortgage, before recasting to require higher monthly payments that cover principal as well as interest and to pay off (amortize) the outstanding balance over the remaining term of the loan. Payment-option mortgages allow borrowers to make minimum payments that do not cover principal or all accrued interest, but can result in increased loan balances over time (negative amortization). Typically after 5 years, or if the loan balance increases to a cap specified in the mortgage terms, payments recast to include an amount that will fully amortize the outstanding balance over the remaining years of the loan.

As AMP lending grew, federal banking regulators and consumer advocates expressed concerns about loans that allow deferred repayment of principal or negative amortization; borrowers' ability to make future, higher payments; and lenders' underwriting practices (criteria for issuing loans).[1] As a result of these and other factors, we studied the potential risks of AMPs for borrowers and lenders. This report discusses (1) recent trends in the AMP market, (2) the impact of AMPs on borrowers and on the safety and soundness of financial institutions, (3) the extent to which mortgage disclosures discuss the risks of AMPs, (4) the federal regulatory response to the risks of AMPs for lenders and borrowers, and (5) selected state regulatory responses to the risks of AMPs for lenders and borrowers.

To identify recent trends in the AMP market, we gathered information from federal banking regulators and the residential mortgage lending industry on AMP product features, customer base, and originators as well as the reasons for the recent growth of these products. To determine the potential risks of AMPs for borrowers and lenders, we analyzed the changes in future monthly payments that can occur with AMPs during periods of rising interest rates. We also interviewed officials from the federal banking regulators (federal regulatory officials) and representatives from the residential mortgage lending industry and reviewed studies on the risks of these mortgages compared with conventional fixed-rate mortgages. In addition, we obtained information on the securitization of AMPs from federal banking regulators, government-sponsored enterprises, and secondary mortgage market participants. To determine the extent to which mortgage disclosures explain the risks of AMPs, we reviewed federal laws and regulations governing the required content of mortgage disclosures, reviewed studies on borrowers' understanding of adjustable-rate products, and interviewed federal regulatory officials and industry participants. We also selected a sample of eight states to obtain state regulators' views on these disclosures—Alaska, California, Florida, Nevada, New Jersey, New York, North Carolina, and Ohio. We reviewed these states' laws and regulations governing the required content of mortgage disclosures and interviewed state officials. We selected these states on the basis of a number of criteria, including volume of AMP lending and geographic location. We also conducted a readability and design analysis of a selection of written disclosures that AMP lenders provide to borrowers. To obtain information on federal regulatory responses to the risks of AMPs for lenders and

[1]For the purposes of this report, we use the term "federal banking regulators" to refer to federal agencies that oversee federally insured depository institutions and their subsidiaries. These agencies are the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

borrowers, we reviewed the draft interagency guidance on AMP lending issued by federal banking regulators and interviewed regulatory officials. We also reviewed comments written by industry participants in response to the draft guidance. To obtain information on selected states' regulatory responses to the risks of AMPs for lenders and borrowers, we reviewed current laws and, where applicable, draft legislation, from the eight states in our sample and interviewed these states' banking and mortgage lending officials.

We performed our work between September 2005 and September 2006 in accordance with generally accepted government auditing standards. Appendix I provides additional information on our scope and methodology.

Results in Brief

From 2003 through 2005, AMP originations grew threefold, from less than 10 percent of residential mortgage originations to about 30 percent. Most of the AMPs originated during this period consisted of interest-only and payment-option ARMs. The initial lower payments associated with AMPs enable borrowers to afford homes that they might not be able to afford using conventional fixed-rate mortgages. Therefore, AMPs have been particularly popular in higher-priced regional markets concentrated on the East and West Coasts where prices have risen appreciably. For example, based on data from mortgage securitizations in 2005, about 47 percent of interest-only ARMs and 58 percent of payment-option ARMs originated in California, where NAR reports that 7 of the 20 highest-priced metropolitan real estate markets in the country are located. For many years lenders have marketed AMPs to wealthy and financially sophisticated borrowers as financial management tools. However, more recently, lenders have marketed AMPs as affordability products that enable a wider spectrum of borrowers to purchase homes they might not be able to afford using a conventional fixed-rate mortgage. Lenders also have increased the variety of AMPs offered as interest rates have risen and ARMs have become less attractive to borrowers.

Although most AMPs originated in recent years have yet to reach the date at which monthly payments increase to cover principal as well as the interest, regulators have expressed concerns that some borrowers may not be able to withstand the "payment shock" of substantially higher monthly payments. Statistics reveal that lenders originated AMPs to recent borrowers with lower credit scores, higher loan-to-value (LTV) and debt-to-income (DTI) ratios, and less stringent or no income and asset verification requirements than what they traditionally permitted for these products. Recent AMP borrowers who have fewer financial resources and have not benefited from appreciation in home values may be more vulnerable to payment shock, especially if their loan balance increased because they were making only the minimum payment. These borrowers may lack the equity to refinance their mortgages or sell their homes, and would have to face higher payments. Borrowers who cannot afford the higher payments face increased risk of default, thereby increasing credit risk for lenders, including banks. Although federal regulatory officials expressed concerns about underwriting practices related to AMP lending, they said that banks generally have taken steps to manage the credit risk that results from AMPs.[2] For example, these officials said that most banks have diversified their assets sufficiently to manage the credit risk of AMPs held in their portfolios, or have reduced their risk through loan sales or securitizations. However, federal regulatory officials and industry participants agreed that it was too soon to tell whether AMPs would result in significant delinquencies and foreclosures for borrowers and corresponding losses for banks that hold AMPs in their portfolios.

Because AMPs are complex products and advertising and mortgage disclosures may not completely or effectively explain their terms and risks, regulatory officials and others believe that some borrowers may not fully understand the risks of AMPs. Borrowers can acquire information on mortgage options from a variety of sources—including loan officers and brokers, or as noted by mortgage industry representatives, through the Internet, television, radio and telemarketing. However, federal and state regulatory officials raised concerns that the promotional materials some lenders and brokers provided to borrowers might emphasize the benefits of AMPs without explaining the associated risks. For example, some advertisements suggested that AMPs' initial low monthly payments allow borrowers to afford a larger house, but did not disclose that over time these monthly payments could increase substantially. Furthermore, a recent study by staff economists at the Federal Reserve suggested that some borrowers (particularly some low-income and less-educated borrowers) appeared to not understand fully how much monthly payments with adjustable-rate products could increase. With borrowers sometimes exposed to unbalanced information about AMPs, written disclosures that provide clear and comprehensive information about the key terms,

[2]Credit risk involves the concerns that borrowers may become delinquent or default on their mortgages, and that lenders may not be paid in full for the loans they have issued.

conditions, and costs of the mortgage can help borrowers to make better-informed decisions. The quality of information conveyed through mortgage disclosures depends on both content, which is mandated by statute and federal regulation, and presentation. Regarding content, the Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, require certain product information to be included in disclosures to borrowers for many types of credit products, including mortgages.[3] For example, Regulation Z requires creditors (lenders and those brokers that close loans in their own name) to provide borrowers with certain information about their ARM products. However, these requirements are not designed to address more complex products such as AMPs. The Federal Reserve has recently initiated a review of Regulation Z that will include reviewing the disclosures required for all mortgage loans, including AMPs. Regarding presentation, current guidance developed by the Securities and Exchange Commission (SEC) recommends practices on developing disclosures that effectively communicate key information on financial products.[4] Most of the AMP disclosures we reviewed did not fully or effectively explain the key risks of payment shock or negative amortization for these products and lacked information on some important loan features, both because Regulation Z does not require lenders to tailor this information to these more complex products and because lenders did not always follow leading practices for writing disclosures that are clear, concise, and user-friendly. Appendix II provides additional information on our evaluation of these disclosures according to these leading practices. According to officials from one federal banking regulator, amending Regulation Z to require lenders to more fully and clearly explain the key terms and risks of complex mortgages such as AMPs in mortgage disclosures was one of several steps needed to increase borrower understanding about these products and the mortgage process in general—which many described as generally overwhelming and confusing for the average borrower. Without clear and comprehensive disclosures on AMP risks, borrowers may not understand the extent to which monthly payments could rise and loan balances could increase.

In response to concerns about AMP risks to federally regulated banks and their borrowers, federal banking regulators issued draft interagency guidance in December 2005 for these institutions and have taken other

[3]TILA is codified at 15 U.S.C. § 1601 *et seq.* and Regulation Z can be found at 12 C.F.R. Part 226.

[4]SEC is the primary overseer of the U.S. securities markets.

steps to monitor AMP lending. The draft guidance discusses prudent underwriting, portfolio and risk management, and consumer disclosure practices related to AMP lending. When finalized, the guidance will apply to all federally regulated financial institutions.[5] Federal regulatory officials said they developed the draft guidance to clarify how institutions can offer AMPs in a safe and sound manner and clearly disclose the potential AMP risks to borrowers. These officials told us they will request remedial action from institutions that do not adequately measure, monitor, and control risk exposures in loan portfolios. In commenting on the proposed guidance, various lenders suggested that the stricter underwriting recommendations were overly prescriptive and could result in fewer mortgage choices for consumers. Others observed that the recommendations for stricter underwriting and increased disclosure might put federally and state-regulated banks at a competitive disadvantage, because the guidance would not apply to state non-bank mortgage lenders (independent mortgage lenders) or brokers. Consumer advocates expressed concerns that regulators might not be able to enforce recommendations that were not written in law or regulation to protect consumers. Federal banking regulators currently are reviewing all comments as they finalize the draft guidance. In addition to issuing the draft guidance, federal regulatory officials have publicly reinforced their concerns about AMPs and some have taken steps to increase their monitoring of high-risk lending, including AMPs, and to improve consumer education about AMP risks. The Federal Trade Commission (FTC) also has given some attention to consumer protection issues related to AMPs. For example, in May 2006, the FTC sponsored a public workshop that explored consumer protection issues as a result of AMP growth in the mortgage marketplace.

Officials from state banking and financial regulators in eight states with whom we spoke shared some of the federal regulators' concerns about AMP lending, and to varying degrees, have responded to the increase in this lending activity among the independent mortgage lenders and brokers they oversee. Most of the state regulators rely upon state law to license mortgage lenders and brokers and to ensure that these entities meet minimum experience and operations standards. Regulatory officials from most of the states said they also periodically examine these entities for

[5]Federally regulated financial institutions include all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

compliance with state licensing; mortgage lending; and consumer protection laws, including applicable fair advertising requirements. In addition, some states have taken action to better understand issues related to AMP lending and expand consumer protections. For example, some regulators have gathered data on these products, or plan to use guidance developed by state regulatory associations to oversee AMP lending by independent mortgage lenders and brokers.

This report includes a recommendation to the Board of Governors of the Federal Reserve System to consider, in connection with its review and revision of Regulation Z, amending federal mortgage disclosure requirements to improve the clarity and comprehensiveness of AMP disclosures. We requested comments on a draft of this report from the Federal Reserve, FDIC, NCUA, OCC, and OTS. The Federal Reserve provided written comments on a draft of this report that are reprinted in appendix III. It noted that it has already initiated a comprehensive review of Regulation Z, including its requirements for mortgage disclosures. As part of this effort, it recently held four public hearings on home equity lending that partly focused on AMPs, and in particular, whether consumers receive adequate information about these products. Furthermore, in response to our recommendation, the Federal Reserve noted that it will be conducting consumer testing to determine what and when information is most useful to consumers, what language and formats work best, and how disclosures can be designed to reduce complexity and information overload. The Federal Reserve's comments are discussed in more detail at the end of this letter. We also provided a draft to FTC, and selected sections of the report to the relevant state regulators for their review. FDIC, FTC, NCUA, OCC, and OTS did not provide written comments. FDIC, FTC, and OCC provided technical comments, as did the Federal Reserve, which have been incorporated as appropriate.

Background

Borrowers arrange residential mortgages through either mortgage lenders or brokers. The funding for mortgages can come from federally or state-chartered banks, mortgage lending subsidiaries of these banks or financial holding companies, or independent mortgage lenders, which are neither banks nor affiliates of banks. Mortgage brokers act as intermediaries between lenders and borrowers, and for a fee, help connect borrowers with various lenders who may provide a wider selection of mortgage products. Mortgage lenders may keep the loans that they originated or purchased from brokers in their portfolios or sell the loans in the secondary mortgage market. Government-sponsored enterprises (GSEs) or investment banks pool many mortgage loans that lenders sell to the secondary market, and these lenders or investment banks then sell claims to these pools to investors as mortgage backed-securities (MBS).[6]

Lenders consider whether to accept or reject a borrower's loan application in a process called underwriting. During underwriting, the lender analyzes the borrower's ability to repay the debt. For example, lenders may determine ability to repay debt by calculating a borrower's DTI ratio, which consists of the borrowers' fixed monthly expenses divided by gross monthly income. The higher the DTI ratio, the greater the risk the borrower will have cash-flow problems and miss mortgage payments. During the underwriting process, lenders usually require documentation of borrowers' income and assets. Another important factor lenders consider during underwriting is the amount of down payment the borrower makes, which usually is expressed in terms of a LTV ratio (the larger the down payment, the lower the LTV ratio). The LTV ratio is the loan amount divided by the lesser of the selling price or appraised value. The lower the LTV ratio, the smaller the chance that the borrower would default, and the smaller the loss if the borrower were to default. Additionally, lenders evaluate the borrowers' credit history using various measures. One of these measures is the borrowers' credit score, which is a numerical measure or score that is based on an individual's credit payment history and outstanding debt. Mortgage loans could be made to prime and subprime borrowers. Prime borrowers are those with good credit histories that put them at low risk of default. In contrast, subprime borrowers have poor or no credit histories, and therefore cannot meet the credit standards for obtaining a prime loan.

Chartering agencies oversee federally and state-chartered banks and their mortgage lending subsidiaries. At the federal level, OCC, OTS, and NCUA oversee federally chartered banks (including mortgage operating subsidiaries), thrifts, and credit unions, respectively. The Federal Reserve oversees insured state-chartered member banks, while FDIC oversees insured state-chartered banks that are not members of the Federal Reserve System. Both the Federal Reserve and FDIC share oversight with the state regulatory authority that chartered the bank. The Federal Reserve also oversees mortgage lending subsidiaries of financial holding companies,

[6]Housing-related GSEs, such as Fannie Mae and Freddie Mac, are privately owned and operated corporations whose public missions are to enhance the availability of mortgage credit across the United States.

although FTC is responsible for enforcement of certain federal consumer protection laws as discussed in the following text.

Federal banking regulators have responsibility for ensuring the safety and soundness of the institutions they oversee and for promoting stability in the financial markets. To achieve these goals, regulators establish capital requirements for banks, conduct on-site examinations and off-site monitoring to assess their financial condition, and monitor their compliance with applicable banking laws, regulations, and agency guidance. As part of their examinations, for example, regulators review mortgage lending practices, including underwriting, risk management, and portfolio management practices. Regulators also try to determine the amount of risk lenders have assumed. From a safety and soundness perspective, risk involves the potential that events, either expected or unanticipated, may have an adverse impact on the bank's capital or earnings. In mortgage lending, regulators pay close attention to credit risk. Credit risk involves the concerns that borrowers may become delinquent or default on their mortgages and that lenders may not be paid in full for the loans they have originated.

Certain federal consumer protection laws, including TILA and the act's implementing regulation, Regulation Z, apply to all mortgage lenders, including mortgage brokers that close loans in their own name. Implemented by the Federal Reserve, Regulation Z requires these creditors to provide borrowers with written disclosures describing basic information about the terms and cost of their mortgage. Each lender's primary federal supervisory agency holds responsibility for enforcing Regulation Z. Regulators use examinations and consumer complaint investigations to check for compliance with both the act and its regulation. FTC is responsible for enforcing certain federal consumer protection laws for brokers and lenders that are not depository institutions, including state-chartered independent mortgage lenders and mortgage lending subsidiaries of financial holding companies. However, FTC is not a supervisory agency; instead, it enforces various federal consumer protection laws through enforcement actions. The FTC uses a variety of information sources in the enforcement process, including its own investigations, consumer complaints, state and other federal agencies, and others.

State regulators oversee independent lenders and mortgage brokers and do so by generally requiring business licenses that mandate meeting net worth, funding, and liquidity thresholds. They may also mandate certain experience, education, and operational requirements to engage in mortgage activities. Other common requirements for licensees may include maintaining records for certain periods, individual prelicensure testing, posting surety bonds, and participating in continuing education activities. States may also examine independent lenders and mortgage brokers to ensure compliance with licensing requirements, review their lending and brokerage functions for state-specific and federal regulatory compliance, and look for unfair or unethical business practices. When such practices arise, or are brought to states' attention through consumer complaints, regulators and State Attorneys General may pursue actions that include licensure suspension or revocation, monetary fines, and lawsuits.

AMP Lending Rapidly Grew as Borrowers Sought Mortgage Products That Increased Affordability

The volume of interest-only and payment-option ARMs grew rapidly between 2003 and 2005 as home prices increased nationwide and lenders marketed these products as an alternative to conventional mortgage products. During this period, AMP lending was concentrated in the higher-priced real estate markets on the East and West Coasts. Also at that time, a variety of federally and state-regulated lenders participated in the AMP market, although a few large federally regulated dominated lending. Once considered a financial management tool for wealthier borrowers, lenders have marketed AMPs as affordability products that enable borrowers to purchase homes they might not be able to afford using conventional fixed-rate mortgages. Furthermore, lenders have increased the variety of AMP products offered to respond to changing market conditions.

AMP Share of Mortgage Originations Grew Threefold from 2003 to 2005, with Higher Concentrations in the Coastal Markets

As home prices increased nationally and lenders offered alternatives to conventional mortgages, AMP originations tripled in recent years, growing from less than 10 percent of residential mortgage originations in 2003 to about 30 percent in 2005.[7] Most of the AMPs originated during this period consisted of interest-only or payment-option ARMs. In 2005, originations of these two products totaled $400 billion and $175 billion, respectively.[8] According to federal regulatory officials, consumer demand for these products grew because their low initial monthly payments enabled

[7]Data used in this report reflect mortgages that were securitized and sold to the private label secondary market, which do not include mortgages guaranteed by the GSEs or held by banks in their portfolios.

[8]*Inside Mortgage Finance*, Conventional Conforming Market Continued to Erode in 2005 as Nontraditional Mortgage Products Boomed, (February 24, 2006) 6.

borrowers to purchase homes that they otherwise might not have been able to afford with a conventional fixed-rate mortgage.[9]

AMP lending has been concentrated in the higher-priced regional markets on the East and West Coasts, where homes are least affordable. For example, based on data from mortgage securitizations in 2005, about 47 percent of interest-only ARMs and 58 percent of payment-option ARMs that were securitized in 2005 originated in California, where NAR reports that 7 of the 20 highest-priced metropolitan real estate markets in the country are located.[10] On the East Coast, Virginia, Maryland, New Jersey, Florida and Washington, D.C., exhibited high concentrations of AMP lending in 2005, as did Washington, Nevada, and Arizona on the West Coast. These areas also have experienced higher rates of house price appreciation than the rest of the United States.

A variety of federally and state-regulated lenders were involved in the recent surge of AMP originations. Six large federally regulated lenders dominated much of the AMP production in 2005, producing 46 percent of interest-only and payment-option ARMs originated in the first 9 months of that year.[11] The six included nationally chartered banks and thrifts under the supervision of OCC and OTS as well as mortgage lending subsidiaries of financial holding companies under the supervision of the Federal Reserve. Although these six large, federally-regulated institutions accounted for a large share of AMP lending in that year, other federally and state-regulated lenders also participated in the AMP market, including other nationally and state chartered banks and independent nonbank lenders. Additionally, independent mortgage brokers have been an important source of originations for AMP lenders. Some mortgage brokers in states with high volumes of AMP lending told us in early 2006 that they estimated interest-only and payment-option ARM lending accounted for as much as 35 to 50 percent of their recent business.

[9]As many as 58 percent of interest-only ARMs and 37 percent of payment-option ARMs that were securitized that year were used to purchase homes, with the remainder percent used for refinancing purposes. David Liu, "Credit Implications of Affordability Mortgages," *UBS* (Mar. 3, 2006).

[10]David Liu, 6, and David Liu, "Credit Implications---Fixed-rate, IO" UBS Mortgage Strategist (Mar. 28, 2006) 26.

[11]*Inside Alternative Mortgages*, Countrywide Tops Option ARM Market at 3Q Mark (Dec. 23, 2005), 5; and *Inside Alternative Mortgages*, Wells tops Interest-Only Market in 3Q of 2005 (Dec. 19, 2005), 3.

Once Considered a Specialized Product for the Financially Sophisticated, Lenders Have Offered AMPs Widely as Affordability Products

Once considered a specialized product, AMPs have entered the mainstream marketplace in higher-priced real estate markets. According to federal regulatory officials and a mortgage lending trade association, lenders originally developed and marketed interest-only and payment-option ARMs as specialized products for higher-income, financially sophisticated borrowers who wanted to minimize mortgage payments to invest funds elsewhere. Additionally, they said that other borrowers who found AMPs suitable included borrowers with irregular earnings who could take advantage of interest-only or minimum monthly payments during periods of lower income and could pay down principal and any deferred interest when they received an increase in income. However, according to federal banking regulators and a range of industry participants, as home prices increased rapidly in some areas of the country, lenders began marketing interest-only and payment-option ARMs widely as affordability products. They also said that in doing so, lenders emphasized the low initial monthly payments offered by these products and made them available to less creditworthy and less wealthy borrowers than those who traditionally used them.

After the recent surge of interest-only and payment-option ARMs, lenders have increased the variety of AMPs offered as market conditions have changed. According to industry analysts, as interest rates continued to rise, by the beginning of 2006, mortgages with adjustable rates no longer offered the same cost-savings over fixed-rate mortgages, and borrowers began to shift to fixed-rate products.[12] These analysts reported that in response to this trend, lenders have begun to market mortgages that are less sensitive to interest rate increases. For example, interest-only fixed-rate mortgages (interest-only FRMs) offer borrowers interest-only payments for up to 10 years but at a fixed interest rate over the life of the loan. Another mortgage that has gained in popularity is the 40-year mortgage. This product does not allow borrowers to defer interest or principal, but offers borrowers lower monthly payments than conventional mortgages. For example, some variations of the 40-year mortgage have a standard 30-year loan term, but offer lower fixed monthly payments that are based on a 40-year amortization schedule for part or all of the loan

[12] As of April 2006, the interest rate on 1-year ARMs averaged 5.62 percent, while interest rates on 30-year fixed-rate mortgages averaged 6.51 percent.

term.[13] According to one professional trade publication,—37 percent of first half of 2006 mortgage originations were AMPs, and a significant number of them were 40-year mortgages.[14]

Borrowers Could Face Payment Shock; Lenders Face Credit Risk but Most Appear to be Taking Steps to Manage the Risk

Depending on the particular loan product and the payment option the borrower chooses, rising interest rates or choice of a minimum monthly payment and corresponding negative amortization can significantly raise future monthly payments and increase the risk of default for some borrowers. Underwriting trends that, among other things, allowed borrowers with fewer financial resources to qualify for these loans have heightened this risk because such borrowers may have fewer financial reserves against financial adversity and may be unable to sustain future higher monthly payments in the event that they cannot refinance their mortgages or sell their home. Higher default risk for borrowers translates into higher credit risk for lenders, including banks. However, federal regulatory officials and industry participants agree that it is too soon to tell whether risks to borrowers will result in significant delinquencies and foreclosures for borrowers and corresponding losses for banks that hold AMPs in their portfolios.

AMPs Create Potential for Borrowers to Face Payment Shock, Particularly as Interest Rates Rise

AMPs such as interest-only and payment-options ARMs are initially more affordable than conventional fixed-rate mortgages because during the first few years of the mortgage they allow a borrower to defer repayment of principal and, in the case of payment-option ARMs, part of the interest as well. Specifically, borrowers with interest-only ARMs can make monthly payments of just interest for the fixed introductory period. Borrowers with payment-option ARMs typically have four payment options. The first two options are fully amortizing payments that are based on either a 30-year or 15-year payment schedule. The third option is an interest-only payment, and the fourth is a minimum payment, which we previously described, that

[13]In the most common variation, the lower payments are in effect for the entire 30-year loan term, and the borrower makes a balloon payment at the end to pay off the remaining loan balance. In another variation, the lower payments are in effect for the first 10 years; then, the loan is recast to require higher monthly payments that fully amortize the loan over the remainder of the 30-year term. An increasing number of lenders are offering 40-year mortgages that also have a 40 year maturity.

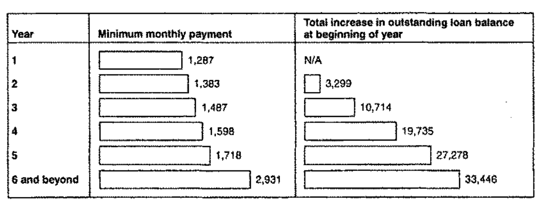
[14]*Inside Mortgage Finance*, Longer Amoritzation Products Gain Momentum In Still-Growing Nontraditional Mortgage Market (July 14, 2006), 3.

does not cover all of the interest. The interest that does not get paid gets capitalized into the loan balance owed, resulting in negative amortization.

The deferred payments associated with interest-only and payment-option ARMs will eventually result in higher monthly payments after the introductory period expires. For example, for interest-only mortgages, payments will rise at the expiration of the fixed interest-only period to include repayment of principal. Similarly, when the payment-option period ends for a payment-option ARM, the monthly payments will adjust to require an amount sufficient to fully amortize the outstanding loan balance, including any deferred interest and principal, over the remaining life or term. Depending on the particular loan product, a combination of rising interest rates and deferred or negative amortization can raise monthly payments twofold or more, causing payment shock for those borrowers who cannot avoid and are not prepared for these larger payments.

For example, consider the borrower in the following example who took out a $400,000 payment-option ARM in April 2004. The borrower's payment options for the first year ranged from a minimum payment of $1,287 to a fully amortizing payment of $2,039. Figure 1 shows how monthly payments for the borrower who chose to make only the minimum monthly payments during the 5-year payment-option period could increase from $1,287 to $2,931 or 128 percent, when that period expires.

Figure 1: Increase in Minimum Monthly Payments and Outstanding Loan Balance with an April 2004 $400,000 Payment-Option ARM, Assuming Rising Interest Rates



Source: GAO.

The example in figure 1 assumes loan features that were typical of payment-option ARMs offered during 2004, including

- a promotional "teaser" rate of 1 percent for the first month of the loan, which set minimum monthly payments for the first year at $1,287;[15]

- a payment reset cap, which limits any annual increases in minimum monthly payments due to rising interest rates to 7.5 percent for the first five years of the loan;[16] and

- a negative amortization cap, which limits the amount of deferred interest that could accrue during the first five years until the mortgage balance reaches 110 percent of its original amount, and if reached, triggers a loan recast to fully amortizing payments.

After the first month, the start rate of 1 percent expired and the interest due on the loan was calculated on the basis of the fully indexed interest rate, which was 4.55 percent in April 2004 and rose to 6.61 percent in April 2006.[17] Minimum monthly payments were adjusted upward every April, but only by the maximum 7.5 percent allowed. By year 5, the minimum payments reset to $1,718, a 33 percent increase from the initial minimum payment required in year 1.

As shown in figure 1, these minimum monthly payments were not enough to cover the interest due on the loan after the start rate expired in the first month of year 1, and the loan immediately began to negatively amortize. By year 2, the loan balance increased by $3,299. As interest rates rose, the

[15]The initial minimum monthly payment amount is derived by calculating the 30-year, fully amortizing payment for the loan on the basis of the teaser rate. This initial minimum payment is in effect for the first year of the loan.

[16]The payment reset cap keeps monthly payments affordable by protecting borrowers from rising interest rate during the payment-option period. Minimum monthly payments are adjusted annually depending on movements in interest rates. According to the June 2005 *OTS Examination Handbook*, payment reset caps for payment-option ARMs are typically 7.5 percent per year for 5 years, unless deferred interest accrues and the loan balance reaches the negative amortization cap specified in the loan terms. According to OCC officials, caps on recently sold payment-option ARMs have ranged from 110 percent to 125 percent of the loan balance, although caps of 110 percent and 115 percent are most common.

[17]The fully indexed interest rate comprises an adjustable interest rate index, such as the Federal Home Loan Bank of San Francisco Cost of Funds Index (COFI), plus the lender's margin. In April 2004, the COFI was 1.80 percent, and the lender in this example added a margin of about 2.75 percent to determine the initial fully indexed rate of 4.55 percent on the loan. Between April 2004 and April 2006, the COFI increased to 3.86 percent, causing the fully-indexed interest rate to increase to 6.61 percent. The example does not assume further interest rate increases.

amount of deferred interest grew more quickly, reaching $33,446 by the beginning of year 6. Because the start of year 6 marked the end of the 5-year payment-option period, the loan recast to require fully amortizing monthly payments of $2,931. This payment represented a 70 percent increase from the minimum monthly payment required a year earlier and a 128 percent increase from the initial minimum monthly payment in year 1. Note that the largest monthly payment increase occurred at this time, reflecting the combined effect of a fully amortizing payment that is calculated on the basis of both the fully indexed interest rate and the increased loan balance.

In Contrast to Past Borrowers, Recent AMP Borrowers May Find It More Difficult to Avoid Payment Shock

Federal regulatory officials have cautioned that the risk of default could increase for some recent AMP borrowers. This is because lenders have marketed these products to borrowers who are not as wealthy or financially sophisticated as previous borrowers, and because rising interest rates, combined with constraints on the growth in minimum payments imposed by low teaser rates, have increased the potential for payment shock.[18] FDIC officials expressed particular concern over payment-option ARMs, as they are more complex than interest-only products and have the potential for negative amortization and bigger payment shocks.

Mortgage statistics of recently securitized interest-only and payment-option ARMs show a relaxation of underwriting standards regarding credit history, income, and available assets during the years these products increased in popularity. According to one investment bank, interest-only mortgages that were part of subprime securitizations were negligible in 2002, but rose to almost 29 percent of subprime securitizations in 2005. Lenders also originated payment-option ARMs to borrowers with increasingly lower credit scores (see table 1). In addition, besides permitting lower credit scores, lenders increasingly qualified borrowers with fewer financial resources. For example, lenders allowed higher DTI ratios for some borrowers and began combining AMPs with "piggyback" mortgages—that is, second mortgages that allow borrowers with limited or no down payments to finance a down payment. As table 1 shows, by June 2005, 25 percent of securitized payment-option ARMs included

[18]While the inability to make higher monthly payments could cause loan defaults, job loss, divorce, serious illness, and a death in the family are commonly identified as the major reasons borrowers' default on their mortgages. In each of these examples, the borrower can experience a major drop in income, or a major increase in expenses.

piggyback mortgages—up from zero percent 5 years earlier.[19] Furthermore, lenders increasingly have qualified borrowers for AMPs under "low documentation" standards, which allow for less detailed proof of income or assets than lenders traditionally required.[20]

Table 1: Underwriting Trends of Recent Payment-Option ARM Securitizations, January 2001 to June 2005

Origination year	Origination amount (in millions of dollars)[a,b]	Percentage of FICO scores below 700[c]	Average DTI ratio[d]	Percentage of option ARMs with piggyback mortgages	CLTV>80 percent[e]	Percentage with low documentation
2001	$2,210	32.4%	24.4	0.0%	1.8%	69.4%
2002	3,745	33.4	29.2	0.3	1.9	67.6
2003	2,098	42.4	28.9	6.3	10.4	74.4
2004	37,117	43.1	31.6	11.4	12.0	75.4
2005	13,572	48.2	32.6	25.3	22.2	74.7

Source: Loan Performance and UBS.

[a]The data in this table capture only mortgages that are securitized and sold to the private label secondary market, which do not include mortgages guaranteed by GSEs or held by banks in their portfolios.

[b]The 2005 origination amount reflects data from the first half of the year.

[c]FICO scores are credit scores used to evaluate a borrower's credit history.

[d]A DTI ratio is the borrower's fixed monthly expenses divided by gross monthly income.

[e]Combined loan-to-value (CLTV) is the percentage that the first and second mortgages make up of the property value.

Federal banking regulators cautioned that "risk-layering", which results from the combination of AMPs with one or more relaxed underwriting practices could increase the likelihood that some borrowers might not withstand payment shock and may go into default. In particular, federal regulatory officials said that some recent AMP borrowers, particularly those with low income and little equity, may have fewer financial reserves against financial adversity, which could impact their ability to sustain future higher monthly payments in the event that they cannot refinance

[19]In a typical piggyback mortgage arrangement, the borrower takes a first mortgage for 80 percent of the property value, and a second mortgage or a home equity line of credit for part or all of the remaining 20 percent of the property value. Piggyback mortgages typically are used to avoid the purchase of private mortgage insurance, which many lenders require when the down payment is less than 20 percent of the property value.

[20]For example, with a no income/no asset verification loan, the borrower provides no proof of income and the lender relies on other factors such as the borrower's credit score.

their mortgages or sell their homes. Although concerns about the effect of risk-layering exist, OCC officials observed that while underwriting characteristics for AMPs have trended downward over the past few years, lenders generally attempt to mitigate the additional credit risk of AMPs compared to traditional mortgages by having at least one underwriting criteria (such as LTV ratio, DTI ratio, or loan size) tighter for AMPs than for a traditional mortgage. In addition, both OCC and Federal Reserve officials said that most lenders qualify payment-option ARM borrowers at the fully-indexed rate, and not the teaser rate, suggesting that these borrowers have the financial resources to either make more than the minimum monthly payment or to manage any future rise in monthly payments.[21] However, Federal Reserve officials said that borrowers of interest-only loans are qualified on the interest-only payment.

For borrowers who intend to refinance their mortgages to avoid higher monthly payments, FDIC officials expressed concern that some may face prepayment penalties that could make refinancing expensive. In particular, they said that borrowers with payment-option ARMs that choose the minimum payment option could reach the negative amortization cap well before the expiration of the five-year payment option period, triggering a loan recast to fully amortizing payments, the need to refinance the mortgage, and the imposition of prepayment penalties.

Some recent borrowers may find that they do not have sufficient equity in their homes to refinance or even to sell, particularly if their loans have negatively amortized or they have borrowed with little or no down payment. Again, consider the borrower in figure 1. To avoid the increase in monthly payments when the loan recasts at the end of year 5, the borrower would either have to refinance the mortgage or sell the home. However, because the borrower made only minimum payments, the $400,000 debt would have increased to $433,446. To the extent that the home's value has risen faster than the outstanding mortgage, or the borrower contributed a substantial down payment, the borrower might have enough equity to obtain refinancing or could sell the house and pay off the loan. However, if

[21]In the example of the $400,000 payment-option ARM discussed earlier, the lender likely would have qualified the borrower based on fully-indexed interest rate of 4.41 percent, which corresponds to the first-year's fully amortizing monthly payment of $2,039. Although the borrower is faced with a payment shock of 128 percent in year six as a result of making minimum payments, the increase is a smaller 44 percent greater than the monthly payment that was originally used to qualify the borrower.

the borrower has little or no equity and home prices remain flat or fall, the borrower could easily have a mortgage that exceeds the value of his or her home, thereby making the possibility of refinancing or home sale very difficult. According to an investment bank, as of July 2006, about 75 percent of payment-option ARMs originated and securitized in 2004 and 2005 were negatively amortizing, meaning that borrowers were making minimum monthly payments, and more than 70 percent had loan balances that exceeded the original loan balances.[22]

Federal Reserve officials also said they are concerned that some recent borrowers who used AMPs to purchase homes for investment purposes may be less inclined to avoid defaulting on their loans when faced with financial distress, on the basis that mortgage delinquency and default rates are typically higher for these borrowers than for borrowers who use them to purchase their primary residences. According to these officials, borrowers who used AMPs for investment purposes may have less incentive to try to find a way to make their mortgage payments if confronted with payment shock or difficulties in refinancing or selling, because they would not lose their primary residence in the event of a default. According to FDIC officials, this is particularly acute during instances where the borrower has made little or no down payment. Although the majority of borrowers used AMPs to purchase their primary residence, data on recent payment-option ARM securitizations indicate that 14.4 percent of AMPs originated in 2005 were used by borrowers to purchase homes for purposes other than use as a primary residence, up from 5.3 percent in 2000.[23] However, this data did not show the proportion of these originations that were used to purchase homes for investment purposes as compared to second homes.

[22]Some borrowers, who are making minimum monthly payments now, may have made a number of fully amortizing payments previously. Thus, while their loan is now negatively amortizing, their loan balance has not yet grown to more than the original loan amount. According to UBS, more than 80 percent of borrowers with lower credit scores were making minimum monthly payments, compared to more than 65 percent for borrowers with high credit scores.

[23]David Liu, "Credit Implications of Affordability Mortgages," 13.

Most AMPs Originations Are Too Recent to Generate Sufficient Performance Data to Predict Delinquencies and Losses to Banks, but Regulators Said Most Banks Appeared to Be Managing Credit Risk

AMP underwriting practices may have increased the risk of payment shock and default for some borrowers, resulting in increased credit risk for lenders, including banks. However, federal regulatory officials said that most banks appeared to be managing this credit risk. First, they said that banks holding the bulk of residential mortgages, including AMPs, are the larger, more diversified financial institutions that would be able to better withstand losses from any one business line. Second, they said that most banks appear to have diversified their assets sufficiently and maintained adequate capital to manage the credit risk of AMPs held in their portfolios or have reduced their risk through loan sales and securitizations. Investment and mortgage banking officials told us that hedge funds, real estate investment trusts, and foreign investors are among the largest investors in the riskiest classes of these securities, and that these investors largely would bear the credit risk from any AMP defaults.[24]

In addition, several regulatory officials noted borrowers who have turned to interest-only FRMs are subject to less payment shock than interest-only and payment-option ARM borrowers. As we previously discussed, interest-only FRMs are not sensitive to interest rate changes. For example, the amount of the initial interest-only payment and the later fully amortizing payment are known at the time of loan origination for an interest-only FRM and do not vary. Furthermore, these products tend to feature a longer period of introductory payments than did the interest-only and payment-option ARMs sold earlier, thus giving the borrower more time to prepare financially for the increase in monthly payments or plan to refinance or sell.[25]

Federal regulatory officials and industry participants agree that it is too soon to tell how many borrowers with AMPs will become delinquent or go into foreclosure, thereby producing losses for banks that hold AMPs in their portfolios. Most of the AMPs issued between 2003 and 2005 have not recast; therefore, most of these borrowers have not yet experienced payment shock or financial distress. As a result, lenders generally do not yet have the performance data on delinquencies that would serve as an indicator of future problems. Furthermore, the credit profile of recent

[24]Fannie Mae and Freddie Mac purchased limited amounts of AMPs during 2005. Thirteen percent of Fannie Mae loan purchases comprised interest-only and payment-option ARMs during 2005. These loans comprised 10 percent of Freddie Mac loan purchases during the first 3 quarters of 2005.

[25]The majority of interest-only FRM sold in 2005 had an interest-only period of 10 years.

AMP borrowers is different from that of traditional AMP borrowers, because it includes less creditworthy and less affluent borrowers. Consequently, it would be difficult to use past performance data to predict how many loans would be refinanced before payment shock sets in and how many delinquencies and foreclosures could result for those borrowers who cannot sustain larger monthly payments.

Regulators and Others Are Concerned That Borrowers May Not Be Well-informed About the Risks of AMPs

The information that borrowers receive about their loans through advertisements and disclosures may not fully or effectively inform them about the risk of AMPs. Federal and state banking regulatory officials expressed concern that advertising practices by some lenders and brokers emphasized the affordability of these products without adequately describing their risks. Furthermore, a recent Federal Reserve staff study and state complaint data indicated that some borrowers appeared to not understand (1) the terms of their ARMs, including AMPs, and (2) the potential magnitude of changes to their monthly payments or loan balance. As AMPs are more complex than conventional mortgage products and advertisements may not provide borrowers with balanced information on these products, it is important that written disclosures provide borrowers with clear and comprehensive information about the key terms, conditions, and costs of these mortgages to help them make an informed decision. That information is conveyed both through content and presentation, including writing style and design. With respect to content, Regulation Z, which includes requirements for mortgage disclosures, requires all creditors (lenders and those brokers that close loans in their own name) to provide borrowers with information about their ARM products. However, these requirements are not designed to address more complex products such as AMPs. The Federal Reserve has recently initiated a review of Regulation Z that will include reviewing the disclosures required for all mortgage loans, including AMPs. For presentation, current guidance available in the federal government suggests good practices on developing disclosures that effectively communicate key information on financial products. Most of the AMP disclosures we reviewed did not always fully or effectively explain the risks of payment shock or negative amortization for these products and lacked information on some important loan features, both because Regulation Z currently does not require lenders to tailor this information to AMPs and because lenders do not always follow leading practices for writing disclosures that are clear, concise, and user-friendly. According to Federal Reserve officials, revising Regulation Z to require better disclosures of the key terms and risks of AMPs could increase borrower understanding of these complex mortgage products, particularly if a broader effort were made to simplify and clarify mortgage disclosures generally. Officials added that borrowers who do not understand their AMPs may not anticipate the substantial increase in monthly payments or loan balance that can occur.

Some AMP Advertising Practices Emphasize Benefits over Risks

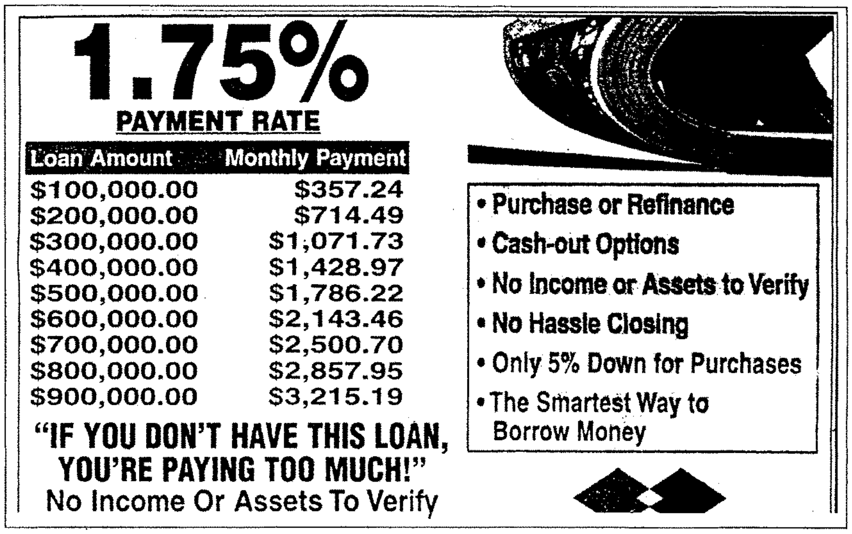
Borrowers can acquire information on mortgage options from a variety of sources, including loan officers and brokers, or as noted by mortgage industry participants, through the Internet, television, radio, and telemarketing. However, federal regulatory officials expressed concerns that some consumers may have difficulty understanding the terms and risks of these complex products. These concerns have been heightened as advertisements by some lenders and brokers emphasize the benefits of AMPs without explaining the associated risks. For example, one print advertisement for a payment-option ARM product we obtained stated on the first page that the loan "started" at an interest rate of 1.25 percent, promised a reduction in the homeowner's monthly mortgage payment of up to 45 percent, and offered three low monthly payment options. However, the lender noted in much smaller print on the second page that the 1.25 percent interest rate applied only to the first month of the loan and could increase or decrease on a monthly basis thereafter. Federal regulatory officials said that less financially sophisticated borrowers might be drawn to the promise of initial low monthly payments and flexible payment options and may not realize the potential for substantial increases in monthly payments and loan balance later.[26]

Officials from three of the eight states we contacted reported similar concerns with AMP advertising distributed by the nonbank lenders and independent brokers under their supervision. For example, one official from Ohio told us that some brokers advertised the availability of large loans with low monthly payments and only specified in tiny print at the bottom of the advertisements that the offer involved interest-only products. According to this official, small print makes it more difficult for

[26]According to Federal Reserve officials, problems with AMP advertising represent potential violations of federal law. For example, Regulation Z rules governing credit advertising require that advertisements with certain "trigger" terms, such as the amount of any payment or finance charge, must also include other specified information, such as the terms of repayment. *See* 12 C.F.R. § 226.24, and the Official Staff Commentary at Paragraph 24(c)(2)-2. Furthermore, Section 5 of the Federal Trade Commission Act prohibits unfair or deceptive practices in commerce, including mortgage lending. A creditor that provides the required Regulation Z disclosures is not immune from possible violations of the FTC Act if the information is so one-sided as to be misleading.

the consumer to see these provisions and more likely for the consumer not to read them at all. Regulatory officials in Alaska told us some advertisements circulating in their state stated that consumers could save money by using interest-only products, without disclosing that over time these loans might cost more than a conventional product. In some cases, the advertisements were potentially misleading. For example, New Jersey officials provided us with a copy of an AMP advertisement that promised potential borrowers low monthly payments by suggesting that the teaser rate (termed "payment rate" in the advertisement) on a payment-option ARM product was the actual interest rate for the full term of the loan (see figure 2). The officials also said that advertising a rate other than the annual percentage rate (APR), without also including the APR (as seen in the advertisement shown in fig. 2) is contrary to the requirements of Regulation Z.

Figure 2: Example of a 2005 Broker Advertisement for a Payment-Option ARM



Source: Name withheld. Used with permission.

Industry representatives also expressed concerns about AMP advertising. In 2005, the California Association of Mortgage Brokers issued an alert to warn the public about misleading AMP advertisements circulating in the state. The advertisements offered low monthly payments without clearly stating that these payments were temporary, and that the loan could become significantly more costly over time.

A Recent Study and Initial Complaint Data Indicated Some Borrowers Did Not Understand the Terms and Features of ARMs, Including AMPs

A recent Federal Reserve staff study and state complaint data indicate that some borrowers appeared to not fully understand the terms and features of their ARMs, including AMPs, and were surprised by the increases in monthly payments or loan balance. In January 2006, staff economists at the Federal Reserve published the results of a study that assessed whether homeowners understood the terms of their mortgages.[27] The study was based, in part, on data obtained from the Federal Reserve's 2001 *Survey of Consumer Finances*, which included questions for consumers on the terms of their ARMs. While most homeowners reported knowing their broad mortgage terms reasonably well, some borrowers with ARMs, particularly those from households with lower income and less education, appeared to underestimate the amount by which their interest rates, and thus their monthly payments, could change. The authors suggested that this underestimation might be explained, in part, by borrower confusion about the terms of their mortgages. Although they found that most households in 2001 were unlikely to experience large and unexpected changes in their mortgage payments in the event of a rise in interest rates, some borrowers might be surprised by the change in their payments and subsequently might experience financial difficulties.

The Federal Reserve staff study focused on borrowers holding ARM products in 2001—not AMPs. However, as we previously discussed, most AMP products sold between 2003 and 2005 were interest-only and payment-option ARMs that lenders increasingly marketed and sold to a wider spectrum of borrowers. Federal regulatory officials and consumer advocates said that since AMPs tend to have more complicated terms and features than ARMs, borrowers who have these mortgages would be likely to (1) underestimate the potential changes in their interest rates and (2) experience confusion about the terms of their mortgages and amounts of their payments.

Because most AMPs have not recast to fully amortizing payments, many borrowers are still making lower monthly payments that do not cover repayment of deferred principal. However, five of the eight states we contacted reported receiving some complaints about AMPs from borrowers who did not understand their loan terms and were surprised by increases in their monthly payments or loan balances. For example, some

[27] Brian Bucks and Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?*, FEDS Working Paper 2006-03, Board of Governors of the Federal Reserve System (Washington, D.C.: January 2006).

borrowers with payment-option ARMs complained that they did not know that their loans could negatively amortize until they received their payment coupons and saw that their loan balance had increased. In one case, a borrower believed that the teaser rate would be in effect for 1 or more years, when in fact it was in effect for only the first month. Officials from one state said that they anticipated receiving more consumer complaints regarding AMPs as these mortgages recast over the next several years to require fully amortizing payments.

Consumers Receive Disclosures about ARMs but the Federal Reserve Will Consider the Need for Additional Disclosures about AMPs in its Upcoming Review of Regulation Z

As AMPs are more complex than conventional mortgages and advertisements sometimes expose borrowers to unbalanced information about them, it is important that the written disclosures they receive about these products from creditors provide them with comprehensive information about the terms, conditions, and costs of these loans. Disclosures convey that information in the following two ways: content and presentation. Federal statute and regulation mandate a certain level of content in mortgage disclosures through TILA and Regulation Z.

The purpose of both TILA and Regulation Z, which implements the statutory requirements of TILA, is to promote the informed use of credit by requiring creditors to provide consumers with disclosures about the terms and costs of their credit products, including their mortgages. Some of Regulation Z's mortgage disclosure requirements are mandated by TILA. Under Regulation Z, creditors are required to provide three disclosures for a mortgage product with an adjustable rate:

- a program–specific disclosure that describes the terms and features of the ARM product,
- a copy of the federally authored handbook on ARMs, and
- a transaction-specific TILA disclosure that provides the borrower with specific information on the cost of the loan.

First, Regulation Z requires that creditors provide a program-specific disclosure for each adjustable-rate product the borrower is interested in when the borrower receives a loan application or has paid a nonrefundable fee. Among other things, lenders must include

- a statement that the interest rate, payment, or loan term may change;

- an explanation of how the interest rate and payment will be determined;
- the frequency of interest rate and payment changes;
- any rules relating to changes in the index, interest rate, payment amount, and outstanding loan balance—including an explanation of negative amortization if it is permitted for the product; and
- an example showing how monthly payments on a $10,000 loan amount could change based on the terms of the loan.

Second, Regulation Z also requires creditors to give all borrowers interested in an ARM a copy of the *Consumer Handbook on Adjustable Rate Mortgages* or CHARM booklet. The Federal Reserve and OTS wrote the booklet to explain how ARMs work and some of the risks and advantages to borrowers that ARMs introduce, including payment shock, negative amortization, and prepayment penalties.

Finally, for both fixed-rate and adjustable-rate loans for home purchases, lenders are required to provide a transaction-specific TILA disclosure to borrowers within 3 days of loan application for loans used to purchase homes. For other home-secured loans this disclosure must be provided before the loan closes. The TILA disclosure reflects loan-specific information, such as the amount financed by the loan, related finance charges, and the APR. Lenders also must include a payment schedule, reflecting the number, amounts, and timing of payments needed to repay the loan.

The Federal Reserve periodically has updated Regulation Z in response to new mortgage features and lending practices. For example, in December 2001, the Federal Reserve amended the Regulation Z provisions that implement the Home Ownership and Equity Protection Act (HOEPA), which requires additional disclosures with respect to certain high-cost mortgage loans.[28] The Federal Reserve has also developed model disclosure forms to help lenders achieve compliance with the current requirements.

According to Federal regulatory officials, current Regulation Z requirements are designed to address traditional fixed-rate and adjustable-

[28]Congress enacted HOEPA in 1994 in response to reports of predatory home equity lending practices in underserved markets.

rate products—not more complex products such as AMPs. Consequently, lenders are not required to tailor the mortgage disclosures to communicate information on the potential for payment shock and negative amortization specific to AMPs. The Federal Reserve has recently initiated a review of Regulation Z that will include reviewing the disclosures required for all mortgage loans, including AMPs. In addition, the Federal Reserve has begun taking steps to consider revisions that would specifically address AMPs. During the summer of 2006, the Federal Reserve held a series of four hearings across the country on home-equity lending.[29] Federal Reserve officials said that a major focus of these hearings was on AMPs, including the adequacy of consumer disclosures for these products, how consumers shop for home-secured loans, and how to design more effective disclosures. According to these officials, they are currently reviewing the hearing transcripts and public comment letters as a first step in developing plans and recommendations for revising Regulation Z. In addition, they said that they are currently revising the CHARM booklet to include information about AMPs and are planning to publish a consumer education brochure concerning these products.

Leading Practices for Financial Product Disclosures Include the Use of Clear Language to Explain Information That Is Most Relevant to the Consumer

As we previously noted, the presentation of information in disclosures helps convey information. Regulation Z requires that the mortgage disclosures lenders provide to consumers are clear and conspicuous. Current leading practices in the federal government provide useful guidance on developing financial product disclosures that effectively present and communicate key information on these products. The SEC publishes *A Plain English Handbook* for investment firms to use when writing mutual fund disclosures.[30] According to the SEC handbook, investors need disclosures that clearly communicate key information about their financial products so that they can make informed decisions about their investments. SEC requires investment firms to use "plain English" to communicate complex information clear and logical manner so that investors have the best possible chance of understanding the information.

[29]HOEPA directs the Federal Reserve to periodically hold public hearings to examine the home equity lending market and the adequacy of existing regulatory and legislative provisions for protecting the interests of consumers, particularly low-income consumers. The last hearings were held in 2000.

[30]SEC, *A Plain English Handbook: How to Create Clear SEC Disclosure Documents* (1998).

A Plain English Handbook presents recommendations for both the effective visual presentation and readability of information in disclosure documents. For example, the handbook directs firms to highlight information that is important to investors, presenting the "big picture" before the details. Also, the handbook recommends tailoring disclosures to the financial sophistication of the user by avoiding legal and financial jargon, long sentences, and vague "boilerplate" explanations. Furthermore, it states that the design and layout of the document should be visually appealing, and the document should be easy to read.

According to SEC, it developed these recommendations because investor prospectuses were full of complex, legalistic language that only financial and legal experts could understand. Because full and fair disclosures are the basis for investor protection under federal securities laws, SEC reasoned that investors would not receive that basic protection if a prospectus failed to provide information clearly.

The Disclosures That We Reviewed Generally Did Not Provide Clear and Complete Information on AMP Features and Risks

To see how lenders implemented Regulation Z requirements for AMPs and the extent to which they discussed AMP risks and loan terms, we reviewed eight program-specific disclosures for three interest-only ARMs and five payment-option ARMs, as well as transaction-specific TILA disclosures associated with four of them. Six federally regulated lenders, representing over 25 percent of the interest-only and payment-option ARMs produced in 2005, provided these disclosures to borrowers between 2004 and 2006. We found that the program-specific disclosures, while addressing current Regulation Z requirements, did not always provide full and clear explanations of the potential for payment shock or negative amortization associated with AMPs. Furthermore, in developing these program-specific disclosures, lenders did not always adhere to "plain English" practices for designing disclosures that are readable and visually effective, thus potentially reducing their effectiveness. Finally, we found that Regulation Z does not require lenders to completely disclose important loan information on the transaction-specific TILA disclosures, and, in most cases, lenders did not go beyond these minimum requirements when developing TILA disclosures for AMP borrowers.

Program-Specific Disclosures Did Not Always Clearly Discuss the Risk of Payment Shock or Negative Amortization for AMPs

While addressing current Regulation Z requirements, the program-specific disclosures for the eight adjustable-rate AMPs we reviewed did not always consistently provide clear and full explanations of payment shock and negative amortization as they related to AMPs. For example, in describing how monthly payments could change, two of the disclosures we reviewed closely followed the "boilerplate" language of the model disclosure form, which included a statement that monthly payments could "increase or decrease annually" based on changes to the interest rate, as illustrated in figure 3.

Figure 3: Example of a 2005 Interest-Only ARM Disclosure Explaining How Monthly Payments Can Change

How Your Monthly Payment Can Change

1. During the first 60 months, your monthly payments will include interest only and will not require any payment of principal.

2. Your monthly payment can increase or decrease annually based on changes in the interest rate.

   Potential change in monthly payments

3. For example, on a $10,000 30-year loan with an initial interest rate of 5.500 percent (interest rate reflective of index plus margin) in effect in January 2005, the maximum amount that the interest rate can rise is 5.000 percentage points to 10.500 percent, and the monthly payment can rise from a first-year payment of $45.83 to a maximum of $94.42 in the sixth year.

4. To see what your payments would be, divide your mortgage amount by $10,000; then multiply the monthly payment by that amount. For example, the monthly payment for a mortgage amount of $60,000 would be: $60,000 ÷ $10,000 = 6; 6 x $45.83 = $274.98.

5. You will be notified in writing at least 25 days before the due date of a payment at a new level. This notice will contain information about your index, interest rate, payment amount, and loan balance.

Sources: Name withheld. Used with permission; GAO (boxed comments).

While factually correct, these disclosure statements do not clearly inform the borrower about the dramatic increase in monthly payments that could occur at the end of the introductory period for an AMP—twofold or more as we previously discussed—particularly in a rising interest rate environment. The remaining six disclosures more accurately signaled this risk to the borrower by stating that the payments could change substantially. One of these disclosures most clearly alerted borrowers to this risk by including both a bold-faced heading "Potential Payment Shock" on the first page of the disclosure and the following explanatory text:

"As with all Adjustable Rate Mortgage (ARM) loans, your interest rate can increase or decrease. In the case of a *[brand name of product]*, the monthly payment can increase substantially after the first 60 months or if the loan balance rises to 110 percent of the original amount borrowed, and this creates the potential for payment shock. *Payment shock means that the increase in the payment is so significant that it can affect your monthly cash flow.*" [Emphasis added.]

In reviewing the five payment-option ARM disclosures, we also found that they did not always clearly describe negative amortization and its risks for the borrower. As required by Regulation Z, all of the disclosures explained that the product allowed for negative amortization and described how. However, the disclosures we reviewed did not always clearly or completely explain the harmful effects that could result from negative amortization. In the example above, where the disclosure did link an increased loan balance with payment shock, the effectiveness of the statement is blunted because it does not tell the borrower early on how the loan balance could rise. Instead, in a separate paragraph under the relatively nondescript heading, "More Information About [product name] Payment Choices," the lender tells the borrower that the "minimum payment probably will not be sufficient to cover the interest due each month." [Emphasis added.]

In another case, although the disclosure does say that because of negative amortization the borrower can owe "much more" than originally borrowed, the effect of that disclosure may be blunted by the inclusion of positive language about taking advantage of the negative amortization features and by non-loan-specific examples of payment changes, which are in separate sections of the disclosure:

"If your monthly payment is not sufficient to pay monthly interest, you may *take advantage of the negative amortization feature* by letting the interest rate defer and become part of the principle balance to be paid by future monthly payments, or you may also choose to limit any negative amortization by increasing the amount of your monthly payment or by paying any deferred interest in a lump sum at any time." [Emphasis added].

In addition, three of the five payment-option ARM disclosures did not explain how soon the negative amortization cap could be reached in a rising interest rate environment and trigger an early recast. Without this information, borrowers who considered purchasing a typical 5-year payment-option ARM for its flexibility might not realize that their payment-option period could expire before the end of the first 5 years, thus recasting the loan and increasing their monthly payments.

Disclosures Generally Did Not Prominently Present Key Information on Changes to Monthly Payments and Loan Balance or Adhere to Other "Plain English" Principles

Although the potential for payment shock and negative amortization are the most significant risks to an interest-only or payment-option ARM, the program-specific disclosures we reviewed generally did not prominently feature this key information. Instead, in keeping with the layout suggested by the model disclosure form, most of the disclosures we reviewed first provided lengthy discussions on the borrower's interest rate and monthly payment and the rules related to interest rate and payment changes, before describing how much monthly payments could change for the borrower. One disclosure did use the heading, "Worst Case Example," to highlight the potential for payment shock for the borrower. However, this information could be hard to find because it is located on the third and fourth page of an eight-page disclosure.

Furthermore, the program-specific disclosures generally did not conform to key plain English principles for readability or design in several key areas. In particular, we found that these disclosures were generally written with a complexity of language too high for many adults to understand. Also, most of the disclosures used small, hard-to-read typeface, which when combined with an ineffective use of white space and headings, made them even more difficult to read and hindered identification of important information. Appendix II provides additional information on the results of our analysis.

Transaction-Specific TILA Disclosures Lacked Key Information for AMP Borrowers

Regulation Z does not require lenders to completely disclose important AMP loan information on the transaction-specific TILA disclosures, including the interest-rate assumptions underlying the payment schedule, the amount of deferred interest that can accrue, and the amount and duration of any prepayment penalty. In most cases, lenders did not go beyond minimum requirements when developing transaction-specific disclosures for AMP borrowers. First, when the mortgage product features an adjustable rate, Regulation Z requires lenders to (1) include a payment schedule and (2) assume that no changes occur in the underlying index over the life of the loan. However, it does not require the disclosures to indicate this assumption, and the four transaction-specific disclosures we reviewed did not include this information. Regulation Z only requires lenders to remind borrowers in the transaction-specific disclosure that the loan has an adjustable rate and refer them to previously provided adjustable-rate disclosures (see fig. 4); therefore, borrowers might not understand that the payment schedule is not representative of their payments in a changing interest rate environment. Figure 4 shows the payment schedule for a 5-year payment-option ARM originated in 2005. The first 5 years show the minimum monthly payments increasing to reflect the difference between the teaser rate and the initial fully-indexed interest rate, but the amount of the increase is constrained each year by the payment reset cap in effect for the loan. The loan recasts in the 6th year to fully amortizing payments. However, this increase could be considerably more if the fully-indexed interest rate were to rise during the first 5 years of the loan.

Figure 4: Transaction-Specific TILA Disclosure from a 2005 Payment-Option ARM Disclosure

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf.	Total of Payments The amount you will have paid after you have made all payments as scheduled.
6.876%	$ 383,433.59	$ 238,864.92	$ 622,298.51

PAYMENT SCHEDULE:

NUMBER OF PAYMENTS	AMOUNT OF PAYMENTS		WHEN PAYMENTS ARE DUE
12	813.97	Minimum monthly payment option	MONTHLY BEGINNING 10/01/2005
12	875.02		MONTHLY BEGINNING 10/01/2006
12	940.65		MONTHLY BEGINNING 10/01/2007
12	1,011.20		MONTHLY BEGINNING 10/01/2008
12	1,087.04		MONTHLY BEGINNING 10/01/2009
299	1,885.21	Fully amortizing monthly payment	MONTHLY BEGINNING 10/01/2010
1	1,886.16		LAST PAYMENT DUE 09/01/2035

DEMAND FEATURE: [X] This loan does not have a Demand Feature. [ ] This loan does have a Demand Feature.

VARIABLE RATE FEATURE:
[X] This loan has a Variable Rate Feature. Variable Rate Disclosures have been provided to you earlier. — **Variable rate loan feature**

SECURITY: You are giving a security interest in the property located at:
[redacted]

ASSUMPTION: Someone buying this property [ ] cannot assume the remaining balance due under original mortgage terms.
[X] may assume, subject to lender's conditions, the remaining balance due under original mortgage terms.

PROPERTY INSURANCE: Hazard insurance, including flood insurance if the property is in a Special Flood Hazard Area is required as a condition of the loan. You may obtain the insurance coverage from any insurance company acceptable to the lender. Complete details concerning insurance requirements will be provided prior to loan closing.

LATE CHARGES: If your payment is more than 15 days late, you will be charged a late charge of 5.000% of the overdue payment

PREPAYMENT: If you pay off your loan early, you
[X] may [ ] will not have to pay a penalty. — **Possible prepayment penalty**
[ ] may [X] will not be entitled to a refund of part of the finance charge.
See your contract documents for any additional information regarding non-payment, default, required payment in full before scheduled date and prepayment refunds and penalties.
* means estimate

Sources: Name withheld. Used with permission; GAO (boxed comments).

Second, although negative amortization increases the risk of payment shock for the payment-option ARM borrower, Regulation Z does not require lenders to disclose the amount of deferred interest that would accrue each year as a result of making minimum payments. None of the lenders whose transaction-specific disclosures for payment-option ARMs we reviewed elected to include this information. Without it, borrowers would not be able to see how choosing the minimum payment amount could increase the outstanding loan balance from year to year. We reviewed two loan payment coupons that lenders provide borrowers on a monthly basis to see if they provided the borrower with information on negative amortization. Although they included information showing the increased loan balance that resulted from making the minimum monthly payment, borrowers only would receive these coupons once they started making payments on the loan.[31]

Finally, Regulation Z requires lenders to disclose whether the loan contains any prepayment penalties, but the regulation does not require the lender to provide any details on this penalty on the transaction-specific disclosure. Three of the four disclosures used two checkboxes to indicate whether borrowers "may" or "will not" be subject to a prepayment penalty if they paid off the mortgage before the end of the term, but did not disclose any additional information, such as the amount of the prepayment penalty (see fig. 4). One disclosure provided information on the length of the penalty period. Without clear prepayment information, borrowers may not understand how expensive it could be to refinance the mortgage if they found their monthly payments were rising and becoming unaffordable.

Revisions to Regulation Z May Increase Understanding of AMPs, Particularly If Broader Effort Were Made to Reform the Mortgage Disclosure Process

According to federal banking regulators, borrowers who do not understand their AMP may not anticipate the substantial increase in monthly payments or loan balance that could occur, and would be at a higher risk of experiencing financial hardship or even default. One mortgage industry trade association told us that it is in the best interest of lenders and brokers to provide adequate disclosures to their customers so that they will be satisfied with their loan and consider the lender for future business or refer others to them. Officials from one federal banking regulator said that revising Regulation Z requirements so that lender

[31]Regulation Z does not require creditors to send payment coupons to borrowers each month.

disclosures more clearly and comprehensively explain the key terms and risks of AMPs would be one of several steps needed to increase borrower understanding about these more complex mortgage products. Federal Reserve officials said that there is a trade-off between the goals of clarity and comprehensiveness in mortgage disclosures. In particular, they said that there is a desire to provide information that is both accurate and comprehensive in order to mitigate legal risks, but that might also result in disclosures that have too much information and therefore, are not clear or useful to consumers. According to these officials, this highlights the need for using consumer testing in designing model disclosures to determine (1) what information consumers need, (2) when they need it, and (3) which format and language that will most effectively convey the information so that it is readily understandable. In conducting the review of Regulation Z rules for mortgage disclosures, they said that they plan to use extensive consumer testing and will also use design consultants in developing model disclosure forms.

In addition, Federal Reserve officials and other industry participants said that the benefits of amending federally required disclosures to improve their content, usability, and readability might not be realized if revisions were not part of a broader effort to simplify and clarify mortgage disclosures. According to a 2000 report by the Department of the Treasury and the Department of Housing and Urban Development, federally required mortgage disclosures account for only 3 to 5 forms in a process that can generate up to 50 mortgage disclosure documents, most of which are required by the lender or state law.[32] According to federal and state regulatory officials and industry representatives, existing mortgage disclosures are too voluminous and confusing to clearly convey to borrowers the essential terms and conditions of their mortgages, and often are provided too late in the loan process for borrowers to sort through and read. Officials from one federal banking regulator noted that disclosures often are given when borrowers have committed money to apply for a loan, thereby making it less likely that the borrowers would back out even if they did not understand the terms of the loan.

[32]U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Joint Report on Recommendations to Curb Predatory Home Mortgage Lending* (Washington, D.C.: June 20, 2000).

Federal Banking Regulators Issued Draft Guidance and Took Other Actions to Improve Lender Practices and Disclosures and Publicize Risks of AMPs

Federal banking regulators have responded, collectively and individually, to concerns about the risks of AMP-lending. In December 2005, regulators collectively issued draft interagency guidance for federally regulated lenders that suggests tightening underwriting for AMP loans, developing policies for risk management of AMP lending, and improving consumer understanding of these products. For instance, the draft guidance states that lenders should provide clear and balanced information on both the benefits and risks of AMPs to consumers, including payment shock and negative amortization. In comments to the regulators, some industry groups said the draft guidance would put federally regulated lenders at a disadvantage, while some consumer advocates questioned whether it would protect consumers because it did not apply to all lenders or require revised disclosures. Federal regulatory officials discussed AMP lending in a variety of public and industry forums, widely publicizing their concerns and recommendations. In addition, some regulators individually increased their monitoring of AMP lending, taking such actions as issuing new guidance to examiners and developing new review programs.

Draft Interagency Guidance on AMP Lending Recommends Tightening Underwriting Standards, Developing Risk Management Policies, and Improving Consumer Information

Draft interagency guidance, which federal banking regulators released in December 2005, responds to their concern that banks may face heightened risks as a result of AMP lending and that borrowers may not fully understand the terms and risks of these products.[33] Federal regulatory officials noted that the draft guidance did not seek to limit the availability of AMPs, but instead sought to ensure that they were properly underwritten and disclosed. In addition, they said the draft guidance reflects an approach to supervision that seeks to help banks identify emerging and growing risks as early as possible, a process that encourages banks to develop advanced tools and techniques to manage those risks, for their own account and for their customers. Accordingly, the draft guidance recommends that federally regulated financial institutions ensure that (1) loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity; (2) risk management policies and procedures appropriately mitigate any risk

[33]Some banking regulators have addressed risks posed by AMPs through guidance that precedes the 2005 interagency guidance. For example, OTS revised its real estate lending guidance in June 2005, and it includes guidance on interest-only and negative amortizing mortgages. In addition, in January 2001, federal banking regulators developed *Expanded Guidance for Subprime Lending Programs*, which lists certain characteristics of predatory or abusive lending, such as failure to adequately disclose mortgage terms and basing the loan on the borrower's assets and not the borrower's repayment ability.

exposures created by these loans; and (3) consumers are provided with balanced information on loan products before they make a mortgage product choice.

To address AMP underwriting practices, the draft guidance states that lenders should consider the potential impact of payment shock on the borrower's capacity to repay the loan. In particular, lenders should qualify borrowers on the basis of whether they can make fully amortizing monthly payments determined by the fully-indexed interest rate, and not on their ability to make only interest-only payments or minimum payments determined from lower promotional interest rates. The draft guidance also notes increased risk to lenders associated with combining AMPs with risk-layering features, such as reduced documentation or the use of piggyback loans. In such cases, the draft guidance recommends that lenders look for off-setting factors, such as higher credit scores or lower LTV ratios to mitigate the additional risk. Furthermore, the draft guidance recommends that lenders avoid using loan terms and underwriting practices that may cause borrowers to rely on the eventual sale or refinancing of their mortgages once full amortization begins.

To manage risk associated with AMP lending, the draft guidance recommends lenders develop written policies and procedures that describe AMP portfolio limits, mortgage sales and securitization practices, and risk-management expectations. The policies and procedures also should establish performance measures and management reporting systems that provide early warning of portfolio deterioration and increased risk. The draft guidance also recommends policies and procedures that require banking capital levels that adequately reflect loan portfolio composition and credit quality, and also allow for the effect of stressed economic conditions.

To help improve consumer understanding of AMPs, the draft guidance recommends that lender communications with consumers, including advertisements, promotional materials, and monthly statements, be consistent with actual product terms and payment structures and provide consumers with clear and balanced information about AMP benefits and risks. Furthermore, the draft guidance recommends that institutions avoid advertisement practices that obscure significant risks to the consumer. For example, when institutions emphasize the AMP benefit of low initial payments, they also should disclose that borrowers who make these payments may eventually face increased loan balances and higher monthly payments when their loans recast.

The draft guidance also recommends that lenders fully disclose AMP terms and features to potential borrowers in their promotional materials, and that lenders not wait until the time of loan application or closing, when they must provide written disclosures that fulfill Regulation Z requirements. Rather, the draft guidance states that institutions should offer full and fair descriptions of their products when consumers are shopping for a mortgage, so that consumers have the appropriate information early enough to inform their decision making. In doing so, the draft guidance urges lenders to employ a user-friendly and readily navigable design for presenting mortgage information and to use plain language with concrete examples of available loan products. Further, the draft guidance states that financial institutions should provide consumers with information about mortgage prepayment penalties or extra costs, if any, associated with AMP loans. Finally, after loan closing, financial institutions should provide monthly billing statement information that explains payment options and the impact of consumers' payment choices. According to the draft guidance, such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to lending institutions.

Federal regulatory officials said they developed the draft guidance to clarify how institutions can offer AMPs in a safe and sound manner and clearly disclose the potential AMP risks to borrowers. These officials told us they will request remedial action from institutions that do not adequately measure, monitor, and control risk exposures in their loan portfolios.

Many Industry Groups Opposed the Draft Guidance and Some Consumer Advocates Questioned Whether It Would Add Consumer Protections

In response to the draft interagency guidance, federal regulators received various responses through comment letters from various groups, such as financial institutions, mortgage brokers, and consumer advocates, and began reviewing comments to develop final guidance. For example, several financial institutions such as banks and their industry associations opposed the draft guidance, suggesting that it put federally regulated institutions at a competitive disadvantage because its recommendations would not apply to lenders and brokers that were not federally regulated. Some lenders suggested implementing these changes through Regulation Z so that they apply to the entire industry, and not just to regulated institutions. Organizations such as the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) also noted the possibility of competitive disadvantage and have responded by developing guidance for state-licensed mortgage lenders and brokers who offer AMPs but were not covered by the draft federal guidance issued in December 2005. Other financial institutions said that the recommendations regarding borrower qualification and general underwriting practices were too prescriptive and would have the effect of reducing mortgage choice for consumers.

Consumer advocates supported the need for additional consumer protections relating to AMP products, but several questioned whether the draft guidance would add needed protections. They also contended, as did lenders, that since the draft guidance applies only to federally regulated institutions, independent lenders and brokers would not be subject to recommendations aimed at informing and protecting consumers. One advocacy organization said that the proposed guidance is only a recommendation by the agencies regulating some lenders, and that failure to follow the guidance neither leads to any enforceable sanctions nor provides a means of using guidance to obtain relief for a harmed consumer. Although not in a comment letter, another advocate echoed these concerns by saying the draft guidance would not expand consumer protections because it neither requires revisions to mortgage disclosures, nor allows consumers to enforce the application of guidance standards to individual lenders.

Federal Officials Reinforced Their Messages by Publicizing Their Concerns, Highlighting AMP Risks, and Taking Other Actions

Although the draft interagency guidance has not been finalized, officials from the Federal Reserve, OCC, OTS, FDIC, and NCUA have reinforced messages regarding AMP risks and appropriate lending practices by publicizing their concerns in speeches, at conferences, and the media. According to an official at the Federal Reserve, federal regulatory officials who publicized their concerns in these outlets raised awareness of AMP risks and reinforced the message that financial institutions and the general public need to manage risks and understand these products, respectively.

In addition to drafting interagency guidance and publicizing AMP concerns, officials from each of the federal banking regulators told us they have responded to AMP lending with intensified reviews, monitoring, and other actions. For instance, FDIC developed a review program to identify high-risk lending areas, adjust supervision according to product risk levels, and evaluate risk management and underwriting approaches. OTS staff has performed a review of its 68 most active AMP lenders to assess and respond to potential AMP lending risks while the Federal Reserve and OCC have begun to conduct reviews of their lenders' AMP promotional and marketing materials to assess how well they inform consumers. As discussed earlier, the Federal Reserve has taken several steps to address consumer protection issues associated with AMPs, including initiating a review of Regulation Z that includes reviewing the disclosures required for all mortgage loans and holding public hearings that in part explored the adequacy and effectiveness of AMP disclosures. In addition, NCUA officials told us they informally contacted the largest credit unions under their supervision to assess the extent of AMP lending at these institutions.

FTC also directed some attention to consumer protection issues related to AMPs. In 2004, it charged a California mortgage broker with misleading AMP consumers by making advertisements that contained allegedly false promises of fixed interest rates and fixed payments for variable rate payment option mortgages. As a result of FTC's actions, a U.S. district court judge issued a preliminary injunction barring the broker's allegedly illegal business practices. More recently in May 2006, FTC sponsored a public workshop that explored consumer protection issues as a result of AMP growth in the mortgage marketplace. FTC, along with other federal banking regulators and departments, also helped create a consumer brochure that outlines basic mortgage information to help consumers shop for, compare, and negotiate mortgages.

Most States in Our Sample Responded to AMP Lending Risks within Existing Regulatory Frameworks, While Others Had Taken Additional Actions

Along with federal regulatory officials, state banking and financial regulatory officials we contacted expressed concerns about AMP lending and some have incorporated AMP issues into their licensing and examinations of independent lenders and brokers and worked to improve consumer protection. While the states we reviewed had not changed established licensing and examinations procedures to oversee AMP lending, some currently have a greater focus on and awareness of AMP risks. Two states also had collected AMP-specific data to identify areas of concerns, and one state had proposed changing a consumer protection law to cover AMP products.

States in Our Sample Identified Concerns about AMP Lending by Independent Mortgage Lenders and Brokers

Most regulatory officials from our sample of eight states focused their concerns about AMP lending on the potential negative effects on consumers. For example, many officials questioned (1) how well consumers understood complex AMP loans, and therefore, how susceptible consumers with AMPs therefore might be to payment shock and (2) how likely consumers would then be to experience financial difficulties in meeting their mortgage payments. Some state officials also said that increased AMP borrowing heightened their concern about mortgage default and foreclosure, and some officials expressed concern about unscrupulous lender or broker operations and the extent to which these entities met state licensing and operations requirements. In addition to these general consumer protection concerns, some state officials spoke about state-specific issues. For example, Ohio officials put AMP concerns in the context of larger economic issues and said AMP mortgages were part of wider economic challenges facing the state, including an already-high rate of mortgage foreclosures and the loss of manufacturing jobs that hurt both Ohio's consumers and the overall economy. Officials from another state, Nevada, said they worried that lenders and brokers sometimes took advantage of senior citizens by offering them AMP loans that they either did not need or could not afford.

State banking and financial regulatory officials expressed concerns about the extent to which consumers understood AMPs and that potential for those who used them to experience monthly mortgage payment increases. Some state officials said that current federal disclosures were complicated, difficult to comprehend, and often did not provide information that could help consumers. However, these officials thought that adding a state-developed disclosure to the already voluminous mortgage process would add to the confusion and paperwork burden. Officials from most states have not created their own mortgage disclosures.

States in Our Sample Generally Increased Their Attention to AMPs Through Licensing and Examination, and by Taking New Approaches

State banking and financial regulators from our sample generally responded to concerns about AMP lending by increasing their attention to AMP issues through their existing regulatory structure of lender and broker licensing and examination, but some states had taken additional approaches. Most of the state officials from our sample suggested they primarily used their own state laws and regulations to license mortgage lenders and brokers and to ensure that these entities met minimum experience and operations standards. While these were not AMP-specific actions, several state officials told us these actions help ensure that lenders had the proper experience and other qualifications to operate within the mortgage industry. Some officials told us that these requirements also helped ensure that those with criminal records or histories of unscrupulous mortgage behavior would not continue to harm consumers. Some state officials said that they were particularly sensitive to AMP lenders' records of behavior because of the higher risks these products entailed for consumers.

However, Alaska provided an exception. Alaska had not specifically responded to AMP lending and Alaska officials noted that the state does not have statutes or regulations that govern mortgage lending, nor are mortgage lenders or brokers required to be licensed to make loans.

Many of the state banking and financial regulatory officials we contacted also told us that they periodically examine AMP lenders and brokers for compliance with state licensing, mortgage lending, and general consumer protection laws, including applicable fair advertising requirements. Because state officials perform examinations for all licensed lenders and brokers, these regulatory processes also are not AMP-specific. However, some state officials said they were particularly aware of AMP risks to consumers and had begun to pay more attention to potential lender, broker, and consumer issues during their oversight reviews. For example, because AMP lending heightens potential risks for consumers, several state officials said they had taken extra care during their licensing and examination reviews to review lender and broker qualifications and loan files.

A few states had worked outside of the existing licensing and examination framework to identify AMP issues and protect consumers. Officials from several states said that because they did not collect data on AMP loans and borrowers, they did not fully understand the level and types of AMP lending in their states. However, two states from our sample had begun to gather AMP data to improve their information on AMP lending. New Jersey conducted a mortgage lending survey among its state-chartered banks that specifically collected data on interest-only and payment-option mortgages, while Nevada implemented annual reporting requirements for lenders and brokers on the types of loans they originate. New Jersey and Nevada officials told us that these efforts would provide an overview of AMP lending in each state and would serve to help identify emerging AMP issues.

Other states reacted by focusing on consumer protection or using guidance for independent lenders and mortgage brokers. Ohio addressed mortgage issues, including AMP concerns, by working to improve its consumer protection law. This law originally did not cover mortgage lenders and brokers, but was amended to include protections found in other states. As of June 2006, officials drafted and passed legislation to expand the law's provisions to cover these entities and require lenders and brokers to meet fiduciary standards to offer loans that serve the interest of potential borrowers. Officials from another state in our sample, New York, said they planned to use guidance developed by the Conference of State

Bank Supervisors and American Association of Residential Mortgage Regulators to address AMP lending concerns at the state level. In addition, they said that they were revising their banking examination manual to address AMP concerns, reflect recommendations made in their guidance, and provide examiners with areas of concern on which to focus during their reviews.

Conclusions

Historically AMPs were offered to higher-income, financially sophisticated borrowers who wanted to minimize their mortgage payments to better manage their cash flows. In recent years, federally and state-regulated lenders and brokers widely marketed AMPs by touting their low initial payments and flexible payment options, which helped borrowers to purchase homes for which they might not have been able to qualify with a conventional fixed-rate mortgage, particularly in some high-priced markets. However, the growing use of these products, especially by less informed, affluent, and creditworthy borrowers, raises concerns about borrowers' ability to sustain their monthly mortgage payments, and ultimately to keep their homes. When these mortgages recast and payments increase, borrowers who cannot refinance their mortgages or sell their homes could face substantially higher payments. If these borrowers cannot make these payments, they could face financial distress; delinquency; and possibly, foreclosure. Nevertheless, it is too soon to tell the extent to which payment shock will produce financial distress for borrowers and induce defaults that would affect banks that hold AMPs in their portfolios.

Federal banking regulators have taken steps to address the potential risks of AMPs to lenders and borrowers. They have drafted guidance for lenders to strengthen underwriting standards and improve disclosure of information to borrowers. Because the key features and terms of AMPs may continue to evolve, it is essential for the regulators to make an effort to respond to AMP lending growth in ways that seek to balance market innovation and profitability for lenders with timely information and mortgage choices for borrowers. Furthermore, with the continued popularity of AMPs, it is important that the federal banking regulators finalize the draft guidance in a timely manner.

The popularity and complexity of AMPs and lenders' marketing of these products highlight the importance of mortgage disclosures in helping borrowers make informed mortgage decisions. As lenders and brokers increasingly market AMPs to a wider spectrum of borrowers, more borrowers may struggle to fully understand the terms and risks of these products. While Regulation Z requires that lenders provide certain information on ARMs, currently lenders are not required to tailor the mortgage disclosures to communicate to borrowers information on the potential for payment shock and negative amortization specific to AMPs. In particular, although they may be in compliance with Regulation Z requirements, the disclosures we reviewed did not provide borrowers with easily comprehensible information on the key features and risks of their mortgage products. Furthermore, the readability and usability of these documents were limited by the use of language that was too complex for many adults and document designs that made the text difficult to read and understand. As such, these documents were not consistent with leading practices at the federal level for financial-product disclosures that are predicated on investment firms' providing investors with important product information clearly to further their informed decision making. Although the draft interagency guidance by federal banking regulators addressed some of the concerns with consumer disclosures, the draft guidance focuses on promotional materials, not the written disclosures required by Regulation Z at loan application and closing. In addition, the guidance does not apply to nonbank lenders, whereas Regulation Z applies to the entire industry. We recognize that the Federal Reserve has begun to review disclosure requirements for all mortgage loans, including AMPs, under Regulation Z and has used the recent HOEPA hearings to gather public testimony on the effectiveness of current AMP disclosures. Furthermore, we agree with regulators and industry participants' views that revising Regulation Z to make federally required mortgage disclosures more useful for borrowers that use complex products like AMPs is a good first step to addressing a mortgage disclosure process that many view as overwhelming and confusing for the average borrower. Without amending Regulation Z to require lenders to clearly and comprehensively explain the terms and risks of AMPs, borrowers might not be able to fully exercise informed judgment on what is likely a significant investment decision.

Recommendation for Executive Action

We commend the Federal Reserve's efforts to review its existing disclosure requirements and focus the recent HOEPA hearings in part on AMPs. As the Federal Reserve begins to review and revise Regulation Z as it relates to disclosure requirements for mortgage loans, we recommend that the Board of Governors of the Federal Reserve System consider improving the clarity and comprehensiveness of AMP disclosures by requiring

- language that explains key features and potential risks specific to AMPs, and
- effective format and visual presentation, following criteria such as those suggested by SEC's *A Plain English Handbook.*

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Federal Reserve, FDIC, NCUA, OCC, and OTS. We also provided a draft to FTC and selected sections of the report to the relevant state regulators for their review. The Federal Reserve provided written comments on a draft of this report, which have been reprinted in appendix III. The Federal Reserve noted that it has already begun a comprehensive review of Regulation Z, including its requirements for mortgage disclosures. The Federal Reserve reiterated that one of the purposes of its recent public hearings on home equity lending was to discuss AMPs, and in particular, whether consumers receive adequate information about these products. It intends to use this information in developing plans and recommendations for revising Regulation Z within the existing framework of TILA. The Federal Reserve stressed that any new disclosure requirements relating to features and risks of today's loan products must be sufficiently flexible to allow creditors to provide meaningful disclosures even as those products develop over time. In response to our recommendation to consider improving the clarity and comprehensiveness of AMP disclosures, the Federal Reserve noted that it plans to conduct consumer testing to determine what information is important to consumers, what language and formats work best, and how disclosures can be revised to reduce complexity and information overload. To that end, the Federal Reserve said that it will use design consultants to assist in developing model disclosures that are most likely to be effective in communicating information to consumers. In addition, the Federal Reserve provided examples of other efforts that it is currently engaged in to enhance the information consumers received about the features and risks associated with AMPs, which we have previously discussed in the report. FDIC, FTC, NCUA, OCC, and OTS did not provide written comments. Finally, the Federal Reserve, FDIC, FTC, and OCC provided technical comments, which we have incorporated into the final report.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this report. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on

Banking, Housing, and Urban Affairs and the Ranking Minority Member of its Subcommittee on Housing and Transportation; the Chairman and Ranking Minority Member of the House Committee on Financial Services; other interested congressional committees. We will also send copies to the Chairman, Federal Deposit Insurance Corporation; the Chairman, Board of Governors of the Federal Reserve System; the Chairman, National Credit Union Administration; the Comptroller of the Currency; and the Director, Office of Thrift Supervision. We will also make copies available to others upon request. The report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Sincerely yours,

Orice M. Williams
Director, Financial Markets
and Community Investment

Appendix I: Scope and Methodology

To identify recent trends in the market for alternative mortgage products (AMPs), we gathered information from federal banking regulators and the residential mortgage lending industry on AMP product features, customer base, and originators as well as on reasons for the recent growth of these products.

To determine the potential risks of AMPs for lenders and borrowers, we analyzed the changes, especially increases, in future monthly payments that can occur with AMPs. We analyzed these data using several scenarios, including rising interest rates and negative amortization. We obtained data from a private investment firm on the underwriting characteristics of recent interest-only and payment-option adjustable rate mortgage (ARM) issuance and obtained information on the securitization of AMPs from federal banking regulators, government-sponsored enterprises, and the secondary mortgage market. We conducted a limited analysis to assess the reliability of the investment firm's data. To do so, we interviewed a firm representative and an official from a federal banking regulator (federal regulatory official) to identify potential data limitations and determine how the data were collected and verified and to identify potential data limitations. On the basis of this analysis, we concluded that the firm's data were sufficiently reliable for our purposes. Finally, we interviewed federal regulatory officials and representatives from the residential mortgage lending industry and reviewed studies on the risks of these mortgages compared with conventional fixed rate mortgages.

To determine the extent to which mortgage disclosures present the risks of AMPs, we reviewed federal laws and regulations governing the content of required mortgage disclosures. We obtained examples of AMP-related advertising and mortgage disclosures, reviewed studies on borrowers' understanding of adjustable rate products, and conducted interviews with federal regulatory officials and industry participants. To obtain state regulators' views on AMP mortgage disclosures, we also selected a sample of eight states and reviewed laws and regulations related to disclosure requirements. We obtained examples of AMP advertisements, disclosures, and AMP-related complaint information and interviewed state officials. We generally selected states that 1) exhibited high volumes of AMP lending, 2) provided geographic diversity of state locations, and 3) provided diverse regulatory records when responding to the challenges of a growing AMP market. Because state-level data on AMP lending volumes were not available, we determined which states had high volumes of AMP lending by using data obtained from a Federal Reserve Bank on states that had high levels of ARM growth and house price appreciation in 2005, factors which this study suggested corresponded with high volumes of AMP lending. Furthermore, we reviewed regulatory data showing that the largest AMP lenders conducted most of their lending in these states. We selected eight states and conducted in-person interviews with officials from California, New Jersey, New York, and Ohio. We conducted telephone interviews with officials from the remainder of the sample states (Alaska, Florida, Nevada, and North Carolina).

We also analyzed for content, readability, and usability a selected sample of eight written disclosures that six federally regulated AMP lenders provided to borrowers between 2004 and 2006. The sample included program-specific disclosures for three interest-only ARMs and for five payment-option ARMs as well as transaction-specific disclosures associated with four of them. The six lenders represented over 25 percent of the interest-only and payment-option ARMs produced in the first 9 months of 2005. First, we assessed the extent to which the disclosures described the key risks and loan features of interest-only and payment-option ARMs. Second, we conducted a readability assessment of these disclosures using computer-facilitated formulas to predict the grade level required to understand the materials. Readability formulas measure the elements of writing that can be subjected to mathematical calculation, such as the average number of syllables in words or number of words in sentences in the text. We applied the following commercially available formulas to the documents: Flesch Grade Level, Frequency of Gobbledygook (FOG), and Simplified Measure of Gobbledygook (SMOG). Using these formulas, we measured the grade levels at which the disclosure documents were written for selected sections. Third, we conducted an evaluation that assessed how well these AMP disclosures adhered to leading practices in the federal government for usability. We used guidelines presented in the Securities and Exchange Commission's (SEC) *A Plain English Handbook: How to Create Clear SEC Disclosure Documents (1998)*. SEC publishes the handbook for investment firms to use when writing mutual fund disclosures. The handbook presents criteria for both the effective visual presentation and readability of information in disclosure documents.

To obtain information on the federal regulatory response to the risks of AMPs for lenders and borrowers, we reviewed the draft interagency guidance on AMP lending issued in December 2005 by federal banking regulators and interviewed regulatory officials about what actions they could use to enforce guidance principles upon final release of the draft. We also reviewed comments written by industry participants in response to the draft guidance. To review industry comments, we selected 29 of the 97 comment letters that federal regulators received. We selected comment letters that represented a wide range of industry participants, including lenders, brokers, trade organizations, and consumer advocates. We analyzed the comment letters for content; sorted them according to general comments, issues of institutional safety and soundness, consumer protection, or other concerns; and summarized the results of the analysis.

To obtain information on selected states' regulatory response to the risks of AMPs for lenders and borrowers, we reviewed current laws and, where applicable, draft legislation from the eight states in our sample and interviewed these states' banking and mortgage lending officials.

We performed our work between September 2005 and September 2006 in accordance with generally accepted government auditing standards.

Appendix II: Readability and Design Weaknesses in AMP Disclosures That We Reviewed

The AMP disclosures that we reviewed did not always conform to key plain English principles for readability or design. We analyzed a selected sample of eight written AMP disclosures to determine the extent to which they adhered to best practices for financial product disclosures. In conducting this assessment, we used three widely used "readability" formulas as well as guidelines from the SEC's *A Plain English Handbook*. In particular, the AMP disclosures that we reviewed were written at a level of complexity too high for many adults to understand. Also, most of the disclosures that we reviewed used small typeface, which when combined with an ineffective use of white space and headings, made them more difficult to read and hindered identification of important information.

Disclosures Required Reading Levels Higher Than That of Many Adults in the U.S.

The AMP disclosures that we reviewed contained content that was written at a level of complexity higher than the level at which many adults in the United States read. To assess the reading level required for AMP disclosures, we applied three widely used "readability" formulas to the sections of the disclosures that discussed how monthly payments could change. These formulas determined the reading level required for written material on the basis of quantitative measures, such as the average numbers of syllables in words or the number of words in sentences.[1]

On the basis of our analysis, the disclosures were written at reading levels commensurate with an education level ranging from 9th to 12th grade, with an average near the 11th grade. A nationwide assessment of reading comprehension levels of the U.S. population reported in 2003 that 43 percent of the adult population in the United States reads at a "basic" level or below.[2] While certain complex terms and phrases may be unavoidable in discussing financial material, disclosures that are written at too high a reading level for the majority of the population are likely to fail in clearly communicating important information. To ensure that disclosures investment firms provide to prospective investors are understandable, the Plain English Handbook recommends that investment firms write their disclosures at a 6th- to 8th-grade reading level.

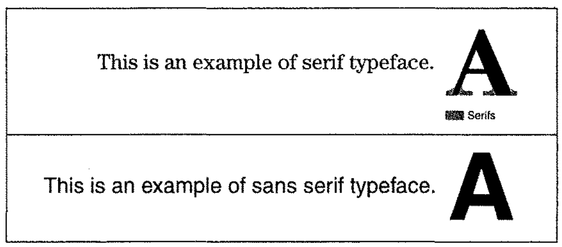
[1]These readability formulas did not evaluate the content of the disclosures or assess whether the information was conveyed clearly. For more information on this topic, see appendix I.

[2]See the *2003 National Assessment of Adult Literacy*. The study evaluated adults' reading skills according to four levels: below basic, basic, intermediate, and proficient.

Size and Choice of Typeface and Use of Capitalization Made Most Disclosures Difficult to Read

Most of the AMP disclosures used font sizes and typeface that were difficult to read and could hinder borrowers' ability to find information. The disclosures extensively used small typeface in AMP disclosures, when best practices suggest using a larger, more legible type. *A Plain English Handbook* recommends use of a 10-point font size for most investment product disclosures and a 12-point size font if the target audience is elderly. Most of the disclosures we reviewed used a 9-point size font or smaller. Also, more than half of the disclosures used sans serif typeface, which is generally considered more difficult to read at length than its complement, serif typeface. Figure 5 below provides an example of serif and sans serif typefaces.

Figure 5: Examples of Serif and Sans Serif Typefaces



Source: GAO.

The handbook recommends the use of serif typefaces for general text because the small connective strokes at the beginning and end of each letter help guide the reader's eye over the text. The handbook recommends using the sans serif typeface for short pieces of information, such as headings or for emphasizing particular information in the document.

In addition, some lenders' efforts to use different font types to highlight important information made the text harder to read. Several disclosures emphasized large portions of text in boldface and repeated use of all capital letters for headings and subheadings. According to the handbook, formatting large blocks of text in capital letters makes it harder to read because the shapes of the words disappear, thereby forcing the reader to slow down and study each letter. As a result, readers tend to skip sentences that are written entirely in capital letters.

Disclosures Generally Did Not Make Effective Use of White Space or Headings

The AMP disclosures generally did not make effective use of white space, reducing their usefulness. According to the Plain English Handbook, generous use of white space enhances usability, helps emphasize important points, and lightens the overall look of the document. However, in most of the AMP disclosures, the amount of space between the lines of text, paragraphs, and sections was very tight, which made the text dense and difficult to read. This difficulty was compounded by the use of fully justified text—that is, text where both the left and right edges are even—in half of the disclosure documents. According to the handbook, when text is fully justified, the spacing between words fluctuates from line to line, causing the eye to stop and constantly readjust to the variable spacing on each line. This, coupled with a shortage of white space, made the disclosures we reviewed visually unappealing and difficult to read. The handbook recommends using left-justified, ragged right text (as this report uses), which research has shown is the easiest text to read.

Very little visual weight or emphasis was given to the content of the disclosures other than to distinguish the headings from the text of the section beneath it. As a result, it was difficult to readily locate information of interest or to quickly identify the most important information—in this case, what the maximum monthly payment could be for a borrower considering a particular AMP. According to the handbook, a document's hierarchy shows how its designer organized the information and helps the reader understand the relationship between different levels of information. A typical hierarchy might include several levels of headings, distinguished by varying typefaces.

Appendix III: Comments from the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

September 6, 2006

Ms. Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Williams:

Thank you for the opportunity to comment on the GAO's draft report entitled Alternative Mortgage Products: Impact on Defaults Remains Unclear, But Disclosure of Risks to Borrowers Could Be Improved. As the report notes, the Federal Reserve Board has commenced a comprehensive rulemaking to review the Truth in Lending Act (TILA) rules. The primary goal of the review is to improve the effectiveness and usefulness of consumer disclosures and the substantive protections provided under the Board's Regulation Z, which implements TILA. To ensure that consumers get timely information in a form that is readily understandable, the Board will study alternatives for improving both the content and format of disclosures, including revising the model forms published by the Board.

The Board has already taken steps relating to its review of the requirements for mortgage loan disclosures, even though the initial stage of the Board's review of Regulation Z has been focused on open-end credit accounts that are not home-secured. During the summer of 2006, the Board held a series of four public hearings on home-equity lending. One of the principal purposes of the hearings was to gather information to inform the Board's review of Regulation Z. A significant portion of the Board's recent hearings was devoted to discussing alternative or "nontraditional" mortgage products, and in particular, whether consumers receive adequate information about these products. The hearings explored consumer behavior in shopping for mortgage loans and included discussions about the challenges in designing disclosures to more effectively communicate loan terms and risks to consumers. The Board's staff is continuing to review the transcripts of the hearings as well as the public comment letters submitted in connection with the hearings. Staff will consider this information in developing plans and recommendations for revising Regulation Z.

The draft GAO report specifically recommends, in connection with the review and revision of Regulation Z, that the Board consider improving the clarity and comprehensiveness of disclosures for alternative mortgage products by requiring more effective formatting and

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visual presentation as well as additional language explaining the key features and potential risks specific to these products. As part of its review of the effectiveness of closed-end credit disclosures under Regulation Z, the Board will be conducting extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what language and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload. To that end, the Board will be using design consultants to assist in developing model disclosures that are most likely to be effective in communicating information to consumers. The Board also plans to use consumer testing to assist in developing model disclosure forms. Based on this review and testing, the Board will revise Regulation Z within the existing framework of TILA. If we determine that useful changes to the closed-end disclosures are best accomplished through legislation, the Board would develop suggested statutory changes for congressional consideration.

Furthermore, in reviewing the disclosure requirements for closed-end credit transactions, the Board must also be mindful that the loan products offered today might differ substantially from products offered in the future. Thus, any new disclosure requirements relating to features and risks of today's loan products must be sufficiently flexible to allow creditors to provide meaningful disclosures even as those products develop over time.

The Board is also engaged in other efforts to enhance the information consumers receive about the features and risks associated with alternative mortgage products. The Board's staff is currently working with staff of the Office of Thrift Supervision to revise the Consumer Handbook on Adjustable Rate Mortgages (CHARM) to include additional information about these products. The CHARM booklet is an effective means of delivering to consumers information about alternative adjustable rate mortgage products because creditors are required to provide a copy of the booklet to each consumer that receives an application for an ARM. Staff is planning to publish the revised CHARM booklet later this year. The Board is also planning to publish a consumer education brochure titled: Interest-Only Mortgage Payments and Option-Payment ARMs—Are They for You? The brochure is designed to assist consumers who are shopping for a mortgage loan, and will be available in printed form and in electronic form on the Board's Internet web site. The educational brochure is expected to be published within the next several weeks.

In addition, as the GAO draft report notes, the Board and other federal bank and thrift regulators issued draft interagency guidance on alternative mortgage products in December 2005. The proposed guidance addresses both safety and soundness and consumer protection concerns. The proposed guidance focuses on the need to provide consumers with clear and balanced information, at crucial decision-making points, about the relative benefits and risks of nontraditional mortgage products. Accordingly, the draft interagency guidance describes recommended practices for financial institutions in communicating with consumers while they are shopping, not just upon submission of an application or at loan consummation. Specifically, the proposed guidance recommends that institutions' promotional materials and descriptions of these products include information about, among other things, potential increases in consumers' payment obligations ("payment shock") and the potential consequences of increasing principal loan balances and decreasing home equity (negative amortization). The proposed guidance also

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recommends that institutions alert consumers to the amount of any prepayment penalty that may be imposed if the consumer refinances the mortgage. The agencies have reviewed the public comments received on the draft guidance and they are currently working towards finalizing the document.

The Board's staff has provided technical comments on the draft GAO report separately. We appreciate the efforts of your staff to respond to our comments.

Sincerely,

Sandra F. Braunstein

c: Karen Tremba, Assistant Director, GAO

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Orice M. Williams, (202) 512-5837, Williamso@gao.gov

Staff Acknowledgments

In addition to those named above, Karen Tremba, Assistant Director; Tania Calhoun; Bethany Claus Widick; Stefanie Jonkman; Mark Molino; Robert Pollard; Barbara Roesmann; and Steve Ruszczyk made key contributions to this report.

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For Release Upon Delivery
10:00a.m., September 20, 2006

TESTIMONY OF

KATHRYN E. DICK
DEPUTY COMPTROLLER

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON ECONOMIC POLICY

And the

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

September 20, 2006

Statement Required by 12 U.S.C. 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Allard, Chairman Bunning, Ranking Member Reed, Ranking Member Schumer, and members of the Subcommittees, I appreciate the opportunity to appear before you today to discuss nontraditional mortgage products and the proposed interagency guidance on those products. My testimony this morning will focus on a brief overview of the nontraditional mortgage market, the OCC's perspective on factors that precipitated the need for policy guidance, the key elements of the proposed guidance, and a brief discussion of public comments received on the proposal.

Overview

Historically, residential mortgage lending has been a conservatively managed business with low loss levels and reasonably stable underwriting standards. In the past few years, low interest rates and an appetite by lenders for greater acceptance of credit risk has increased housing demand and access to credit; though at the same time contributing to rapid housing appreciation in a number of large regional markets.

Rapid appreciation, coupled with the recent rise in interest rates, has challenged housing affordability and made the payment structure and loan terms of traditional mortgage products less attractive to borrowers. In addition, competitive pressures to maintain origination volumes have provided strong incentives for lenders to promote continued access to credit through product evolution and streamlining costs and underwriting practices.

This environment has led to growing consumer demand, particularly in high priced real estate markets, for residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest. These products, often referred to as nontraditional mortgage loans, include "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan, and "payment option" adjustable-rate mortgages (ARMs) where a borrower has several payment options each month, including one with the potential for negative amortization.

Traditional mortgage loans, both fixed and adjustable rate, typically require that the borrower's monthly payment cover both interest and a reduction in principal, allowing for a reasonably predictable amortization over the life of the mortgage. Alternatively, nontraditional mortgages allow borrowers to exchange lower payments during an initial period for higher, less predictable payments during a later amortization period.

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage products – once used relatively sparingly by more creditworthy and affluent borrowers as a cash-management tool – are now offered by more lenders to a wider spectrum of borrowers, who may not otherwise qualify for traditional mortgage loans and may not fully understand the associated risks. Increasingly, they are being mass marketed as "affordability products" to borrowers who appear to be relying on the initial low payments to afford the often sizeable mortgages necessary to buy homes in many housing markets across the country. According to data from *Inside Mortgage Finance*, an industry trade publication, approximately 30 percent of all mortgages originated in 2005 were interest-only mortgages or payment-option ARMs.

Many of these nontraditional mortgage loans are being underwritten with less stringent income and asset verification requirements ("reduced documentation") than in the past. They are also increasingly combined with simultaneous second-lien loans to reduce down payment requirements and avoid private mortgage insurance (PMI). Such risk layering, combined with the broader marketing of these products, exposes financial institutions and borrowers to increased risk when compared to traditional mortgage loans.

The growth in nontraditional mortgage products and easing of underwriting standards is especially important to the OCC, since national banks have significant involvement in the residential mortgage markets - a market that has become increasingly dominated by a handful of very large lenders. According to data from *Inside Mortgage Finance*, the top five lenders produced approximately 47 percent of all residential mortgages originated in 2005, and three of the top five were national banks.

The Need for Policy Guidance on Nontraditional Mortgage Products

At the OCC, we have identified three primary reasons we believe it is essential to provide clear supervisory expectations to financial institutions that offer nontraditional mortgage products. First, we are concerned that the risks associated with nontraditional mortgage products are no longer limited to a small, homogenous population of borrowers, but rather now apply to a wider spectrum of borrowers, including some who may not fully understand the financial risks they are assuming.

In the past, lenders limited these products to more creditworthy borrowers for use as a cash-management tool. For example, payment option ARMs allowed borrowers to manage uneven cash flows, common for individuals paid on commission, or self-employed, or to cushion the blow of a temporary rise in interest rates, by exercising the option to make a smaller monthly payment. Of course, any unpaid interest would be added to the underlying principal balance of the mortgage, thereby increasing the total amount of the underlying loan.

During the spike in mortgage lending over the past few years, banks and other lenders began marketing nontraditional mortgage products as a type of "affordability product" – which is to say that potential borrowers could use these products as a method to qualify for a larger mortgage. This was accomplished by structuring the payment terms to reduce the monthly payment in the early years of the mortgage. But the trade-off for these much lower monthly payments in the present is the requirement to make much higher monthly payments in the future.

During this initial payment deferral period – typically five years but sometimes longer – an interest-only mortgage reduces the monthly payment by allowing the borrower to pay only the interest due on the loan each month. A payment-option mortgage goes one step further. In addition to forgoing monthly principal payments, it allows the borrower to pay back only *part* of the interest that is accrued each month, with any unpaid interest being added to the underlying principal of the loan. In other words, the mortgage "negatively amortizes," so that with each monthly payment, the borrower's mortgage debt increases.

After the limited initial period ends, the monthly payment for the holder of a nontraditional mortgage must increase – sometimes substantially - even if interest rates stay flat. This occurs because the borrower must now amortize the entire amount outstanding over the shorter remaining term of the loan. In the example that I've attached to my testimony, we assume a modest rise in interest rates of only two percent, and yet the monthly payment literally *doubles* in the first month after the payment deferral period ends and the loan is required to amortize. This is a major, if not unmanageable, stretch. How borrowers will respond – and how these new products will perform under such circumstances – remains an open question.

This potential payment shock problem is the most fundamental issue regarding nontraditional mortgages. For obvious reasons, the financial implications are significant at the individual borrower level, including questions regarding whether borrowers have a reasonable opportunity to understand the loan terms and make informed decisions. The payment shock issue also extends to risk management issues for lenders.

The second reason we are concerned about the rising volume of nontraditional mortgages is that these products may expose both the borrower and a financial institution to unwarranted levels of risk in a stressed environment. On a portfolio level, the risks of nontraditional mortgages can be masked in an active real estate market characterized by rapid home price appreciation. By the time the typical interest only or low minimum monthly payment periods expires, the mortgage can be refinanced and paid off by extracting the increased equity in the appreciated home.

But what happens if rates rise, or home prices fall, or both occur? A borrower can easily be faced with a mortgage that exceeds the value of their home, making it very difficult to refinance or sell if necessary. Borrowers that started out with little or no equity through the combination of a nontraditional mortgage with a simultaneous second-lien loan or borrowers who experienced erosion in their initial equity due to negative amortization could be in an even worse position. At this same time, such borrowers may face a much higher monthly payment, in some cases higher than they can afford, leading to default and foreclosure. By extension, these same scenarios could expose a lender with a portfolio of such loans to much higher credit risk than a portfolio of traditional mortgage loans. Additionally, such lenders could be faced with potential compliance and reputation risks if faced with the prospect of wide-scale foreclosures in any given community.

Third, we are concerned about the ability of current industry practices to adequately inform nontraditional mortgage borrowers of the risks associated with these products. Our final fundamental concern is: Do borrowers who use these products understand the very real possibility of dramatically increased payments in the future? To help answer this question, we looked at samples of actual marketing materials used by lenders to market payment option mortgages. In many cases we found that such materials focused primarily on the initial low monthly payment and gave relatively little attention to the likelihood of much higher payments later. This exercise led us to conclude, at least initially, that nontraditional mortgages are relatively complex, and borrowers unfamiliar with them — which means most borrowers — would benefit greatly from improvements in both the content and timing of disclosures.

Proposed Interagency Guidance

To address these concerns, the OCC and other federal banking agencies (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) proposed guidelines addressing the fundamental issues raised by nontraditional mortgages – specifically, that, over time, borrowers could experience substantial increases in required monthly payments that they may not understand or be able to afford, and therefore, could be putting their homeownership at risk.

This proposed guidance would apply to all insured financial institutions, their affiliates and subsidiaries.

Key Elements of the Proposed Guidance

The proposed guidance directs financial institutions to recognize and mitigate the risks inherent in nontraditional mortgage products. This includes ensuring that loan terms and underwriting standards are consistent with prudent lending practices, with particular attention to conducting a credible analysis of a borrower's repayment capacity. It also includes ensuring that consumers are provided clear and balanced information about the relative benefits and risks, sufficiently early in the process to enable them to make informed decisions.

Loan Terms and Underwriting Standards

The first fundamental issue addressed in the proposed guidance is that loan terms and underwriting standards should be based on a disciplined analysis of a borrower's capacity to repay mortgage debt in an orderly and systematic manner. This includes borrower qualification standards that consider a fully-indexed interest rate and a fully amortizing repayment schedule (*i.e.,* payment of both principal and interest).

Some banks have offered option ARM products for many years. However, as I noted earlier in my testimony, we see some significant differences in the way these products are offered today. Originally, option arm products were offered as cash-management products marketed to higher income or financially-sophisticated clients. However, now we see increased reliance on mass-marketing nontraditional mortgage products to hard-working people whose increases in household income may lag behind the increases in home prices.

According to a recent performance analysis of non-agency, nontraditional securitized mortgages by *UBS Mortgage Strategist (May 16, 2006)*, 75% of borrowers with option ARMs originated between 2003 and 2005 are making minimum payments.

Reduced to its essentials, a payment option loan with a negative amortization feature is functionally equivalent to a traditional mortgage loan coupled with a separate home equity line of credit. With a traditional mortgage and separate home equity line of credit, the borrower may use a check to draw down the line of credit, thereby increasing the total amount borrowed. With a payment option or negative amoritization loan, the borrower has a different way to draw down the embedded line of credit to increase the amount borrowed: he or she can simply choose the minimum payment option so as not to pay the entire amount of interest due for a given monthly payment, and the amount not paid is the additional amount borrowed.

There is, however, a fundamental difference in the way that the two products are underwritten. When a lender underwrites a separate home equity line of credit with a traditional mortgage, the borrower must demonstrate to the lender that he or she has adequate income to service the full amount of additional debt that would be incurred if the borrower drew down the entire line. In contrast, in today's market for payment option loans, lenders do not impose a similar requirement to ensure that a borrower has adequate income to service the full amount of additional debt that would be incurred by electing to make only the minimum monthly payments each month. Moreover, as noted above, the overwhelming majority of recent users of payment option loans have elected to "draw down" on this embedded line of credit by repeatedly choosing to pay only the minimum amount due.

At the OCC, we believe that underwriting standards that do not include a credible analysis of a borrower's capacity to repay their entire debt violate a fundamental principle of sound lending and elevate risks to both the lender and the borrower. Accordingly, for products that permit negative amortization, the proposed guidance provides that a lender's underwriting analysis should be based on the initial loan amount plus any balance increase that may accrue over time by repeatedly choosing the minimum monthly payment and the maximum potential amount of negative amortization that the loan permits.

The proposed guidance also addresses the practice of institutions increasingly relying on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and alternative information for the verified data traditionally used in analyzing a borrower's repayment capacity and general creditworthiness, they should be used with caution. The proposed guidance directs that the use of reduced documentation, such as unverified, stated income, should be accepted only if there are other mitigating factors such as lower loan-to-value limits and other more conservative underwriting standards.

Portfolio and Risk Management Practices

We expect institutions to adopt robust risk management practices, including policies and internal controls that address product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. The proposed guidance also discusses the need for institutions to maintain performance measures and management reporting systems that provide early warning of potential or increasing risks.

This includes stress testing of key performance indicators and ensuring that the results are integrated into the process of calibrating reserve and capital levels, as well as future product terms.

Consumer Protection Issues

Finally, the proposed guidance recommends that financial institutions provide timely, clear, and balanced consumer information about nontraditional mortgage products, and avoid practices that tend to obscure the significant risks these products could pose.

When we say that the disclosure should be "timely," we mean that the information should be available to potential borrowers at crucial decision points — when they're shopping for the loan and when they face the choice each month on how much to pay. Information provided at these points in time will help to fill in some gaps existing in federal disclosure rules concerning nontraditional mortgages. When we say they should be "clear," we mean that the information should be delivered in plain English, free of legal and financial jargon. And when we say they should be "balanced," we mean disclosures should spell out exactly what the consequences of the borrower's decisions will be – both the benefits and the risks. There should be no equivocation about the risks of negative amortization and payment shock, if that's what the product entails.

Public Comments Received

The comment period closed on March 29, 2006. Together, the Agencies received approximately 100 unique comments from the public. Not surprisingly, the majority were from financial institutions and trade groups, though comments were also received from a small number of consumer groups and individuals.

The consensus from the banking trade groups and large banks is that the underwriting, portfolio risk management, and consumer protection provisions are too restrictive or unclear, and should be left to individual institutions rather than prescribed by the regulatory agencies. On the other hand, almost all of the consumer groups, individuals, and the majority of community bankers felt the proposed guidance doesn't go far enough. Their general theme was that these products are contributing to speculation and unsustainable housing price appreciation and could lead to severe problems when and if a correction occurs.

The banking groups also expressed concern that the proposed guidance, if applied only to federally regulated institutions, would provide non-federally regulated lenders with a competitive and cost advantage, while putting at risk consumers of their services. Several made the point that unregulated institutions are driving much of the perceived relaxation in underwriting standards. They suggested that the disclosure aspects of the proposed guidance be deferred and addressed through subsequent rulemaking generally applicable to all lenders, such as through Regulation Z (Truth-in-Lending Act) and/or Regulation X (Real Estate Settlement Procedures Act). A recent announcement by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR), that they are considering similar guidance with the expectation that state agencies that regulate residential mortgage brokers and lenders may adopt and issue for use by their respective licensees, should help mitigate these concerns about a level regulatory playing field.

In addition, there are concerns that the promulgation of this proposed guidance, especially at a time of softening real estate markets in many parts of the country, is inconsistent with the goal of increasing home ownership. Let me emphasize that it is not the intention of the agencies to restrict homeownership opportunities in the market today. Rather the proposed guidance is intended to ensure that lenders take steps now to address weak underwriting practices for nontraditional mortgages and potentially misleading product information – to avoid credit and consumer protection problems in the future.

Our goal in proposing this guidance, instead, is to ensure that nontraditional mortgage products and the risks associated with them are managed properly by the banks that offer them, so that they do not compromise the safety and soundness of financial institutions and their ability to continue providing a steady, reliable stream of finance to homebuilders and purchasers. The proposed guidance is predicated on a belief that we do no one any favors – not the buyer, not the lender, and not the community in which the home is situated – to underwrite the purchase of a home that an individual buyer cannot afford in the long run. Supervisory guidance is the key instrument through which we communicate our expectations to bank management and bank examiners, and modulate market behavior in a way that causes the least disruption to existing markets and practices.

I can assure you that all of the comments we received are receiving careful consideration by an interagency taskforce that is at work right now. We expect the final guidance to be released this fall.

ATTACHMENT

Payment Shock: Payment Option ARM

The payment shock for payment option ARMs can be substantial...

	If Rates Stay Flat	If Rates Increase 2%
Loan Amount	$360,000	$360,000
Initial Payment (1.25%)	$2,000	$2,000
Payment Reset after 5th year	$2,495	$3,153
Payment Shock in Dollars (60th – 61st Payment)	**+$893**	**+$1,551**
Payment Shock Percentage (60th – 61st Payment)	**56%**	**97%**
Negative Amortization Amount (at reset)	**$27,274**	**$48,566**

For release on delivery
10:00 a.m. EDT
September 20, 2006

Statement of

Sandra F. Braunstein

Director, Division of Consumer and Community Affairs

Board of Governors of the Federal Reserve System

before the

Subcommittee on Housing and Transportation

and the

Subcommittee on Economic Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

September 20, 2006

Chairman Allard, Chairman Bunning, Senators Reed and Schumer, and members of the Subcommittees, I appreciate the opportunity to appear today to discuss how loan cost disclosures provided to consumers under the Truth in Lending Act (TILA) apply to "nontraditional" or "alternative" mortgage products, such as "interest-only" loans and "option-ARMS." As the Subcommittees have requested, I will address only consumer issues related to these disclosures.

Nontraditional mortgage products have increased the range of financing options available to consumers and have grown in popularity over the past few years. With traditional thirty-year fixed-rate loans, consumers have equal monthly payments that are sufficient to cover the accrued interest and pay down the principal. In contrast, interest-only loans allow consumers to defer the payment of principal and make only interest payments for an initial period. Option-ARMs allow consumers to make "minimum payments" of less than the accrued interest, which causes the loan balance to increase ("negative amortization").

Some consumers may benefit from these products and the more flexible payment options, for example, consumers with seasonal or irregular income. For consumers who expect their incomes to increase, the initially lower monthly payment with these loans may enable them to purchase homes that they otherwise might not be able to afford. But these loan products are not appropriate for everyone, depending on their individual circumstances. When monthly payments increase, sometimes substantially, consumers may face "payment shock." Thus, it is important for consumers to have the information necessary to understand the features and risks associated with these types of mortgages. The Federal Reserve is committed to doing what it can to improve the information consumers receive, including improving the Truth in Lending disclosures. Because these products are complex, the disclosures describing them are also complex and can be difficult for some consumers to understand. To address this issue, the Federal Reserve will focus its efforts on making Truth in Lending disclosures more readable and easier for consumers to use. TILA is implemented by the Board's Regulation Z. As part of the Federal Reserve's overall review and revision of Regulation Z, which is currently underway, we will consider changes to both the content and format of mortgage disclosures to improve their effectiveness.

The Federal Reserve plays several roles and engages in various activities to ensure that consumers understand credit terms and the options available to them when they are shopping for mortgage credit. First, in our role as a rulewriter, the Board issues regulations implementing TILA and its required disclosures. These regulations apply to all creditors. But we recognize that required disclosures alone cannot ensure that consumers understand these loan products. Thus, the Federal Reserve also promotes consumer understanding through other means, such as the development of educational materials for consumers. In addition, through the issuance of guidance and recommended practices, we encourage industry to improve its communications with consumers, for example, by developing promotional materials that are complete and balanced in their description of loan features and risks. The financial institutions that we supervise are examined to ensure that they comply with existing disclosure laws. The Federal Reserve also engages in numerous outreach activities and conducts research to help us better understand consumer behavior and to inform our judgment with regard to the best approaches for assisting consumers. Toward this end, we sponsor consumer surveys, hold public hearings, discuss issues with our Consumer Advisory Council, and conduct consumer focus groups and other types of consumer testing, in addition to considering the public comments on proposed rules. In order to address the complex issues associated with nontraditional mortgages, we plan to utilize a number of these approaches. In my testimony, I will first discuss the Truth in Lending disclosures, and the Board's plan to review and revise them. I will then discuss other efforts that we have already undertaken and planned efforts regarding nontraditional mortgages.

The Truth in Lending Act

TILA is the primary federal law governing disclosures for consumer credit, including home mortgage loans. It is implemented by the Board's Regulation Z. TILA has distinct rules for two categories of consumer credit: open-end (revolving) credit plans, such as credit card accounts; and closed-end (installment) transactions, such as home mortgage loans and auto loans.

TILA's purpose is to assure the meaningful disclosure of credit terms so that consumers can compare more readily the available terms and avoid the uninformed use of credit. This goal is carried out by requiring the uniform disclosure of costs and other terms to consumers. For closed-end loans transactions such as mortgage loans, TILA requires creditors to provide transaction-specific disclosures before the loan closing. For home-purchase loans, these transaction-specific disclosures must be given within three days after consumers apply for the loan. For nearly twenty years, Regulation Z has also required additional extensive disclosures about lenders' adjustable rate mortgage programs.

Background on the Disclosures for Alternative Mortgage Products

The rapid growth of nontraditional mortgages has been largely associated with loan products that have variable-rate features. The Truth in Lending Act did not specifically require the disclosure of variable-rate features. However, in 1977, the Board revised Regulation Z to require creditors to provide basic information for both mortgage and non-mortgage loans with variable-rate features, including: the circumstances under which the interest rate may increase (for example, when the index used to make rate adjustments rises); any limitations on the increase (such as a periodic or overall interest rate cap); and the effect of a rate increase (for example, whether it would result in an increase in the number or amount of payments).

As adjustable-rate mortgages became more prevalent, and the variety of ARM products became more extensive, the Board grew concerned that the Regulation Z disclosures did not fully meet consumers' needs. Accordingly, in 1987, the Board amended Regulation Z to provide consumers with more information about ARMs. The 1987 amendments to Regulation Z required creditors to provide consumers with detailed, specific information about all major aspects of their variable rate programs. Creditors must provide these "program" disclosures with every ARM application, and are required to do so before consumers pay a nonrefundable fee. This allows consumers to review the information in an unpressured environment before they apply for the loan.

The 1987 amendments to Regulation Z also required creditors to provide consumers with a copy of the "Consumer Handbook on Adjustable Rate Mortgages" (the "CHARM booklet"), which was created by the Federal Reserve working in concert with the Office of Thrift Supervision (OTS). The CHARM booklet was designed to educate consumers about the features and risks associated with alternative mortgages. Creditors are required to give consumers a copy of the CHARM booklet with each application for an ARM, including any nontraditional mortgage that has a variable rate.

Revising the Disclosures for Alternative Mortgages

At this point, I would like to describe the information that is currently included in TILA disclosures and highlight some of the issues the Board will study as it reviews and revises these disclosures. TILA provides specific disclosure requirements for variable-rate loans and other disclosure requirements that apply to all mortgage loans. I will focus primarily on the disclosures for variable-rate mortgage loans, as many nontraditional mortgages have adjustable-rate features.

ARM Program Disclosures

In ARM program disclosures, creditors are required to state how the interest rate and payment will be determined. They must explain any rules relating to changes in the index, interest rate, and payment amount. The disclosure must also explain any rules relating to changes in the outstanding loan balance, including, for example, an explanation of payment caps, and the possibility of negative amortization if the payment is not sufficient to cover the accrued interest. Regulation Z requires either a 15-year historical example showing how payments for a $10,000 loan would have been affected by interest rate changes during that period, or a "worst case" payment example showing the maximum interest rate and maximum payment for a $10,000 loan.

Although it is important for consumers to have complete and accurate information about the features of their ARMs, we recognize that "information overload" can impair the effectiveness of consumer disclosures. In addition, describing loan terms in legally precise language can make disclosures difficult to read and can hinder consumers' understanding. In revising Regulation Z, the Board will use consumer testing and work closely with design consultants to try to improve both the format and language of the ARM program disclosures. The goal is to make these disclosures easier to understand and more useful to consumers.

Transaction-specific Disclosures

For both variable-rate and fixed-rate mortgage loans, the transaction-specific disclosures provided before loan consummation express the cost of the loan as an annualized rate, the APR, over the full loan term. These disclosures include a payment schedule showing the amount and timing of payments, including any balloon payment. Regulation Z further requires that the transaction-specific disclosures indicate if the loan has a variable-rate feature. Creditors must also specify if a prepayment penalty may be charged.

The APR. For variable-rate loans, the disclosed APR is based on the rates currently in effect. The APR calculation does not consider the effect of possible future changes to any index used to adjust the interest rate. However, when the loan's initial interest rate has been discounted and is not based on the index used to make later adjustments, the APR is a composite rate based on the discounted rate for as long as it is in effect, and the fully indexed rate in effect at the time the loan is consummated for the remainder of the loan term.

The Payment Schedule. The TILA payment schedule, like the APR, is based on the interest rates that are in effect at the time the loan is closed. No assumption is made about possible future changes in the index used to set the rate. Consequently, a consumer's actual payments may be higher than the amount shown in the schedule if interest rates increase due to changes in the index.

Although the payment schedule disclosures do not assume changes in the interest rate, they must reflect increases in the monthly payment that will be required for interest-only loans or option-ARMs in order to amortize the principal. In general, for option-ARMs, the payment schedule is based on the assumption that the consumer makes only the required minimum payment each month. Accordingly, the payment schedule for an option-ARM should reflect the higher monthly payment that will be required to amortize the new loan balance after the option period ends.

There has been much discussion about the value of also requiring a worst-case payment disclosure based on the loan's interest rate caps. Some believe that such a disclosure would provide consumers with useful information to assess the affordability of a particular loan. Others assert that disclosing a worst-case payment has "shock value" that would alert the consumer to the loan's inherent risk. Some industry representatives question the usefulness of the disclosure, particularly if the worst-case payment would occur so far in the future that the consumer's payment is unlikely to reach that level before the home is sold or refinanced. Others argue that if the disclosure is provided, individual consumers will be able to evaluate for themselves the relevance of this information in light of their own financial circumstances.

In 1998, the Board and the Department of Housing and Urban Development (HUD) submitted a joint report to the Congress making recommendations for legislative reform of the mortgage disclosure requirements. The 1998 joint report contained model disclosures which included a proposed disclosure of the maximum interest rate that could be charged on the loan and the resulting payment for that "worst-case" scenario. In reviewing Regulation Z, the Board plans to study this aspect of the disclosures carefully by using consumer testing to determine its usefulness.

Negative Amortization. The ARM program disclosures must note the possibility that negative amortization will occur if the consumer's payments are not sufficient to cover the interest due. The transaction-specific disclosures are not required to show how much the consumer's loan balance will increase if the loan has a negatively amortizing payment schedule. Whether or not consumers would find such disclosures useful is something that the Federal Reserve will evaluate through consumer testing during the Regulation Z review.

Fixed-Rate Loans. There have been recent reports of an increase in the popularity of fixed-rate loans that allow consumers to make interest-only payments or choose to make minimum payments that are less than the accrued interest. With some loans, consumers may start out by making small payments of principal based on a forty-year amortization schedule (or longer), but the required monthly payments subsequently increase so that the loan will be paid off in thirty years. As with ARMs, these fixed-rate alternative mortgages can also result in increasing loan balances and payment shock when consumers' payments increase to fully amortize the loan. Because the interest rate is fixed, however, the increase in payments may be smaller and more predictable. For fixed-rate loans, the payment schedule currently required under TILA will show the consumer's future payment amounts, including any expected increases, assuming that the consumer makes only the required minimum payment.

Timing of Disclosures. For home-purchase loans, TILA's transaction-specific disclosures must be provided within three days after a consumer applies for a loan, and additional disclosures must be given before the loan closing if the terms subsequently change. In non-purchase transactions, these disclosures may be provided at or just before the loan closing. The timing of these disclosures for nonpurchase loans presents an issue that the Board will consider during its review of Regulation Z. The Board has previously studied whether TILA disclosures should be provided to consumers earlier in the mortgage shopping process. This issue was discussed in the 1998 joint report to the Congress by the Board and HUD. In considering this issue, a trade-off must be weighed: the value of providing estimated disclosures before the underwriting process is complete, versus the value of later disclosures that are firmer and less likely to change. Consistent with the framework of TILA, the Board will consider whether the transaction-specific TILA disclosures for non-purchase loans should be provided earlier in the loan process, as they currently are for home-purchase loans.

The Process for Reviewing and Revising Regulation Z

The Board and its staff have reviewed and updated Regulation Z and its interpretations frequently to address new products and issues. Moreover, in December 2004, the Board began a comprehensive review of Regulation Z starting with the publication of an advance notice of proposed rulemaking (ANPR). Although the first phase of the Board's review has concentrated on the rules for credit card accounts, the ultimate goal of the Regulation Z review is to improve the effectiveness and usefulness of all TILA disclosures, including mortgage disclosures. To ensure that consumers get timely information in a form that is readily understandable, the Board will study alternatives for improving both the content and format of disclosures, including revising the model forms published by the Board.

Although the initial focus has been on credit cards, the Board's staff has already taken steps relative to its review of mortgage disclosures, beginning with the home-equity lending hearings that we held this past summer. Those hearings were particularly focused on the information consumers receive regarding ARMs and other alternative mortgage products. However, because rulemakings and consumer testing take time, the Board is taking more immediate steps to improve the information consumers receive about alternative mortgages. These steps include: revising the CHARM booklet; publishing a consumer education brochure; and issuing interagency guidance to help financial institutions improve their communications with consumers.

As a general matter, in crafting regulations, the Board seeks to gather as much information as possible by conducting outreach to the industry, consumer interest groups, consumers, regulators, and other interested parties. We use research and survey data, consumer focus groups, and consumer testing to learn how consumers use and process information about financial services. After regulatory proposals have been published, we obtain input through the public comment process. In addition, we obtain input from the Board's Consumer Advisory Council, comprised of representatives from consumer and community organizations, financial institutions, and industry trade groups from across the country. And sometimes we hold public meetings such as the home-equity hearings that were just held.

In considering how to improve disclosures for alternative mortgage products under TILA, the Board will conduct extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what wording and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload. To that end, the Board will use design consultants to assist in developing model disclosures that will be effective in communicating information to consumers. The Board will also use consumer testing to assist in developing model disclosure forms. Based on this review and testing, the Board will revise Regulation Z within the existing framework of TILA. If the Board determines that useful changes to the closed-end disclosures are best accomplished through legislation, the Board will inform the Congress.

Furthermore, in reviewing the disclosure requirements for closed-end credit transactions, the Board will also be mindful that loan products will change over time, and that future products might differ substantially. Thus, any new disclosure requirements relating to features and risks of today's loan products must be sufficiently flexible to allow creditors to provide meaningful disclosures even as these products change over time and new products are developed.

Interagency Guidance

In December 2005, the Federal Reserve and other federal bank and thrift regulators issued draft interagency guidance on alternative mortgage products. The proposed guidance addresses both safety and soundness and consumer protection concerns. In particular, guidance is provided to institutions on ensuring that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity. With regard to consumer issues, the proposed guidance focuses on the need to provide consumers with clear and balanced information at crucial times, when they are making decisions about the relative benefits and risks of nontraditional mortgage products. Accordingly, the draft interagency guidance describes recommended practices for financial institutions in communicating with consumers while they are shopping, not just when they submit an application or close a loan.

Specifically, the proposed guidance recommends that institutions' promotional materials and descriptions of these products include information about, among other things, potential increases in consumers' payment obligations ("payment shock") and the potential consequences of increasing principal loan balances and decreasing home equity ("negative amortization"). The proposed guidance also recommends that institutions alert consumers to the amount of any prepayment penalty that may be imposed if the consumer refinances the mortgage. Lenders' communications regarding the features and risks of these products can be enhanced, for example, through the use of illustrations for sample loan amounts and interest rates, based on the products actually being offered by the lender at that time.

The agencies have considered the public comments received and are currently finalizing the draft guidance. As the public comments recognized, the interagency guidance is directed only at depository institutions and their affiliates. This highlights the importance of the TILA disclosures and CHARM booklet, which must be provided by all lenders.

The Federal Reserve's Hearings on Home-equity Lending

During the summer of 2006, the Federal Reserve held public hearings on the topic of home-equity lending in four cities. One of the principal purposes of the hearings was to gather information to inform the Board's review of Regulation Z disclosures for nontraditional mortgage products, such as option-ARMs. A significant portion of the hearings was devoted to discussing these products and, in particular, whether consumers receive adequate information about the features and risks associated with nontraditional mortgages. The hearings explored consumer behavior in shopping for mortgage loans and included discussions about the challenges involved in designing more effective and informative disclosures.

At the hearings, lenders testified that they underwrite these loans carefully, and they cited the historically strong performance of these products. Industry representatives believe that when loans are prudently underwritten, consumers are able to benefit from the flexibility these products provide without being at risk of default.

On the other hand, consumer advocates and state officials testified that aggressive marketing and the complexity of these products put borrowers at additional risk for obtaining mortgages that they do not understand and might not be able to afford. Consumer advocates were particularly concerned about mortgage brokers and lenders "push-marketing" nontraditional mortgages to low-income consumers and borrowers living on fixed-incomes, without adequate regard for whether the products are appropriate for their particular circumstances. They expressed concerned about marketing that focuses too heavily on low initial payments that are based on discounted rates that quickly expire. While they supported enhanced disclosures to inform borrowers about worst-case payment scenarios, they questioned whether disclosures alone can protect consumers because the products are so complex. Accordingly, consumer advocates who testified favored the adoption of legal standards that would hold brokers and lenders liable for making unaffordable mortgages loans.

Federal Reserve staff is considering carefully the transcripts of the hearings as well as the related public comment letters. Staff will consider this information in developing its plans and recommendations for revising the mortgage disclosure requirements in Regulation Z.

The Consumer Handbook on Adjustable-Rate Mortgages

As previously noted, nearly twenty years ago, the Federal Reserve, working with the OTS, created the "Consumer Handbook on Adjustable Rate Mortgages." The CHARM booklet is designed to educate consumers about the features and risks associated with alternative mortgages. To enhance the information consumers receive about nontraditional mortgage products, the Board's staff is currently working with staff of the OTS to revise the CHARM booklet to include additional information about these products.

The CHARM booklet can be an effective means to educate consumers because the Board's Regulation Z requires creditors to give a copy to consumers with each application for an ARM, including nontraditional mortgages such as option-payment ARMs. Because the booklet is provided at this early stage in the process, it is useful in encouraging consumers to ask brokers and lenders the right questions to decide if this type of loan is right for them. The booklet explains such features as payment shock and negative amortization. It also provides numerical examples of how consumers' payments can change and how their loan balances may increase. The agencies plan to publish a revised CHARM booklet later this year that will contain additional information tailored to interest-only and option-ARMs.

Consumer Education

The Federal Reserve engages in a number of consumer education activities. For example, we plan to publish a consumer education brochure titled: "Interest-Only Mortgage Payments and Option-Payment ARMs--Are They for You?" The brochure is designed to assist consumers who are shopping for a mortgage loan. We expect to publish the brochure within the next several weeks. It will be available in printed form and on the Board's web site. We are also developing an interactive mortgage calculator for the Internet, which consumers can use to compare the repayment terms for different products.

Conclusion

The Federal Reserve is actively engaged in efforts to ensure that consumers understand the terms and features of nontraditional mortgage products. Improving federally required disclosures under TILA is one aspect of this endeavor. We are also pursuing other opportunities, such as consumer education publications and interagency regulatory guidance that will include recommended best practices for depository institutions. We expect the Board will continue these efforts over time as mortgage products evolve in response to consumers' changing needs.

STATEMENT OF

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FEDERAL DEPOSIT INSURANCE CORPORATION

on

NONTRADITIONAL MORTGAGE PRODUCTS

before the

SUBCOMMITTEE ON ECONOMIC POLICY

and

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

September 20, 2006
Room 538, Dirksen Senate Office Building

Chairman Allard, Chairman Bunning, Senator Reed, Senator Schumer and members of the Subcommittees, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the growth in nontraditional mortgage products and the federal agencies' draft guidance to address this issue.

My testimony will review recent developments in the use of nontraditional mortgage products. In addition, I will discuss the respective risks posed by these products to borrowers and to financial institutions. My testimony also will describe the draft guidance on nontraditional mortgage products issued by the bank and thrift regulators late last year as well as the comments we have received.

Background

One-to-four family mortgages, both fixed rate and adjustable rate, historically have had some of the lowest loss rates among the assets held by banks and thrifts. With the recent housing boom, the performance of one-to-four family mortgage loans continues to be strong with charge-off rates less than one tenth of one percent (0.06) of all one-to-four family mortgage loans as of June 30, 2006.

In recent years, there has been an increase in the prevalence of new mortgage products beyond the typical fixed rate and adjustable rate mortgages (ARMs). These nontraditional mortgage products are designed to minimize mortgage payments by deferring repayment of principal, and sometimes part of the interest, during the early years of the loan. These products include interest-only mortgage loans, payment-option adjustable rate mortgage loans and extended maturity mortgage loans (terms beyond 30 years). Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Borrowers pay no principal for the first five to ten years under an interest-only loan. Payment-option ARMs have existed for many years. However, until recently, payment-option ARMs were used primarily by financially sophisticated borrowers as a financial management tool. Payment-option ARMs provide the borrower with flexible payment options, although there is an accompanying potential for negative amortization if the borrower chooses a minimum payment that is less than the interest accrued so that the loan balance increases as a result.

Since 2003, there has been a growing use of nontraditional mortgage loans among a wider array of borrowers. Nontraditional mortgage products have been especially popular in states with the strongest home price growth (see Chart 1). With the growth in home price appreciation, nontraditional mortgage products have been marketed as an affordable loan product. Specifically, some borrowers, often first-time home buyers, used these products to purchase higher-priced homes than they could have qualified for using more traditional mortgage loans. Investors also used nontraditional mortgage products as a way to purchase properties with lower upfront and monthly payments. According to the publication *Inside Mortgage Finance*, an estimated $432 billion of interest-only loans and payment-option ARMs were originated during the first half of 2006. This represents approximately 29 percent of all mortgages originated during the same period.

It is difficult to establish a clear cause and effect relationship between the increased prevalence of nontraditional mortgage products and the surge in home prices in certain areas of the country in recent years. Two FDIC reports issued under its *FYI* series in early 2005[1] were among the first to raise the possibility that the post-2003 acceleration in U.S. home price increases might be related to changes that were taking place in the mortgage markets. The reports noted a sharp rise in subprime loans in 2004 and the emergence of interest-only and payment-option mortgages that borrowers were in some cases using to cope with home price increases in boom markets. Despite observing these trends during the same period of time, we have no way, as yet, to statistically test the relationship between the trends. In addition, there are other factors that contributed to the increase in home prices, including availability of land, increased costs of building materials and population increases.

Based on the limited information available, the acceleration of the U.S. home price boom does appear to have been related to changes in the mortgage markets -- and causation probably runs both ways. The greater availability of flexible mortgage structures probably allowed price increases to outstrip growth in incomes to a greater extent than would otherwise have been the case. In addition, high-priced homes probably induced at least some borrowers to use interest-only or payment-option mortgages in order to afford their home.

[1] C. Angell and N. Williams, "U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, *FYI*, February 10, 2005, http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html, and Angell and Williams, "FYI Revisited - U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, *FYI*, May 2, 2005, http://www.fdic.gov/bank/analytical/fyi/2005/050205fyi.html.

Nontraditional mortgage products are available to borrowers from a number of sources. While banks and thrifts (and their mortgage subsidiaries) offer these products, nontraditional mortgage products also are provided by independent mortgage companies and brokers that are outside the purview of the federal banking agencies. Additionally, many insured institutions that originate nontraditional mortgages act as conduits by selling the loans they originate to the secondary market through private-label securitizations, thereby removing them from the institutions' books.

It also is important to appreciate the role played by the issuers of non-government sponsored enterprise (GSE) asset-backed securities in fueling the growth in the mortgage market in the last several years. While the share of outstanding U.S. mortgage debt financed through private asset-backed securities trusts more than doubled between the end of 2003 and the end of 2005 (from 8.6 percent to 17.4 percent), the holdings of the GSEs and GSE mortgage pools fell from 53 percent to 43 percent during the two-year period. Clearly, market share shifted toward the private asset-backed securities issuers where the nontraditional products were being securitized. The ability to securitize pools of nonprime and nontraditional mortgages certainly helped to make these loans available to borrowers through both FDIC-insured institutions and through mortgage brokers. It also helped to spread the credit risks associated with nontraditional mortgages to investors across the financial system and around the world.

In response to the growth of nontraditional mortgage products, the FDIC and other federal banking regulators (collectively, the agencies) conducted a review in mid-

2005 of the supervisory data for six of the most sophisticated residential mortgage lenders for trends and current practices.[2] These six lenders represented half of the projected 2005 nontraditional mortgage product originations, as well as half of aggregate mortgage originations. The review found indications of loosening in underwriting standards, some instances of borrowers not being qualified based on fully amortizing payments, and an increase in simultaneous second mortgages and other activities that added an additional layer of credit risk. The survey also found geographic concentrations of these products in areas experiencing rapid home price appreciation.

The FDIC also conducted a supervisory review of FDIC-supervised institutions with total assets greater than $1 billion that were located in areas experiencing rapid home price appreciation. Of the 30 FDIC-supervised institutions that met these criteria, nine did not offer nontraditional mortgage products. The remaining 21 institutions, with a combined total asset base of $190 billion, held $24.5 billion in nontraditional mortgage loans. Interest-only products represented $24.4 billion of these loans while payment-option ARMs represented only $120 million. Only two of the FDIC-supervised institutions captured in the review offer payment-option ARMs.

As part of its supervisory review, the FDIC also examined the manner in which nontraditional mortgages were marketed to borrowers. Although institutions generally appeared to be making the disclosures required by current law and regulations, these disclosures were not designed to address the features of nontraditional mortgage products

[2] In 2005, these six institutions had growth of 69.6 percent in payment-option ARMs, growth of 24.0 percent in interest only mortgages, and combined payment-option arm and interest only loan growth of 38.5 percent.

and may not provide adequate information to enable borrowers to make informed decisions.

Risks of Nontraditional Mortgage Products

Risks to Borrowers

Consumers can benefit from the wide variety of financial products available in the marketplace. However, nontraditional mortgage products present significant risks to borrowers because the product terms are complex and can be confusing. Moreover, the required disclosures may be insufficient to help borrowers make informed decisions about whether these products are appropriate. The primary risk to borrowers is payment shock, which may occur when a nontraditional mortgage loan is recast and the monthly payment increases significantly, *sometimes doubling or tripling*. This risk is heightened as interest rates rise and as home appreciation slows. This is especially true in the case of payment-option ARMs where the unpaid interest is added to the principal balance of the mortgage loan. This results in the total mortgage debt ultimately exceeding the value of the property, or negative amortization. Negative amortization can steadily increase the amount owed and significantly increase future payments.

With payment-option ARMs, the borrower has multiple monthly payment options during the initial option period. These include: (1) a minimum payment option based on a low introductory (teaser) interest rate; (2) an interest-only payment option based on the fully-indexed interest rate; or (3) a conventional amortizing principal and interest payment option, sometimes with more than one term offered (i.e., 15 or 30 years). The minimum payment option amount is typically less than the interest accruing on the loan, resulting in negative amortization. The borrower's monthly payment may increase dramatically when the minimum payment period ends or when negative amortization causes the principal balance to reach its limit. At that time, the borrower's monthly payment is recast to require payments that will fully amortize the outstanding loan balance over the remaining loan term.

For example, a borrower purchases a single family home for $250,000 with a 20 percent down payment and finances $200,000 via a payment-option ARM loan. The loan has a teaser rate of one percent, resulting in a minimum monthly payment of $643 for the first 12 months based on a 30-year amortization period. However, the loan accrues interest at the index rate of five percent, which rises one-half of one percent each year. At the beginning of the sixth year, the borrower's monthly payment will have more than doubled from $643 in the first year to $1,578.[3] In addition, the borrower's outstanding loan balance increased by $14,857 during this timeframe even though every required minimum loan payment was remitted on time.

For interest-only products, the principal loan balance does not decline during the interest-only payment period, which varies in length (i.e., seven or ten years), and the

[3] While the borrower's minimum monthly payment increases slightly in response to increases in the index rate, it remains too low to pay all of the accrued interest due to a 7.5 percent payment reset cap for the first five years of the loan. The monthly payment also increases to permit the amortization of principal over the remaining 25-year life of the loan.

amortization period is shorter (i.e., 23 or 20 years verses the traditional 30 years). When principal amortization begins, the borrower's monthly payment will increase due to the addition of this principal payment. In addition, if the interest rate is adjustable, the monthly payment may increase (or decrease) with the change in the stated interest rate. Interest payments on ARMs rise (or decline) with interest rates until the mortgage loan's cap (or floor) is reached.

Federal Reserve Board economists recently found that a sizable number of borrowers do not understand the terms of their adjustable rate mortgages – particularly the percent by which the interest rate can change, whether there is a cap on increases and the index to which the rate is tied.[4] This was especially true for lower income borrowers and those with less education. The Federal Reserve study found that borrowers tend to significantly underestimate the amount by which the interest rate can change. This could result in significant payment shock for some lower income borrowers, for whom a mortgage payment is likely to be a larger portion of their income than upper income borrowers. If borrowers cannot meet their monthly obligations, refinance their loans or sell their property, they may face default and foreclosure.

Because of the potential impact on borrowers' payments, it is critical that borrowers fully understand the risks and benefits of the mortgage products they are considering. Current disclosure requirements, however, were not designed to address the characteristics of nontraditional mortgage products. In some cases, marketing materials

[4] See "Do Homeowners Know Their House Values and Mortgage Terms?" by Brian Bucks and Karen Pence, Federal Reserve Board, January 2006, published on the internet at: http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf

for nontraditional products emphasize the benefits on the products and provide minimal information regarding the risks. In addition, some borrowers do not receive information regarding the risk of nontraditional products early enough in the loan shopping process to allow them to fully compare available products. Moreover, some periodic statements fail to provide borrowers with information about the payment options available. Instead, the statements encourage borrowers to make the minimum payment by highlighting that option. Borrowers would benefit from information with their periodic payment materials that explains the various payment choices as well as their consequences, such as negative amortization.

Risks to Lenders

As the prevalence of nontraditional mortgage products has increased, there have been indications that underwriting standards have loosened. Over the years, mortgage lenders that relaxed certain underwriting terms, such as the level of documentation required, would mitigate the additional credit risk incurred by imposing more stringent terms in other areas. However, competition has begun to erode these compensating controls. Many nontraditional loan products require little or no documentation or have been accompanied by practices such as simultaneous second-lien mortgages that create additional layers of risk for lenders.

Although streamlined mortgage underwriting standards are not unique to nontraditional mortgage products, nontraditional mortgage loans written with less stringent underwriting standards are of particular concern. For products that permit negative amortization, some lenders' borrower repayment analyses may not include the full amount of credit that may be extended (initial balance plus the potential negative amortization amount). Lenders that do not qualify borrowers at the full amount of credit that may be extended are not appropriately evaluating the ability of borrowers to repay their loans, resulting in possible losses for both lenders and borrowers.

In traditional mortgage lending, the borrower's repayment capacity, including debt-to-income ratios, has been a key underwriting consideration. However, there is growing evidence of interest-only and payment-option ARMs being made to borrowers with little or no documentation to verify income sources or financial assets (see Table 1). Reduced documentation increases risk since institutions are essentially relying on assumptions and unverifiable information to analyze the borrower's repayment capacity.

Many lenders justify foregoing income verification because they rely on credit scores. Credit scoring models were developed for the credit card industry, and they have been very reliable in predicting risk of default and other adverse events for smaller-denomination consumer lending products such as credit cards and auto loans. However, credit scoring models do not consider income information. In addition, credit scoring models have not been fully tested as a predictor of default for loans that are such a large percentage of a borrower's income, especially when the monthly payment increases substantially in a short timeframe. Over-reliance on credit scores in the context of mortgage lending is an unacceptable underwriting risk.

The combination of several liberalized underwriting terms, or "risk layering," also has become more prevalent. Lenders increasingly are providing simultaneous second-lien mortgages to cover a portion of the home purchase price. A simultaneous second-lien mortgage reduces borrowers' equity in their homes and increases borrowers' monthly debt service. When one loan combines several such features, the total risk is compounded. Some lenders argue that risk-based pricing is a compensating control. However, absent other compensating controls, higher interest rates and fees do nothing to improve the credit quality of a higher-risk loan and can result in higher default rates.

Financial institutions are managing the risks associated with nontraditional mortgage products primarily through underwriting and securitization. Some institutions manage the risk these products pose by following prudent underwriting policies and practices, instituting borrower qualification standards that recognize the possibility negative amortization will contribute to payment shock, and implementing strong management information systems and controls to specifically monitor these products. Other institutions are securitizing their nontraditional mortgage originations and spreading the risks of these products to investors.

Proposed Interagency Guidance

In light of the increasing originations of nontraditional mortgage products by financial institutions and the increasing use of these products by a wider spectrum of borrowers, the agencies began to develop interagency guidance to address the issues of risk management and appropriate consumer disclosure. On December 29, 2005, the agencies jointly issued for comment proposed guidance entitled, "Interagency Guidance on Nontraditional Mortgage Products." The proposed guidance was intended to convey the agencies' expectations about how financial institutions should effectively address the risks associated with underwriting nontraditional mortgage loan products. Toward that end, the guidance stressed that financial institution management should: (1) assess a borrower's ability to repay the loan, including any balances added through negative amortization, at the fully indexed rate that would apply after the introductory period; (2) recognize that certain nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves; and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

The agencies together received approximately 100 letters from financial institutions, trade associations, consumer and community organizations, state financial regulatory organizations, and others on the proposed guidance. A majority of the financial institutions and industry groups that commented stated that the guidance is too prescriptive and suggested that institutions should have more flexibility in determining appropriate risk management practices. Other industry comments centered on the following observations: (1) nontraditional mortgage products have been offered successfully for many years; (2) the guidance would stifle innovation and result in qualified borrowers not being approved for these loans; (3) the guidance is not an appropriate mechanism for addressing the regulatory agencies' consumer protection concerns; and (4) the guidance will not apply to all lenders, and thus federally regulated financial institutions will be at a competitive disadvantage.[5]

Some commenters, including most of the consumer groups, argued that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These commenters noted that nontraditional mortgage products: (1) contribute to speculation and unsustainable appreciation in the housing market; (2) could lead to severe problems if and when there is a downturn in the economy; and (3) are harmful to borrowers and borrowers may not understand the associated risks. A number of commenters, including industry trade associations, asked the agencies to include model or sample disclosures or other descriptive materials as part of the guidance to assist lenders in following the recommended practices for communications with consumers. This is an important idea that warrants consideration.

The FDIC and the other bank and thrift regulators have carefully reviewed the commenters' views on the proposed guidance and are nearing completion of the final version of this guidance. The FDIC believes that insured financial institutions and consumers will benefit from the final guidance.

[5] The regulatory agencies note that both state financial regulatory organizations that commented on the proposed guidance – the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR) – committed to working with state regulatory agencies to distribute guidance that is similar in nature and scope to the financial service providers under their jurisdictions. Subsequently, CSBS, along with a national organization representing state residential mortgage regulators, issued a press release confirming their intent to offer guidance to state regulators to apply to their licensed residential mortgage brokers and lenders. Refer to CSBS media release dated June 7, 2006.

Conclusion

The growth of nontraditional mortgage products has been accompanied by a number of risks for lenders and borrowers. These products are being offered to a broader spectrum of borrowers to address housing affordability issues, especially in locations which have seen significant home price appreciation in recent years. This expansion of credit has been accompanied in some instances by lowered underwriting standards and additional layers of credit risk. In addition, the consumer disclosures are neither adequate for consumers to fully understand the risks associated with these complex loan products, nor provided at the points in time when it is most needed.

The FDIC will continue to monitor FDIC-insured institutions with significant exposures to nontraditional mortgage products and to ensure that institutions follow the final guidelines when they are issued. The FDIC expects institutions to both maintain qualification standards that include credible analysis of a borrower's capacity to repay the full amount of credit that may be extended, as well as to provide borrowers with clear, understandable information when they are making mortgage product and payments decisions.

This concludes my statement. I look forward to any comments provided by the Committee and will be happy to answer any questions.

Tables and Charts Accompanying the Testimony of Sandra L. Thompson
Federal Deposit Insurance Corporation
September 20, 2006

In order of reference

Chart 1. Nontraditional Mortgage Products Are Most Popular in States with the Strongest Home Price Growth

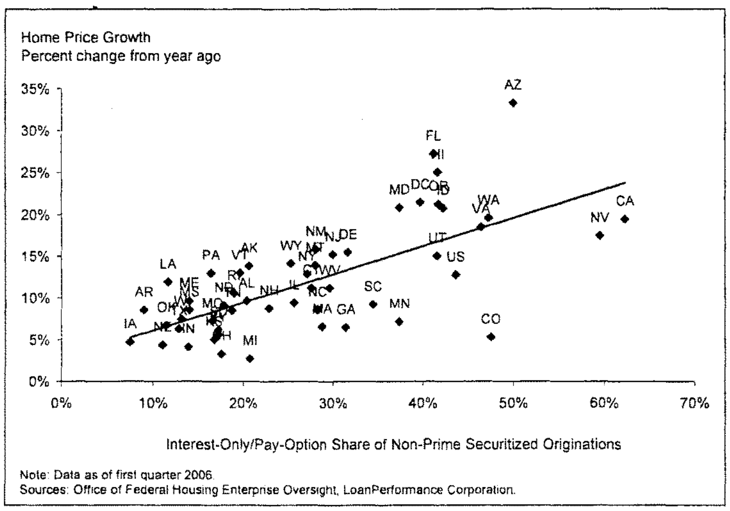

Table 1. Combining Higher-Risk Loan Features Results in "Risk Layering" and Heightens the Overall Level of Credit Risk

Recent Collateral Trends in Lending for Interest-Only and Pay-Option Adjustable Rate Mortgages

Year	Low or No Documentation (a)	Loan to Value (b)	Credit Score (b)	Investor Share (c)	Prepayment Penalty (a)
2003	53.9%	76.0	701	11.6%	50.5%
2004	58.0%	77.1	692	12.6%	51.9%
2005	65.7%	76.4	696	14.1%	59.2%

(a) Calculated as a percentage of total interest-only or pay-option adjustable-rate mortgage originations.

(b) Original combined loans to value and credit scores are weighted averages.

(c) Calculated as nonowner and second home originations.

Source: LoanPerformance Corporation (Alt-A and B&C mortgage securities database).

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Statement of

Scott M. Albinson, Managing Director
Examinations, Supervision & Consumer Protection
Office of Thrift Supervision

concerning

Alternative Mortgage Products

before the

Senate Subcommittee on Economic Policy and
Senate Subcommittee on Housing and Transportation

September 20, 2006

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Alternative Mortgage Products by

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I. Introduction

Good morning, Chairman Allard, Chairman Bunning, Ranking Member Reed, Ranking Member Schumer, and Members of the Subcommittees. Thank you for your continued leadership on issues affecting the mortgage markets and the important topic of Non-Traditional Mortgage Products. We appreciate the opportunity to discuss the views of the Office of Thrift Supervision (OTS) on alternative mortgage products and the risks these products may present to consumers, financial institutions, and financial intermediaries. An important aspect of the OTS's supervisory role is our ability to identify, monitor, and mitigate these risks.

II. History

Thirty years ago, a borrower would pay 8.9 percent to obtain a conventional thirty-year fixed rate mortgage. Less than five years later, the average rate for this loan had almost doubled to 16.8 percent. In the midst of that unprecedented rise in mortgage interest rates, several financial institutions (predominantly thrifts) began to offer two alternative mortgage products that foreign lenders were already successfully offering in other parts of the world.

The first of these products was an adjustable rate mortgage (ARM) that featured an annual cap, or limit, on payment increases. When rising interest rates caused a loan to exceed the payment cap, the borrower had the option to defer paying the additional interest. This deferral resulted in negative amortization of the loan's principal balance, i.e., the interest was added to the existing principal. The advantage of deferring payment of some of the interest owed was that it allowed borrowers to ride out a temporary payment shock caused by a rise in interest rates.

The second ARM product financial institutions began to offer did not allow deferral of interest. That loan allowed the borrower to pay interest at regular intervals until maturity, when the entire balance on the loan was due. The second ARM did not require amortizing payments. Interestingly, thrifts in the western United States adopted the first ARM product, with the option for interest deferral, while thrifts in the east adopted the ARM product that did not permit deferral of interest.

For about twenty years, thrifts offered these products responsibly to qualified borrowers seeking alternatives to the standard, 30-year, fixed rate product. These products provided borrowers payment flexibility and, in some instances, enabled borrowers to purchase homes based on their unique circumstances. In all cases, however, borrowers had to qualify financially for the full amount of the loan.

History has taught us that responsible and successful lending with alternative mortgage products requires a commitment to careful underwriting. This includes close attention to the ratio of the loan amount to the value of the property, and active and continuous risk management. Financial institutions must regularly interact with customers over the life of the loan so they understand how these loan products function. The long-term success of these products was critical to the thrifts that utilized them because the institutions held most of these mortgages in their own portfolios.

Our testimony focuses primarily on two types of alternative mortgage products, also referred to as nontraditional mortgages, that are prevalent in today's market. Both products are ARMs. The first type is called an interest-only ARM and only requires a borrower to make monthly interest payments, often for an extended period. The second type, called an option ARM, offers the borrower a menu of monthly payment options from which he or she can select. These options typically comprise an interest-only payment, a payment based on 15-year amortization, a payment based on 30-year amortization, or a "minimum payment" that often results in negative amortization.

Calculation of the "minimum" payment is the most complex aspect of these option ARMs. For the first year, the lender determines the minimum payment by a marketing-driven "start rate," which is the rate typically advertised with these products. Current start rates average in the range of 1.0 to 1.5 percent, which is substantially below the conventional market rate for such loans. The "start" rate establishes what a borrower's monthly mortgage payment will be for the first year of the mortgage term. For example, on a $500,000 mortgage with a start rate of 1.0 percent and a 6.5 percent fully-indexed rate, a borrower would pay only $1,608 per month in the first year. A similar 30-year fixed rate mortgage would require the borrower to pay $3,160 per month, almost double the first year start rate of an option ARM.

If a borrower selects the minimum payment option, the monthly payment amount for an option ARM is typically insufficient to cover the interest owed. The difference between what the borrower pays and what the borrower owes in interest is added to the principal balance of the loan each month and can result in negative amortization. Each year the minimum payment resets to reflect the current principal balance and interest rate conditions. Option ARMs typically cap both the increase in the minimum payment from year to year as well as the total amount a loan can negatively amortize. The cap on the increase in the minimum payment averages 7.5 percent, which usually allows the borrower to continue to negatively amortize the loan during the option period. The cap on negative amortization usually ranges from ten to 25 percent of the original loan balance.

At the end of a contractually set period, typically five years, or earlier if the loan reaches its negative amortization cap, the loan terms recast to reflect current interest rates without any constraints on the increase allowed in the minimum payment. If a borrower has only made minimum payments, a recast can result in a substantial increase in the borrower's required payment. The increase will often range between 50 and 100 percent of the original minimum payment amount depending on whether interest rates have risen and whether the loan negatively amortized.

Over the last few years, many more lenders, particularly mortgage brokers and nondepository finance companies, have offered variations of the option ARM. The rapid growth in this market is attributable to several factors including rapid home price appreciation, intense mortgage competition, and a strong economy with historically low interest rates. In addition, many financial institutions sell, purchase, or securitize portfolios of mortgage products. New securitization markets and technology developments such as automated underwriting standards, automated valuation models, and credit scoring also contributed to growth in the mortgage markets.

Despite this growth, these newer alternative mortgage products only accounted for approximately 24.6 percent of the U.S. ARM market and an estimated 5.4 percent of the total U.S. mortgage loan market as of June 30, 2006. Newer ARM products remain prevalent on the coasts, with generally more limited adoption throughout the remainder of the U.S. In OTS-regulated thrifts, alternative mortgage product offerings are generally concentrated in a few large institutions. In fact, five thrifts account for approximately three-quarters of total thrift alternative mortgage product originations. Option ARM originations are further concentrated with four thrifts representing approximately 90 percent of all thrift originations. These four institutions have significant experience with this product since they have been providing alternative mortgage products to borrowers for more than 15 years.

Recent data on loan originations indicate that while option ARM originations remain higher than average, the trend among OTS-regulated thrifts is beginning to decline. OTS-regulated thrifts account for approximately 59.5 percent of the total ARM originations. Of the population of mortgages originated solely by OTS-regulated thrifts, ARMs represent 36.8 percent while option ARMs represent approximately 6.5 percent. This is a decline from year-end 2004 and 2005 where option ARM originations were 11.3 and 10.2 percent of OTS-regulated institutions' mortgage loan originations, respectively. The trend is less clear for the entire mortgage market where option ARM originations totaled 7.5, 11.5, and 9.3 percent of mortgage originations for year-end 2004, 2005, and the twelve months ending June 30, 2006, respectively.

The influx of new lenders into the alternative mortgage market over the last several years also includes numerous inexperienced lenders that lack sufficient understanding of newer alternative mortgage products. Many of these new lenders also do not possess the same commitment to strong underwriting and to consumer welfare as more experienced lenders. While the original version of the option ARM is a traditional thrift product, we are concerned that rapid expansion and recent variants of these products coupled with the usage of untested new technologies have elevated the risk profile for these offerings. Over the last few years, as the availability of products and competition among lenders intensified, lenders began offering the option ARM to an increasingly broad demographic of borrowers. Many of these borrowers lack either sufficient understanding of the option ARM product or simply lack the financial wherewithal for products in which they are being qualified by unscrupulous lenders.

The fact that some lenders treat alternative mortgage products as a way to get a borrower in the door, rather than a product that affords financial flexibility magnifies concern with the proliferation of products such as the option ARM. Recent media accounts provide anecdotal evidence that some borrowers have indicated they did not understand the loan terms and ultimately are unable to afford these products in the long-term. However, analytical data indicate that the overwhelming majority of option ARM loans remain current. As of June 30, 2006, approximately 0.11 percent of all option ARMs were 90 or more days past due, compared to 0.16 percent for all ARMs and 0.38 percent for 30-year fixed rate loans. During the same period approximately 0.17 percent of option ARMs were in foreclosure, compared to 0.18 percent for all ARMs and 0.2 percent for 30-year fixed rate loans. By comparison, high loan to value mortgage loans (96-100 percent LTV) of all types displayed the highest level of delinquency and foreclosure with approximately 2.91 percent 90 or more days past due and 1.5 percent in foreclosure. Since many mortgage loans are relatively recent originations and are not fully seasoned, however, it is uncertain as to whether credit quality will significantly deteriorate in future periods.

In December 2005, the federal banking agencies (FBAs) published proposed guidance on alternative mortgage products. Numerous comments were received, many of which were critical of certain aspects of the proposed guidance. The OTS fully supports the need to revise the proposed guidance based on these comments. We are currently working with the other FBAs to issue final interagency guidance that underscores our expectations for institutions, especially new entrants, to conduct alternative mortgage lending in a safe and sound manner.

Our intent is not to discourage alternative mortgage lending, but rather to ensure that it is engaged in safely, soundly and effectively. In particular, institutions should provide full, clear, and balanced disclosure of the risks to any potential borrower at the time the borrower is considering loan options. The OTS also supports baseline underwriting guidelines for all lenders that include certain prudential standards. Standards we support include qualifying borrowers at the fully-indexed, fully-amortizing loan amounts for option ARM products, providing full and balanced disclosure of the risks and benefits of product offerings, and implementing robust risk management practices.

III. Risks

Credit risk varies for all types of mortgages based on numerous factors including, borrower equity, creditworthiness, and income level, property values, loan terms, and economic conditions. Lenders must analyze each of these and other factors in order to manage risk. Additional factors that may influence underwriting include whether the collateral is a primary residence, vacation home, or investment property and whether the loan is a purchase money mortgage or a refinancing. Financial institutions also face compliance, legal, and reputation risk for each product they offer. While alternative mortgage products expose financial institutions to all these risks, an institution's exposure to interest rate risk can be mitigated by transferring that risk to borrowers in exchange for elevated credit risk. However, the complexity of the payment options, amortization schedules, and rate structures require a strong commitment to clear and balanced disclosure to ensure the credit risks assumed by a borrower are in line with the borrowers ability to pay on the loan.

Borrowers may also be exposed to certain risks when obtaining mortgage loans. Rising home prices increase a borrower's equity cushion, while stagnant or falling prices erode borrower equity. The risks associated with an ARM also vary based on changes to the mortgage's interest rate index. The current economic outlook for price appreciation in certain markets as well as the rise in underlying interest rate indexes have contributed to concern about recent ARM offerings. Other lending practices, often referred to as "risk layering", include originating high loan-to-value loans, providing piggyback second mortgages, and lending to borrowers with low credit scores. While these practices can expand homeownership to consumers with weaker credit or related factors, they also increase the risk of default. Alternative mortgage products have one additional risk feature that can unduly pressure an uninformed borrower – payment shock.

Payment shock is the amount of increase in a loan payment when a loan payment adjusts. The size of a payment shock relates directly to the degree to which a loan can negatively amortize and the gap between the marketing-driven start rate and the underlying fully indexed rate. Intense competition in mortgage markets coupled with rising interest rates has widened this gap substantially. Many institutions have expressed concern about the current gap in rates, which is now nearing six percent. Historically, the gap has averaged three percent. Many thrifts have attempted to offer higher start rates to minimize the amount of negative amortization to borrowers, but are often unable to compete as business shifts to competitors with lower start rates. This marketing-driven phenomenon strongly underscores our desire to have a level playing field among all market participants. This is in the best interest of consumers as well as financial institutions.

Absent careful underwriting and full and accurate consumer disclosure, a large gap between the start rate and fully-indexed rate can elevate payment shock and the risk of these products. This is particularly true when lenders do not conduct the necessary analysis of a borrower's ability to pay under varying economic scenarios. Lenders should succinctly outline the payment terms and schedule to ensure that a borrower clearly understands the product and its potential risks, particularly future payment adjustments.

An interagency survey conducted last year among major alternative mortgage lenders indicated that they were generally compensating for the risk of these products by imposing stricter underwriting standards, including higher equity or better credit quality. We also found that disclosures are not consistent as to the type and level of information provided to consumers, with the range of practice varying greatly. We remain focused on working with the other FBAs to establish guidelines for clear, balanced disclosures. Additionally, we support any initiative by the Federal Reserve Board to update Regulation Z specifically to address concerns with alternative mortgage products.

IV. OTS Supervisory Program

The OTS has designed and implemented a comprehensive supervisory program to oversee thrift institution alternative mortgage lending activities. We expect any institution offering these products to disclose the risks and loan terms to prospective borrowers, to adhere to safe and sound underwriting standards, and to manage the product risks. The OTS endeavors to maintain a strong supervisory presence while not stifling innovation or credit availability to responsible borrowers. The OTS is committed to providing examiner education, industry guidance, and consumer information and outreach to meet this goal.

Consistent with national trends, we have seen an increase in the number of thrifts offering alternative mortgage products. We currently use surveys conducted by on-site examiners and information from certain thrifts engaged in alternative mortgage product lending to conduct our off-site monitoring of these thrifts. We also subscribe to a national database that allows us to monitor the volumes and performance of alternative mortgage products for numerous lenders. However, with the increasing risk and prevalence of these products, we proposed in July 2006 to begin collecting key product information from all thrifts on a quarterly basis in the Thrift Financial Report beginning in March 2007. The items we propose to collect include total option ARM loans held in portfolio; ARM loans with negative amortization features; and total capitalized negative amortization. We view these as minimal elements for monitoring alternative mortgage products in OTS-regulated institutions.

As these products expanded nationwide, the OTS offered additional training, led by its most experienced examiners, to the rest of our examination staff. Our most experienced examiners have over 20 years of supervisory experience evaluating non-amortizing mortgage products. The focus has been on training examiners to: (1) understand the mechanics of non amortizing products, (2) analyze the growth in originations as new lenders began originating these products, (3) assess the primary risks to consumers – focusing on various scenarios to illustrate how "payment shock" can occur and the impact of negative amortization on the borrower's indebtedness; (4) review required federal consumer regulatory disclosures; and (5) communicate existing OTS mortgage regulations and supervisory expectations applicable to alternative mortgages.

The OTS has sent a consistent message about our expectations for savings associations that make loans with non-amortizing features. In June 2005, we issued a revised Examiner Handbook section on residential lending, re-emphasizing that institutions should fully understand and manage the additional risks that these alternative products can pose. The Handbook section sets forth the OTS's expectation for robust risk management practices that include strong management information systems, internal controls, periodic reporting, and the need for enhanced servicing operations that mitigate any potential delinquencies.

As part of the examination of each institution, we began collecting data on the extent to which each institution originated and held nontraditional mortgage products in its portfolio. A particular concern was that new entrants may not have the level of expertise necessary for offering these products successfully, especially as rates are rising and there is an indication that home values and appreciation in certain markets are weakening or declining. To date, we have not observed broad, systemic, or excessive risk-taking by the institutions we supervise.

The updated Examiner Handbook emphasizes that examiners should focus on a savings association's underwriting standards to ensure that borrowers qualify for these loans. It also describes the risks that sharp increases in monthly payments can present to consumers and instructs examiners to consider the borrower's ability to repay after the expiration of the interest-only period. The OTS also encourages institutions to have strong management information systems to monitor deferred interest income to total income, the percentage of negative amortization loans in excess of the original principal balance, and other key risk metrics. The OTS carefully reviews this information during on-site examinations.

Our Examiner Handbook also instructs our examiners to carefully analyze loans where consumers are only making the minimum required payments. Examiners recognize that consumers who make the minimum payments are at risk if interest rates increase or they experience financial difficulties. The updated examination procedures instruct our examiners to determine and analyze the amount of mortgages within a savings association's portfolio that are negatively amortizing. This type of supervisory tracking allows the OTS to identify potential weaknesses in a savings association's policies, underwriting criteria, and related factors that may present risks both to the savings association and its borrowers. Such tracking also allows us to require corrective measures, where warranted.

Additionally, OTS examination procedures remind examiners to focus on savings associations' compliance programs to ensure that all loans comply with federal laws governing credit transactions. For example, OTS regulations prohibit a savings association from inaccurately advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of the loans it originates (12 CFR 563.27). Given the potential that consumers may not fully understand the benefits and potential risks associated with alternative mortgages, and the ever-growing range of options available to consumers seeking a mortgage loan, our examination procedures emphasize the need for savings associations to provide clear information to consumers regarding *all* of their mortgage products, including alternative mortgages.

The OTS also monitors and analyzes all consumer complaints during off-site monitoring and on-site examinations. We assess both individual complaints to ensure that financial institutions are not engaging in unfair or deceptive lending activities as well as trends or patterns in consumer complaints. The OTS has not identified a trend in consumer complaints regarding alternative mortgage products, nor have we received a material number of such complaints. The complaints we generally receive regarding ARM vary in nature and usually are aimed at the rate adjustment feature as opposed to the more complex aspects of alternative mortgages.

Beyond internal training and examination guidance, we have also communicated our regulatory expectations to savings associations through industry group meetings, direct communication with institution management, and other outreach efforts. We have indicated that alternative mortgages are not appropriate for all borrowers, particularly those with high debt levels who are using the product to purchase real estate they could not otherwise afford. We have also stated that institutions that offer these products must take steps to manage and ameliorate risks effectively through prudent loan structures and pricing, sound underwriting, strong risk management systems – together with complete disclosure of the benefits and the risks of these products.

OTS senior analysts have developed and presented mock board meetings to bankers and banker associations on consumer protection issues and risk management issues that they should consider in connection with alternative mortgages. These presentations highlight existing OTS mortgage regulations and examiner guidance applicable to alternative mortgage products including sound underwriting that analyzes the borrower's ability to repay. Additionally, these presentations remind institutions about required consumer disclosures and emphasize the need to provide useful and educational information on the benefits and the risks associated with alternative mortgage products.

In 2002, the OTS issued broad guidance for consumer protection programs that outline the components of an effective compliance program. This guidance requires savings associations to monitor and assess their compliance with various consumer protection, civil rights, and public policy laws and regulations, and take appropriate corrective action to remedy identified violations or operational deficiencies.

This guidance defines "compliance risk" and advises savings associations that failure to ensure compliance with laws and regulations exposes the institution's earnings, capital, and market viability to risk. Compliance failure also jeopardizes investor and customer relationships. The guidance reminds institutions that violations or nonconformance with laws, rules, regulations, industry practices, internal policies and procedures, ethical standards, or customer service goals also exposes the institution to fines, civil money penalties, litigation costs, payment of damages, diminished reputation, reduced franchise value, and diminished consumer trust. Through the guidance, the OTS advises all institutions to develop and maintain compliance management programs that are commensurate with their size and complexity. The guidance also directs institutions to establish monitoring, assessment, and corrective-action systems to ensure a sound compliance risk management environment. This is critical when originating alternative mortgage products, where potential risks to consumers are elevated in comparison to less-complex mortgage products.

V. Interagency Supervisory Activity

The federal bank regulatory agencies have engaged since last summer in developing interagency guidance on appropriate risk management and consumer disclosure practices for alternative mortgage products. The agencies published the draft guidance for public comment in December 2005. Because of the intense interest, the agencies extended the public comment period 30 days beyond the original 90 days. The agencies received a full range of comments. The majority stated that the guidance was too prescriptive and that institutions should have more flexibility in determining appropriate risk management practices. Several commenters confirmed the OTS's observations that alternative mortgage products have a successful history as products that offer borrowers payment flexibility. Many of the commenters were concerned that the guidance would stifle innovation and result in a decline in credit availability for qualified borrowers while not addressing the agencies' consumer protection concerns.

Comments from consumer organizations, individuals, and community bankers argued the opposite point that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These comments observed that alternative mortgage products contributed to speculation and unsustainable appreciation in the housing market. They expressed concern that severe problems will occur during an economic downturn, slowdown, or reversal of housing price appreciation. Some also argued that these products are harmful to borrowers who may not understand the associated risks.

Two state financial regulatory trade organizations also commented on the proposed guidance – the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR). They subsequently committed to working with state regulatory agencies to distribute similar guidance to the financial service providers under their jurisdictions. On June 7, 2006, CSBS, and the American Association of Residential Mortgage Regulators (AARMR), issued a press release confirming their intent to offer guidance to state regulators for licensed residential mortgage brokers and lenders. They noted their interest in mitigating the potential for inconsistent regulatory treatment. According to the Mortgage Bankers Association, mortgage brokers originate between 70 and 80 percent of all mortgages that come to depository institutions. The OTS welcomes CSBS, SFRR, and AARMR's commitment to a level playing field. Without their commitment, the proposed nontraditional guidance would be hampered significantly given the growing role that mortgage brokers, finance companies, mortgage companies, and other state licensed lenders play in providing credit to consumers nationwide.

The agencies considered and addressed many of the commenters' concerns in redrafting the guidance. The agencies expect to release the final guidance shortly. The guidance will clearly articulate the risk management and consumer disclosure expectations concerning these products, while recognizing the need for flexibility for regulated institutions in meeting the legitimate credit demands of those seeking to purchase a home.

The OTS believes that an institution's underwriting standards should recognize the risk associated with alternative mortgage products, including the potential impact for payment shock. An institution's underwriting criteria are generally based on multiple factors. Thus, an institution should consider these factors jointly in the underwriting process. The criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes. Accordingly, industry guidance should provide that for all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed, fully amortizing rate. This approach should mitigate the financial risk of potential payment shock to the borrower as well as underscore the appropriate use of these products as financial flexibility tools, and not as affordability products.

Industry guidance should also provide standards for institutions that purchase alternative mortgage products from third parties. Financial institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. The proposed guidance establishes criteria for the third party relationship including, entering into and maintaining relationships with third parties; providing third party compensation that does not provide incentives for weak underwriting or disclosure standards; establishing systems and procedures to monitor whether third parties are complying with agreements made with the institution; and implementing appropriate corrective action if a third party fails to comply with applicable agreements, policies, or laws. The OTS believes that such guidance is important, particularly as depository institutions increasingly use third parties as a pipeline for mortgage originations.

The federal banking agencies continue work on important consumer protection standards for lenders, advising institutions to provide information to consumers that: (1) aligns with actual product terms and payment structures; (2) covers risks areas (such as payment shock and negative amortization) and potential benefits (such as lower initial monthly payments) in a clear and balanced way; and (3) provides clear, balanced, and timely information to consumers at crucial decision making points.

Beyond the interagency guidance, the agencies are working on providing additional direction on ways financial institutions can provide useful information about the benefits and risks of alternative mortgages. As you know, Regulation Z requires all lenders to provide the Consumer Handbook on Adjustable Rate Mortgages (CHARM brochure), which is published by the Federal Reserve Board and OTS. The OTS is collaborating with the Federal Reserve Board to update the CHARM brochure. The updated brochure will continue to inform consumers about ARMs, including issues such as negative amortization and payment shock but it will also provide additional information on specific types of alternative mortgages, such as payment option and interest-only ARMs designed to help consumers make informed choices.

The OTS is also working closely with all the federal bank regulatory agencies to develop a consumer publication focused on interest-only and option ARMs mortgages. This publication advises consumers on how these products work, the potential for large payment increases, and the impact of negative amortization. Additionally, the publication provides consumers with a series of questions they can ask their lender to ensure that they clearly understand the product before agreeing to the mortgage.

VI. Conclusion

Alternative mortgage products have a long history in the thrift industry. Our examination staff is well trained to monitor the trend in alternative mortgage products, to identify and correct weaknesses in underwriting, and to prevent or end abusive lending practices. Historical experience with these products shows that they require a serious commitment to full and balanced disclosure, careful underwriting, and active risk management, including regularly and continually interacting with customers. Alternative mortgage products are a viable method to deliver credit to qualified borrowers. When used correctly, these loans boost home ownership and provide borrowers a method to manage cash flow during times of interest rate volatility. When provided to unqualified or uninformed borrowers, the results are the opposite. The risks of foreclosure, borrower loss, and financial institution loss increase exponentially.

The OTS fully supports efforts to finalize and publish interagency guidance on nontraditional mortgages and already supervises institutions to insure that they follow the sound principles and practices. The OTS is also dedicated to providing an updated CHARM booklet and guidance on consumer disclosures for alternative mortgage products. Additionally, OTS staff participate in several initiatives and programs to educate consumers about alternative mortgage products.

Given the highly competitive nature of the alternative mortgage market, consistent standards and principles applicable to all market participants will help level the playing field and reduce competitive distortions. Nonetheless, it is important to note that the potential risks of these products have in the past, and can in the future, be appropriately managed by well-run institutions. We do not want to stifle innovation, nor unjustifiably restrict the flow of credit, especially during the current housing market. To achieve those goals, the OTS is actively supervising its institutions for weakness in underwriting and consumer disclosures. The OTS will also continue its efforts to promote awareness and understanding of alternative mortgages among consumers. Promptly addressing abuses and poor risk management practices will ensure a steady flow of credit to qualified borrowers in the future.

The OTS believes that the continued success of the alternative mortgage lending market relies on the realization and continuation of several key principles. Market participants should implement sound underwriting practices that include qualifying borrowers at the fully-indexed, fully-amortizing amount of the loan for option ARM loans. This will mitigate the potential for payment shock to the borrower as well as mitigate the use of alternative mortgage products as affordability products, ensuring borrowers have the ability and capacity to repay the loan at the outset.

In addition, there must be full, clear, and balanced disclosure of the benefits and risks of alternative mortgage products at the time the borrower is considering loan options and at settlement. Efforts to communicate with and educate the consumer concerning the features, benefits and risks are essential. Lenders should provide appropriate, ongoing, and conspicuous disclosure on monthly borrower statements indicating the effects of negative amortization. Lenders should also implement robust risk management practices and management information systems to monitor conditions and originations made through third parties.

For the OTS, responsible lending by financial institutions along with informed decision making by borrowers is the cornerstone of a robust mortgage market. We are fully committed to supervising the safety and soundness of U.S. housing financing while ensuring consumers receive clear and balanced disclosures that permit them to make informed decisions.

TESTIMONY OF

. FELECIA A. ROTELLINI

ARIZONA SUPERINTENDENT OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

Before the

SENATE BANKING, HOUSING AND URBAN AFFAIRS

ECONOMIC POLICY SUBCOMMITTEE AND HOUSING AND TRANSPORTATION SUBCOMMITTEE

UNITED STATES SENATE

September 20, 2006

Room 538, Dirksen Senate Office Building

Introduction

Good morning, Chairman Allard, Chairman Bunning, Ranking Member Reed, and Ranking Member Schumer. My name is Felecia A. Rotellini, and I serve as the Superintendent of Financial Institutions for the state of Arizona. I am also a member of the Board of the American Association of Residential Mortgage Regulators (AARMR). I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,230 state-chartered commercial and savings banks. For more than a century, CSBS has given state supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state financial regulation.

In addition to regulating banks, 49 states plus the District of Columbia currently provide regulatory oversight of the mortgage industry. The one exception is Alaska, which introduced legislation this year. Under state jurisdiction are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.[1] In recent years, CSBS has been working with AARMR, a volunteer organization of state officials responsible for the administration and regulation of residential mortgage lending, servicing and brokering, to improve state supervision of the mortgage industry.

Thank you for inviting CSBS here today to discuss non-traditional mortgage products. Regulation of the mortgage industry originated at the state level and has remained there because mortgages are the most locally-oriented of all financial products. For most families, no financial decision is more important than the financing they choose

[1] The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

to obtain their home. CSBS commends our federal banking counterparts in their efforts to provide supervisory guidance for federal financial institutions on non-traditional mortgage products. Effective supervision of the mortgage industry requires a coordinated effort among the federal agencies and the states. It is therefore vital that the states are involved with coordinating policy, regulation, and guidance. State supervision of the residential mortgage industry is evolving to keep pace with the rapid changes occurring in the marketplace. At present, state regulation of the mortgage industry is limited in its consistency. On an individual basis, however, the states' standards are quickly improving and adapting. Through CSBS and AARMR, the states are working together to improve coordination of state supervision as well as to provide best practices and more uniformity.

Evolution of Mortgage Industry

The residential mortgage industry has changed dramatically over the past two decades. Twenty years ago, federal and state regulated savings & loans originated most of the residential mortgages. Federal government-sponsored enterprises or agencies such as Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) held a significant percentage of the market share and effectively set standards for the entire industry. At the time, the majority of mortgages were fixed-rate 15- or 30-year mortgages.

Today, mortgage markets have changed. Savings & loans comprise a minority of the market, loans sold to Fannie and Freddie or insured by FHA now account for less than half the market, and the product choices for consumers have exploded. Consumers can now choose between practically any combination of fixed, adjustable, or hybrid adjustable rate and amortizing, non-amortizing, or negatively amortizing mortgages, with terms anywhere from 15 to 50 years. On top of these changes, risk-based pricing has allowed more consumers than ever to qualify for home financing sooner, by trading a lower credit score or down payment for a higher rate.

More than ever before, homebuyers now view their home as a financial asset. In addition to providing protection from the elements, homes today are seen as a source of financial security for the future. Mortgage lenders have developed a number of products that offer homebuyers a wide variety of choices as they manage this financial asset. Increasingly, many of these products are quite complex, providing both opportunities and perils for consumers. Greater consumer confusion also creates greater opportunities for fraudulent sales practices. The sophisticated nature of these products requires an elevation of professionalism in mortgage originators and robust oversight of the companies and people offering such products.

Recognizing the evolving nature of the industry and its supervisory challenges, most state legislatures have passed laws to regulate mortgage brokers, lenders, and/or loan officers. Under our current regulatory system, the state regulatory agencies have shouldered the primary responsibility for overseeing the residential mortgage industry.

As the mortgage industry has rapidly evolved, the states have played a more active role in its supervision. Forty-nine states and the District of Columbia now regulate mortgage companies and/or professionals. This is a dramatic change since 1993, when only 18 state agencies regulated the mortgage industry.[2] According to industry experts,[3]

[2] Source: Mortgage Asset Research Institute, Inc., Reston, Virginia.
[3] Source: Wholesale Access, Columbia, Maryland. http://www.wholesaleaccess.com/7_28_mbkr.shtml.

mortgage brokers and state-licensed loan correspondents now originate an estimated 68 percent of all residential mortgage loans in the United States.

The increasing role that brokers play in the residential mortgage process, concerns about predatory lending, the explosion of product choices offered by the private sector, and the realignment of the federal role in housing finance have required the states to develop new tools to protect consumers and to ensure that mortgage markets operate in a fair and level manner. This trend is most evident in the number of state legislatures that have enacted legislation designed to eliminate unethical practices, remove bad actors, and ensure transparency for consumer.

Trends in Non-Traditional Mortgage Products

Some states, including my home state of Arizona, have seen particular growth in non-traditional mortgage products, such as interest-only and adjustable-rate mortgages (ARMs). "Stated income"[4] loans are also becoming more popular among consumers. Some borrowers use these complex non-traditional mortgage products not as methods to manage wealth, but as means to afford homeownership, or to purchase a home that would traditionally be considered out of their price range.

In some cases, the borrower does not fully understand how these products work. Sophisticated buyers understand the non-traditional mortgage products and the financial risks. Based upon the consumer complaints the Arizona Department of Financial

[4] "Stated income is a loan feature wherein a mortgage lender requires a borrower to state their income in qualifying for a mortgage but does not require substantiating documentation from the borrower or the loan originator of the income stated. Stated income loans are one of several types of "reduced documentation" loan features that include "low- and no-document," "no income/no asset," and "stated asset" loans that establish reduced or minimal documentation standards necessary during origination to substantiate a borrower's income and/or assets.

Institutions receives, many buyers do not understand the terms or realize the negative consequences of these loans only after the minimum monthly payment has increased. These borrowers claim that they would not have agreed to this type of loan had they known how much the payments would increase in such a short period of time. In many cases, the loan documents include disclosures outlining the interest rate increases and the nature of the product. It appears that many borrowers are so anxious to buy a home that they are willing to take any risk without fully understanding the depth and breadth of the negative consequences.

The current disclosure documents are too complex, and fail to provide consumers with the information they need to protect their interests. CSBS believes that an entirely new disclosure process is necessary to help consumers keep pace with the ever-expanding array of mortgage products.

If properly managed and offered to borrowers in the right situation, non-traditional mortgages may promote homeownership, and in some cases, may lower the long-term costs of homeownership. However, we have seen signs that some underwriting criteria may be inadequate, and some lenders offer these loans in cases where they do not match borrowers' needs. If these are systemic trends, the recent run-up in housing appreciation may be unsupportable.

As a large number of non-traditional mortgage loans re-price and the residential real estate market continues to cool, we fear borrowers may face significant payment shock, or that these mortgages may be unsustainable at fully-indexed rates. These scenarios will likely lead to increased home foreclosures.

Housing and mortgage lending is a significant driver for economic activity. In an environment of higher interest rates, an economic and/or housing market downturn coupled with a high number of borrowers struggling to keep their homes may worsen a negative cycle or speed up any downturn. These non-traditional mortgage products may make a "soft" landing more unlikely.

CSBS-AARMR National Residential Mortgage Licensing System

It is within the context of the growing importance of mortgage brokers in the origination process and significant growth of non-traditional mortgage products offered by state-regulated mortgage brokers and lenders that state regulators find themselves compelled to develop policies and initiatives to safeguard consumers and to protect the economic well-being of their communities. CSBS and AARMR have discussed how our two organizations could best combine the immediacy of local supervision and enforcement with a system that would provide nationwide information sharing and other resources, while at the same time modernizing the state systems.

The result of this discussion was a residential mortgage licensing initiative to create uniform, national mortgage broker and lender licensing applications and a centralized database to house this information. The uniform application and database will significantly streamline processing of licenses at the state level. Additionally, the state agencies will be able to divert resources previously used for processing applications to more supervision and enforcement.

The database will also offer homebuyers a central place to check on the license status of the mortgage broker or lender they wish to do business with, as well as a way to determine whether a state has taken enforcement action against that company or individual.

Since January 2005, state regulators have committed staff to develop this project. These individuals have met monthly to work through state differences and develop uniform applications. Over 20 months, hundreds of conference calls, countless revisions, and consultation with the industry, four national uniform application forms were created. CSBS expects several states to begin using the forms next month.

In June 2006, CSBS contracted with the National Association of Securities Dealers, Inc. (NASD) to develop a nationwide licensing system. The NASD developed and now operates the Central Registration Depository (CRD) ® and the Investment Adviser Registration Depository (IARD) ® system. The NASD brings to this project expertise in developing and operating a national licensing system that is subject to state regulations.

The national database will contain licensing information, enforcement actions, and background data for every state-licensed mortgage broker, mortgage lender, control person, branch location, and loan originator. Each state will continue retain its authority to license and supervise, but the new system will eliminate unnecessary duplication and implement consistent standards and requirements across state lines.

The electronic application and database system will begin operations on January 1, 2008.

Once up and running, database information will be available not only to regulators and law-enforcement officials, but also to the licensees and to consumers. The database will provide immediate and profound benefits to consumers, the industry, and the state supervisory agencies. Consumers will have access to key information about the providers that they trust with the most important financial transactions of their lives. Honest mortgage bankers and brokers will benefit from the creation of a system that drives out fraudulent and incompetent competitors, and from having one central point of contact for submitting license applications. Everyone benefits from a system that makes it easier to identify and punish the small percentage of dishonest operators in the mortgage industry.

This system will play an important role in discussions about non-traditional loan products. In a sense, the changes in the mortgage industry are similar to some of those in the securities industry. Today, more homebuyers view their home as a financial asset. Mortgage companies have developed a number of products that offer homebuyers a wide variety of choices in how to manage this asset. Some of these choices are complicated and are priced on risk, which requires increased education, professionalism, and oversight of those offering these complex products to consumers.

Therefore, the changes in the mortgage industry over the past 20 years requires a more robust licensing system akin to that developed by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and the states for securities brokers.

Given the changes mortgage products and the increased role of brokers, CSBS believes that it is in regulators', consumers', and the mortgage industry's interest to move to the coordinated oversight that the CSBS-AARMR licensing system and database will provide.

CSBS-AARMR Non-traditional Mortgage Product Guidance

In December 2005, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) published a notice of proposed guidance on non-traditional mortgage products. When finalized, the guidance will apply to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. CSBS believes this is important and useful guidance, but it will not apply to those mortgage brokers and mortgage companies not affiliated with a bank holding company or an insured financial institution who originate a vast majority of loans.

In an effort to provide guidance for these state-supervised mortgage providers, CSBS and AARMR are developing parallel guidance which will primarily focus on residential mortgage underwriting and consumer protection. The guidance will be offered to state regulators to apply to their licensed residential mortgage brokers and lenders. CSBS and AARMR intend to release this guidance immediately following the publication of the final federal guidance, which is expected this fall. The CSBS-AARMR guidance is intended to hold state-licensed mortgage brokers and lenders to effectively the same standards as developed by the federal regulators. Specifically, the proposed CSBS-AARMR guidance will help ensure that the marketing and borrower disclosure practices of third party originators reflect the standards and practices used by an institution in its direct lending activities.

Mortgage Training Initiatives

CSBS and AARMR are also working individually to increase the expertise and knowledge of the state supervisors. CSBS has developed and is delivering a comprehensive training program for state residential mortgage examiners. The program, Residential Mortgage Examiner School, is designed to help inexperienced mortgage company examiners understand how the mortgage industry works and also provide them with practical and proven techniques for examining non-depository mortgage companies similar to those used by state and federal bank examiners. The School complements training programs offered by AARMR.

The program features a blended learning format which includes pre-residence session assignments and a 4.5 day residence session. The developers and instructors of the program are experienced state examiners and officials and industry executives.

In addition to the Residential Mortgage Examiner School, other programs are under consideration including a program focusing on non-traditional mortgage products. CSBS also is developing a certification program for mortgage examiners and plans to extend its state agency accreditation program to include mortgage supervision.

AARMR holds Training Schools twice a year, once in the spring and once in the fall. They hold a Basic Examiner School, which provides state residential mortgage regulators/examiners with a brief overview of the mortgage industry and a more comprehensive overview of the federal regulations used during mortgage banking examinations. The school provides an understanding of the industry to new examiners and is geared towards examiners with one year or less experience examining mortgage companies.[5]

AARMR also holds an Advanced Examiner School, which provides participants with updates on federal regulations and recent trends in the mortgage industry. And finally, AARMR has a Fraud School to provide participants with the skills and tools necessary to identify, understand, and document fraud in the mortgage industry.[6]

Conclusion

We have seen dramatic changes in the residential real estate mortgage market. The choice in products has increased, as well as their complexity. Consumers also have greater choice in their service provider. Beyond the traditional bank or savings and loan, a consumer can utilize the services of a mortgage company or mortgage broker. While these choices have in many cases benefited consumers by enabling home purchases and customizing home financing, they have also increased the complexity and dangers in the marketplace, and created more opportunities for outright fraud.

Regulation of the mortgage industry originated at the state level. As the mortgage market has changed, state authorities have enacted new laws and improved overall supervision. The CSBS – AARMR residential mortgage licensing initiative is the cornerstone for a new generation of coordination, cooperation, and effective supervision in the state system.

[5] Source: American Association of Residential Mortgage Regulators. http://www.aarmr.org/page07.htm.
[6] Ibid.

CSBS commends the federal regulators for drafting guidance on non-traditional mortgage products. This guidance has done much to draw attention to the threats that these products may pose to consumers, especially if underwriting is done improperly. When the guidance is implemented, it will not apply to the majority of mortgage providers in this country. The parallel guidance being prepared by CSBS and AARMR will help to ensure consumer protection across the mortgage industry.

Finally, the states have proactively worked to increase the expertise and knowledge of their examiners. It is critical for our examiners to understand the function of the mortgage market and its various products. These are the individuals which will see first hand the practices of the industry and its impact on our consumers.

I commend you, Chairman Allard, Chairman Bunning, Ranking Member Reed, Ranking Member Schumer, and the distinguished members of the Subcommittees for addressing this matter. On behalf of CSBS, I thank you for the opportunity to testify, and I look forward to any questions you may have.

Statement of
Robert D. Broeksmit, CMB
Chairman, Residential Board of Governors
Mortgage Bankers Association

Before a Joint Hearing of the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy U.S. Senate Committee on Banking, Housing and Urban Affairs

"Calculated Risk: Assessing Non-Traditional Mortgage Products"

September 20, 2006

Good Morning Chairman Allard, Ranking Member Reed, Chairman Bunning, Ranking Member Schumer and Members of the Subcommittees.

Overview

My name is Robert Broeksmit and I am President and Chief Operating Officer of the B.F. Saul Mortgage Company of Bethesda, Maryland, a subsidiary of Chevy Chase Bank, FSB. Today, in my capacity as Chairman of the Mortgage Bankers Association (MBA) Residential Board of Governors, I am testifying on behalf of the thousands of MBA members who work day in and day out to help families realize their dreams of homeownership.[1]

In particular, I appreciate the opportunity to participate on the panel this morning to discuss the "non-traditional" mortgage products that are available in today's mortgage marketplace that have been developed by the lending industry in response to consumer demand.

In my testimony I will explain the background and use of these products, MBA's position on several matters addressed in the recent guidance proposed by the Federal financial regulators – including underwriting, risk management and consumer information – and provide recent data on these and other products in the mortgage marketplace.

The term "non-traditional mortgage products" encompasses a variety of financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of many mortgage borrowers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers' incomes. Other borrowers have used these products to tap their homes' increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as "new," many of them actually predate long term fixed-rate mortgages.

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

These products include fixed- and adjustable-rate loans that permit interest only payments, payment option loans or option Adjustable Rate Mortgages (option ARMs) that allow borrowers to choose among different payments each month, including an option that may result in some degree of negative amortization. In the view of some, non-traditional products also include loans that are characterized by streamlined underwriting. These loans forego some aspects of traditional mortgage underwriting in the interest of helping borrowers qualify for financing with less documentation.

I strongly believe that the market's success in making these "nontraditional" products available is a positive development, not cause for alarm. Although these products have been used to finance a relatively small portion of the nation's housing, they have offered and continue to offer new useful choices for borrowers who can benefit from them.

To be sure, as with all mortgage products, they must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. And as with other products, lenders must provide consumers necessary information on a product's terms so a borrower can determine whether the product matches his or her needs.

I would be remiss, however, if I did not point out that lenders have long experience underwriting adjustable rate products including option ARMs. These products are being effectively underwritten and managed today. Moreover, during the real estate and refinancing boom of the last several years, many, many borrowers have come to understand and effectively use these products to become homeowners. Many others have used them to refinance and flexibly manage their home equity as they manage other investments and needs.

The most recent data provided by the mortgage industry on loans made in 2004 and 2005 under the Home Mortgage Disclosure Act (HMDA) demonstrate the greatest and widest availability of mortgage finance in our Nation's history, which, in turn, has made possible record homeownership rates. The data show that borrowers in virtually every area of the Nation, of every race and ethnicity, and at every income level receive an array of credit opportunities as HMDA was intended to achieve.

Homeownership is near its highest level in history. As a result, Americans are building tremendous wealth. According to the Federal Reserve's Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $20.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the Fed's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000. Clearly, many homeowners have been successful in accumulating wealth, both by steadily building up equity through their monthly payments, and through the impressive rate of home price appreciation we have seen in recent years.

More than a third of homeowners, approximately 34 percent, own their homes free and clear. Of the 66 percent of the remaining homeowners, ¾ have fixed rate fixed rate mortgages and only ¼ have adjustable rate mortgages. Many of the borrowers with adjustable rate loans have jumbo loans, indicating that they are wealthier.

In the second half of 2005, according to MBA's Mortgage Originations Survey, 65 percent of the dollar volume of loans originated were prime loans, 11 percent were Alt A, 21 percent were nonprime, with government loans accounting for the remaining 3 percent. Recently, cash out refinances have accounted for about 70 percent of refinances.

Also notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased from 3 to 2 percent. This compression has benefited borrowers in the nonprime market by providing rates that are closer to prime rates. The cause of this compression as well as the abundance of credit is the unparalleled number of loan originators that are competing for borrowers' business. These include mortgage companies, banks, credit unions and mortgage brokers.

Innovations in the mortgage market, resulting in the range of mortgage products available today are a key part of these successes. These products include both fixed-rate mortgages and the "non-traditional products" that we are discussing today.

As my testimony explains, mortgage default and foreclosure rates have been low historically with some increases in the past quarter, the second quarter of 2006. In the second quarter, all ARM loans had higher delinquency rates compared to the first quarter of 2006. Fixed rate mortgage loans (FRM) were either unchanged or saw a decline in delinquencies. The delinquency rate for prime ARMs increased 40 basis points (from 2.30 percent to 2.70 percent) and the rate for prime FRM loans was unchanged (at 2.00 percent). The rate for nonprime FRM loans decreased 38 basis points (9.61 percent to 9.23 percent), whereas the rate for nonprime ARMs increased 22 basis points (12.02 percent to 12.24 percent). MBA has not found evidence that non-traditional products are the cause of these increases. In fact, the evidence we do have from securitized non-traditional mortgages is that they are performing the same or better relative to more traditional products and have done so for a long time.

World Savings, for example, one of the nation's 15 largest financial institutions with $125 billion in assets, which makes residential loans in 39 states, has been originating, maintaining in portfolio, and servicing Option ARMs for the past 25 years. World reports that Option ARMs have been their core product ever since

ARMs were first authorized in 1981, and they now comprise 99 percent of their portfolio. They have been originating these loans, with extremely low losses, throughout interest rate cycles, recessions and home price declines.

World reports that their annual charge offs have averaged less than 5 basis points since 1981, which they believe is lower than that of virtually every other depository institution of size, including institutions that have made only fixed-rate residential mortgage loans. They indicate that their low charge off levels have been equal to or superior to those of Government Sponsored Enterprises, even though their core product has been the Option ARM while the GSEs have essentially held fixed-rate loans and benefited from greater geographical diversity. During the past quarter century, World reports that it has not identified a single delinquent loan in its portfolio, much less a foreclosure or loss, due to the structure of their Option ARM product.

Other lenders report similarly favorable experiences with non-traditional products.

Notably, there are many factors that contribute to the likelihood that a borrower may become delinquent. Some factors are not predictable and include unemployment, death in the family, divorce, medical problems and other life changes. What is predictable is that delinquencies peak in years 3 to 5 of the loan's life.

The number one cause of delinquencies and foreclosures is historically linked to employment. As we can see in the Midwest, states such as Ohio, Indiana, Kentucky and Michigan have lost a significant amount of manufacturing jobs. That combined with a higher rate of homeownership has contributed to the rise of delinquencies and foreclosures in these and other states.

We have indicated that over the last several quarters, a number of factors, including the aging of the portfolio, increasing short-term interest rates, and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and labor markets had kept delinquency rates from rising. As we see some increases in delinquencies and foreclosures, it is not surprising that nonprime borrowers are more susceptible to these changes.

It is important to remember that nonprime borrowers have always had higher delinquency and foreclosure rates, and lenders factor in these risks when making loans to nonprime borrowers. Additionally, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as they have in the past.

Notably, however, while non-traditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market.

Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent, while it was 25 percent in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and significantly better credit scores than nonprime borrowers who choose other products.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have higher credit scores and lower loan-to-value (LTV) ratios. Notably, these reports confirm that mortgage lenders understand that risk-layering requires lenders to contemplate mitigating factors. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high ARM share.

Because of the success of the industry in addressing the Nation's credit needs, particularly those of previously underserved borrowers, the debate today has shifted away from concerns about the availability of credit. Now the discussion at least in part concerns whether some of the many credit options available to borrowers are appropriate for them, whether they are appropriately underwritten and managed to minimize risk and whether borrowers are appropriately informed of the risks of adjustable, non-amortizing or potentially negatively amortizing products.

Some have even suggested that the industry should take on an undefined responsibility to determine the suitability of products for particular borrowers. Although MBA is examining this issue with its members, it is clear that the industry would oppose a vague and uncertain standard that would stem innovation and cause litigation that would increase costs to all borrowers.

At the end of last year, the federal financial regulators issued proposed guidance on non-traditional products. The guidance sought to ensure that sound underwriting, risk management and consumer disclosure accompanied these products.

In MBA's comments on the proposed guidance, several points of which are summarized in this testimony, MBA made clear that it believes that the creation of such guidance is a positive development given increasing consumer interest in these products and the increasing number of lenders offering them to meet consumer demand. Indeed, MBA emphasized that the proposed guidance identified issues that all lenders should consider in developing credit policies and oversight in originating such products.

At the same time, MBA pointed out that certain provisions of the proposed guidance were overly prescriptive, for example, in mandating specific underwriting standards and suggesting a third-party oversight standard for Federally-regulated institutions. MBA also pointed out that the agencies did not sufficiently use the authorities of Board of Governors of the Federal Reserve System (Federal Reserve) to improve consumer disclosures for all borrowers. MBA expressed concern that these deficiencies would stifle mortgage product innovation and hurt consumers' access to homeownership financing.

In its comment letter, MBA said that the guidance should explicitly recognize that lenders have successfully offered these non-traditional products for decades and should not be disadvantaged in the marketplace from continuing to do so. Secondly, interest-only and payment-option loans are different products that require different underwriting standards and risk management practices respectively. Moreover, though defined as products, interest-only and payment-option provisions are actually *loan features* that, in and of themselves, do not inherently pose significant risks.

As the comment letter stated, mortgage lenders, operating within this country's sophisticated real estate finance system, respond to a number of influences in determining their ability to originate mortgages in a manner that is profitable, as well as safe and sound. The primary influence for lenders are the signals received from secondary mortgage market investors. A lender originating a large number of mortgages with an unacceptable level of risk will find itself facing significant price disadvantages in the market. These signals prompt lenders to alter product features, introduce new features and remove features that do not work. These product changes are immediate. In this manner, the private market can and does correct for excess risk more quickly than can a regulator who necessarily must move at a more deliberate pace. MBA believes that market signals have already addressed many of the concerns expressed by the agencies in the proposed guidance.

The past 15 years has been marked by dramatic changes in mortgage originations which have significantly lowered the cost of homeownership for consumers and developed a broad range of products that meet a diversity of homebuyer needs. As I indicated, the evidence of success of these changes is the record high homeownership rate the U.S. currently enjoys.

Where guidance or law imposes a standard that is not aligned with mortgage markets, the net effect is to limit the ability of mortgage lenders to create viable products that respond to consumer demand. MBA believes that particular provisions of the proposed guidance threatened to do this, and we suggested certain clarifications and modifications in order to ensure that the proposed guidance met its stated goal of clarifying "how institutions can offer these products in a safe and sound manner," without disrupting mortgage market innovation or curtailing consumer access to financing.

We and our members strongly believe that sound underwriting, risk management and consumer information are essential to the public interest. At the same time we also believe that it is equally essential to assure a regulatory environment that serves and does not stem innovation in the industry. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. While expectations should be articulated, the details need not be prescribed. Also, while lenders must certainly assure that borrowers meet appropriate eligibility requirements, institution of an unspecific suitability requirement would not serve borrowers well; it would simply increase lenders' liability and borrowers' costs. Any new requirements in this area, therefore, must balance all of these imperatives to truly serve the public interest.

Accordingly, while MBA supports sound underwriting, risk management and consumer education, it does not support the imposition of overly prescriptive requirements or overly broad suitability requirements that risk stemming the availability of these and other products.

Also, while MBA has long supported simplification of the mortgage process and all necessary consumer information, to reach those who do not understand the products and process, it does not support the creation of a new disclosure regimen for these products alone without looking at those disclosures that already exist.

Consumers today face a pile of disclosures when they apply for and close on a mortgage. I wish I could say it all helped. There are already so many disclosures that consumers do no pay attention to what's being disclosed, thus defeating their purposes. Any effort at improvement needs to streamline the existing mandated disclosures as well as being comprehensive and well considered. Disclosure requirements should apply to all originators.

Finally, while any increases in delinquencies and defaults are an important concern, prohibition of particular products is not a solution, certainly not to the many borrowers who have used these products effectively to realize their dreams of homeownership and otherwise satisfy the financial demands that we all face.

Our simple message is that the mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from unparalleled choices and competition resulting in lower prices and greater opportunities than ever before to build the wealth and well being that homeownership brings to our families and communities. It must be permitted to continue to do so. Any consideration of new requirements in this area must be judicious and any such requirements very carefully conceived. We must also assure that borrowers fully understand the choices available to them and take full advantage of efficiencies in the market.

Background

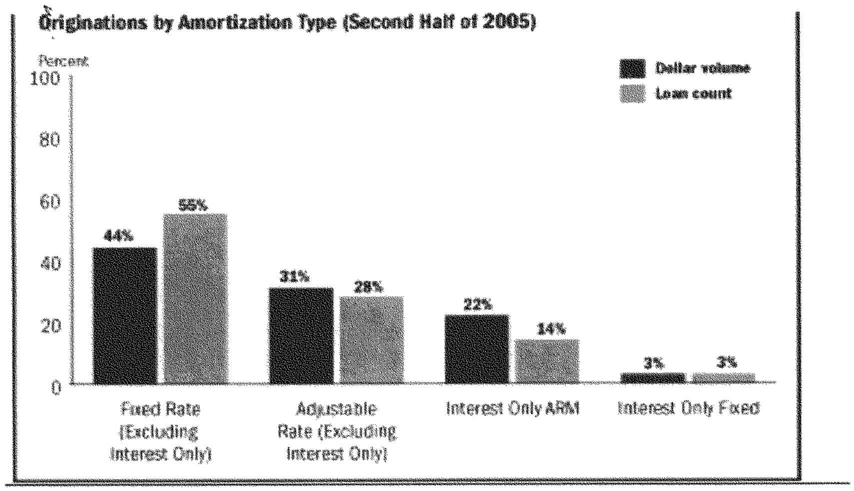
Non-Traditional Mortgage Products Have a Long and Successful History

Some define "non-traditional mortgage products" solely as "interest-only" and "payment-option" mortgages. Such a definition indicates that the key to the non-traditional label is the presence of a non-amortizing or potentially negatively amortizing feature. Ironically though, while currently being termed "non-traditional", non-amortizing mortgages predate amortizing mortgages. In the United States, it was not until the creation of the Federal Housing Administration (FHA) in 1934 that the now ubiquitous 30-year, fixed-rate, amortizing mortgage gained nationwide acceptance. Prior to the FHA, non-amortizing 5-year mortgages with a balloon payment at the end of the term were the market norm.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. Notably, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance. More recently, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance. Both these points evidence the fact that the primary mortgage market has been constantly developing loan features that were "non-traditional" but also beneficial to consumers.

Some lenders, at the forefront of responding to consumer demand for product diversity, began to offer, in addition to ARMs, interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without a threat to their safety and soundness. It is therefore prudent to look to the practices of lenders respecting non-traditional mortgage products but not to impose prescriptive requirements that would force them to change proven standards and disadvantage institutions from effectively participating in this market.

Consumer demand for interest-only mortgage products is significant, as is demonstrated by MBA's 2005 Mortgage Originations Survey. Many consumers today have learned how to effectively use these products and the tradeoff between long-term certainty and higher rates versus future rate uncertainty and lower initial rates. Notably, some consumers prefer fixed products just as they prefer investments with a fixed rate of return. On the other hand, others have opted for lower initial rates mindful that they would move or refinance before rates adjusted uncomfortably.



Source: MBA Mortgage Originations Survey

If lenders are hampered by overly prescriptive underwriting standards, it would restrict the availability of these products by some of the mortgage lenders that have the longest experience in offering them. MBA believes such a curb on consumer choice would be an extraordinarily unfortunate development.

Types of Non-Traditional Products

Interest-Only and Payment Option Mortgages

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards, and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed to make amortizing payments during the interest-only period.

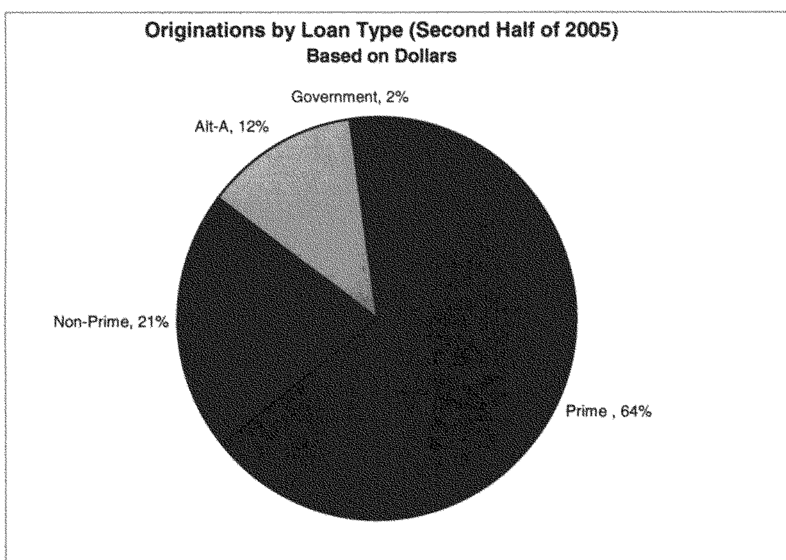
A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule; an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10-25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

In light of these differences, the same attention and policies should not apply to both products. MBA submits that if this matter is to be addressed, any guidance should explicitly recognize that these products or features are different and that any guidance on credit policy and underwriting should not treat the two products the same.

Alt A and other Reduced Documentation Loans

Reduced documentation loans, such as "stated income" loans, have been offered for well over a decade and have grown in popularity with borrowers in recent years, as MBA's Midyear 2005 Mortgage Originations Survey demonstrates:



Lenders have been able to accommodate consumer demand for these "Alt-A" products because tools have been developed that can accurately gauge risk without requiring certain documents to be provided by the borrower. As credit history data and credit scoring models have become more robust and predictive, mortgage lenders have been able to lower costs and streamline processes for certain borrowers while effectively managing any additional risks these products might pose.

II. MBA's Comments on Proposed Guidance

As I indicated, in response to proposed guidance from the Federal financial regulatory agencies of December 29, 2005, MBA provided extensive comments. The following summary outlines MBA's position on key issues relevant to "non-traditional" products.

A. Underwriting Standards

MBA believes it is appropriate that lenders identify the primary credit policy and underwriting concerns that lenders should consider in developing loan terms and underwriting standards. Mortgage lenders, though, are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Therefore, it is not appropriate for specific credit policy criteria or thresholds to be prescribed.

Traditionally, the establishment of underwriting standards is the responsibility of a Federally-regulated institution itself. Certainly, the experience of many such institutions, which have offered non-traditional mortgage products for decades, has demonstrated an ability to develop safe and sound underwriting standards.

Qualification Standards

In developing qualification standards for non-traditional mortgage products, lenders should account for possible risks associated with the non- and/or negative amortizing features of a mortgage product. Mortgage lenders that have successfully offered these products have used credit reports, credit scores, and sophisticated modeling to ensure that the non-amortizing features of non-traditional loans are mitigated with features that reduce risk.

While MBA agrees that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA also does not favor the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. Such an approach is far too prescriptive and will force lenders to apply credit policies that would disadvantage products of various terms in a manner which is inconsistent with their risks. For instance, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a

3/1 hybrid ARM with a 27-year amortization starting in year four (3), despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product. A key risk factor of any hybrid mortgage is the initial length of time during which the interest rate is fixed, an interest-only payment is required, or a loan does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes. Also, any qualification standards must differentiate between interest-only and payment-option mortgages; lenders differentiate the two products in underwriting.

Negative Amortization

MBA also does not favor any requirement that the repayment analysis for products permitting negative amortization include the initial loan amount plus any balance increase that may accrue from the negative amortization provision, assuming the borrower makes only minimum payments during the deferral period. MBA believes such an approach establishes a severe and inconsistent standard not applied to other products.

Such a standard effectively requires underwriting to a worst-case scenario that is not standard practice for other products with variable rates, such as a hybrid ARMs, where a borrower's interest rate (and therefore payment) is fixed for a number of years and then adjusts annually within certain prescribed caps. If a lender establishes an underwriting standard qualifying a payment-option borrower at the fully-indexed rate, it is inconsistent to then additionally assume the borrower will make only the minimum payments and qualify the borrower a second time. Lenders do not underwrite to a worst-case scenario where the interest rate increases to the lifetime cap at the first adjustment. This type of standard would not reflect actual performance by experienced lenders and would preclude some borrowers who could benefit from the product from qualifying for it.

Mortgage lending today need not rely solely on rigid debt-to-income (DTI) ratios because automated tools and advanced risk modeling have allowed lenders to go beyond simple thresholds to appropriately qualify borrowers that exhibit risk mitigating characteristics, such as a high credit score or sufficient cash reserves. MBA believes that effective regulatory guidance in underwriting should not include prescriptions to specific credit policies that a lender should adopt. Lenders should be advised to continue to consider the length of the interest-only period in determining whether or not to qualify the borrower on the interest-only payment or the amortizing payment.

Credit Scores

MBA does not believe that lenders "should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process." Credit scores have proven to be highly predictive of a borrower's capacity and intent to repay a debt. While no mortgage lender should consider only one factor in underwriting any mortgage, MBA is concerned that the term "over-reliance" can be defined too narrowly as requiring the consideration of other less predictive underwriting tools.

Collateral-Dependent Loans

MBA does not favor overly broad restrictions on "collateral-dependent loans" that go beyond the current guidance concerning the consideration of collateral in underwriting the mortgage. For example, a so-called "collateral-dependent loan" with a low LTV to a borrower with a high credit score would not create undue financial risk to a lender.

Risk Layering

MBA supports the view that lenders should adequately account for all risk factors on loan products they offer. For example, the Loan Terms and Underwriting Standards section of the proposed guidance did an excellent job of enumerating some of these risk factors. Federally-regulated institutions with experience in these products have done a good job in managing the various risks that accompany their products and, to date, MBA has not been given any indication that problems exist with their ability to adequately identify risks and establish mitigating factors.

Reduced Documentation

MBA does not believe that reduced documentation loans are incompatible with non-traditional mortgage products. Mortgage lenders do and should continue to prudently assess the risk for reduced documentation loans and look to other risk mitigating factors. Where a lender uses a credit score, especially in conjunction with an automated underwriting system (AUS), for this purpose, MBA believes that a lender is using strongly predictive indicators of general creditworthiness.

Reports from MBA members indicate that portfolios of non-traditional mortgages typically have higher credit scores, lower LTV ratios, and/or other risk mitigating characteristics. Additionally, credit scores are obtained from third-parties beyond the influence of the borrower or any party to the transaction, which means these scores are generally free from fraud or misrepresentation. Credit scoring has enabled lenders to protect the performance of the mortgages they originate while relaxing reliance upon strict income verification requirements or rigid debt-to-income standards.

MBA believes that reduced documentation loans, such as stated income, are generally accepted only if there are other mitigating factors, such as lower LTV and other more conservative underwriting standards. MBA understands that lenders often find that customers with a long history with the bank request these mortgages for their convenience and many mortgage lenders apply reasonableness tests to stated-income loans.

Simultaneous Second-Lien Loans

Simultaneous second-lien mortgages have been developed by MBA members in response to market demand. Mortgage lenders have been able to meet this demand and manage the higher risks associated with lower borrower equity, even when the combined loan-to-value (CLTV) is up to 100 percent.

MBA does not support rigid guidance that would prohibit interest-only and payment-option features on simultaneous second-lien loans when the CLTV is 100 percent. Such a strict prohibition does not allow lenders sufficient flexibility to manage risks by offering these loans where there are other risk mitigating factors. Also, interest-only and payment-option mortgages should in any case not be treated the same in this regard. MBA members report that CLTV policies are typically different for interest-only products than for payment-option products.

The risk of a simultaneous second mortgage to a Federally-regulated institution depends on what the institution does with the second trust. If the second trust is sold or insured, then the risk is much more comparable to that of an 80 percent LTV loan. Furthermore, a lender that originates an 80 percent first trust has no guarantee that a borrower will not subsequently obtain a second trust of 20 percent of the property's value from a different lender.

Lending to Nonprime Borrowers

MBA agrees that lenders should carefully consider the *Interagency Guidance on Nonprime Lending* (issued March 1, 1999) and *Expanded Guidance for Nonprime Lending Programs* (issued January 31, 2001) when determining the credit policies under which non-traditional mortgage products will be offered to nonprime borrowers.

Non Owner-Occupied Investor Loans

MBA notes that interest-only mortgages are a "traditional" loan feature in investment property lending. MBA therefore believes that that a 100 percent CLTV interest-only investor mortgage should be permitted. In such cases, a mortgage lender may apply other risk mitigating credit policies to such a product that would address any risk factors.

MBA's view is that borrower equity is one of many factors a mortgage lender should consider in evaluating the risk of a particular mortgage loan.

B. Portfolio and Risk Management Practices

Concentrations

MBA believes that lenders should pay particular attention to those products in their portfolios that may carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there may be a problem.

MBA does not support the imposition of strict concentration limits by loan types, third-party originations, geographic area, property occupancy status, high LTV loans, high debt-to-income (DTI) ratio loans, loans with potential negative amortization, loans to borrowers with credit scores below established minimums and non-traditional mortgage loans with layered risks.

The proportion of loans with certain characteristics should be monitored, but immediately stopping the pipeline of loans with certain features is impractical and unnecessary for many lenders. Large mortgage lenders with several origination channels and who actively sell loans may have difficulty ensuring that the concentration limits are not exceeded in changing markets. Such concentration limits also may be unnecessary if an increase in a portfolio's risk in one line is offset by a decline in risk in another area.

MBA believes that lending institutions should work with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolio.

Controls

MBA agrees that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate and that non-traditional mortgage products may require controls that others products do not. MBA has asked the regulatory agencies to clarify that such controls are not expected in those cases where the loan is sold without recourse.

Third-Party Originations

MBA believes that mortgage lenders should have "...strong approval and control systems to ensure the quality of third-party originations..." but believes that the requirement that Federally-regulated institutions ensure that third party originators (TPOs) are originating in "...compliance with all applicable laws and regulations, with particular emphasis on marketing and borrower disclosure practices," if interpreted literally, is too expansive. Holding a lender responsible for the marketing practices of TPOs is significantly beyond current industry practices and beyond these institutions' reasonable ability to comply.

When mortgage lenders use TPOs, they are essentially outsourcing some portion of the origination process to a separate mortgage professional. As such, they do not have the same ability to monitor employees of the TPO as they do their own employees. Lenders do not have the same ability to oversee the employees of TPOs as they do their own retail staff. Moreover, such a standard is not in place for traditional mortgage products and should not be implemented for non-traditional mortgage products.

Mortgage brokers and many loan correspondents are governed by state law and regulated by state agencies. These agencies have the jurisdiction and authority to subpoena records and audit these state-regulated entities. Mortgage lenders, even those who are federally-regulated, simply do not have the legal authority to enforce state or federal laws.

An unintended consequence of such a requirement in guidance applicable to federally regulated financial institutions would be to disadvantage Federally-regulated institutions in comparison to other mortgage lenders in working with TPOs, if such institutions are forced to implement invasive monitoring procedures not required by other mortgage lenders.

Secondary Market Activity

MBA does not agree with the assertion that the voluntary repurchase of loans constitutes "implicit recourse" requiring risk-based capital be maintained against the entire portfolio. Regulators should not treat loans as subject to recourse where contract law does not require it. Under this requirement, a Federally-regulated institution would be hampered in its ability to repurchase mortgages for business reasons.

MBA notes that the secondary market takes positions on the current and expected performance of non-traditional mortgage products through pricing and decisions by rating agencies, such as Standard & Poor's June 20, 2005 announcement of changes to its ratings criteria. Secondary market feedback can mollify concerns of excessive risk.

C. Borrower Information Concerning Non-Traditional Products

MBA strongly believes that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. As indicated, many consumers understand the array of products and have used them appropriately to their best advantage.

On the other hand, MBA recognizes that it is possible that some consumers may not fully understand the features of some of the interest-only or payment-option mortgage products they are considering and that reasonable improvements to current disclosure requirements may be warranted.

It is in the interest of mortgage lenders to assure that their customers are provided necessary information to facilitate their understanding of these products. Because there is no single, uniform, mandated disclosure for non-traditional products, many lenders have developed their own disclosures to inform borrowers about the characteristics of these products. As indicated, many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of non-traditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

While mortgage markets are functioning well and serving consumers, as indicated, some borrowers still find it challenging to understand the array of products. While an overhaul of our education system to make financial literacy a priority is a long-term goal, MBA believes steps have to be taken in the short term. These steps should be directed toward three areas to improve borrower understanding and help them get the best prices possible:

- First, borrowers have to be provided effective tools to educate themselves about the mortgage process.

- Second, consumers need simpler, more user friendly disclosures about mortgage loans in order to shop and compare.

- Third, consumers need to be urged to shop more intensely, comparing mortgage offerings from lender to lender.

MBA's research has shown that homebuyers, particularly first-time homebuyers, rely on a trusted advisor, who may have an adverse incentive, to help them through the complex process of buying a home and getting a mortgage. Too often, MBA believes, these new buyers, and particularly minority first-time homebuyers, either contact only one lender or mortgage broker, or are referred by a real estate agent to only one lender or broker while shopping for a mortgage. Borrowers more experienced in the process are generally more likely to seek additional rate quotes.

MBA believes that borrowers need to educate themselves about the mortgage process – so much so that MBA created an educational Web site about the mortgage process for consumer use at www.HomeLoanLearningCenter.com that also offers Spanish language information. In addition, MBA is committed to working to put together a meaningful mortgage disclosure or disclosures that contains relevant, easily understood information that a consumer can use to shop and compare mortgage loans. MBA believes that armed with a basic understanding of the mortgage process, an ability to compare loans, and a willingness to shop, a consumer will be in a far better negotiating position when trying to get a competitive home loan.

MBA cautions, however, that any attempt to establish or improve disclosures for particular mortgage products, including non-traditional products, must be comprehensive and take into account the present system of required borrower information and disclosures. This necessarily would include consideration of the patchwork of non-Federal disclosures and how to present beneficial information in a form and format that will best serve and not overload borrowers. MBA would suggest that such an effort be undertaken on a comprehensive industry-wide basis so that consumers are informed of product features, while choosing their mortgage, in a consistent manner.

As indicated, in response to the proposed interagency guidance, MBA stated that it believes that the best method for achieving the above objectives is for the Federal Reserve to use its regulatory authority under TILA to improve and standardize disclosures following a regulatory process where key stakeholders from the mortgage industry have a meaningful opportunity to participate. The FRB should work closely with HUD to assure that any changes are consistent with any efforts at RESPA reform.

Notably, one initiative currently underway is the FRB's proposed study to include consumers and lenders for the purpose of developing and testing consumer regulatory disclosures that was detailed in the Federal Register on March 15, 2006. The proposed study can assist the process of improving disclosures to benefit consumers.

Another initiative is HUD's effort to reform RESPA to simplify and improve the settlement process. If the FRB chooses to exercise its authority under TILA to simplify and improve consumer disclosures, the FRB and HUD should coordinate their efforts to assure that they are complementary and accomplish their goals in a manner that truly improves the mortgage process.

III. Data on the Market Today

The market for home mortgages has changed radically in recent years. Home prices have increased dramatically, presenting significant affordability challenges in many parts of the country, and the industry has responded by providing flexible and affordable loan products. This same increase in prices has presented opportunities for borrowers to tap into the increased equity in their homes to meet a range of educational, health, housing and other needs. Largely as a result of increasingly sophisticated underwriting tools, risk based pricing permeates the industry. At the same time, technology has improved underwriting and risk management capabilities, enabling the industry to better serve the needs of borrowers with less than perfect credit.

Homeownership is at near record levels, and it is increasing the most among minorities. The homeownership rate in 2005 was 68.9 percent, the rate for African-Americans was 48.2 percent and for Hispanics 49.5 percent. According to MBA's data, at the end of 2005, prime loans accounted for 76 percent, nonprime 13 percent, and FHA and VA the remaining 11 percent of outstanding loans.

Mortgage default and foreclosure rates have been low with some increases in the past quarter, the second quarter of 2006. In the second quarter, ARM loans had higher delinquency rates compared to the first quarter of 2006. Delinquencies for fixed rate mortgage loans (FRM) were either unchanged or saw a decline in delinquencies. The delinquency rate for prime ARMs increased 40 basis points (from 2.30 percent to 2.70 percent) and the rate for prime FRM loans was unchanged (at 2.00 percent). The rate for nonprime FRM loans decreased 38 basis points (9.61 percent to 9.23 percent), whereas the rate for nonprime ARMs increased 22 basis points (12.02 percent to 12.24 percent). MBA has not found evidence that non-traditional products are the cause of these increases. In fact, the evidence we do have from securitized non-traditional mortgages is that they are performing the same or better relative to more traditional products and have done so for a long time.

While foreclosure rates are greater in the nonprime market than in the prime market, the numbers are far less than some have suggested. Let me emphasize again the importance of market growth when interpreting delinquency and foreclosure numbers. According to HMDA data, in 2000, there were 8.3 million applications for mortgages to buy a home. In 2004, there were 9.8 million applications for purchase mortgages. When the market is growing, even if the foreclosure rate remains constant, there will be an increase in the number of foreclosures. However, too frequently some market analysts point to an increase in the number of foreclosures as a problem in and of itself, when in fact it simply may reflect a constant or even declining foreclosure rate in the context of a growing market making more families homeowners than ever.

In the second quarter of 2006, the foreclosure inventory rate for nonprime loans was 3.56 percent. While this rate is greater than the prime market rate of 0.41 percent, nonprime borrowers by definition present greater risks of default than prime borrowers. Indeed this difference in default rates accounts for the mortgage rate differences between prime and nonprime loans.

Compare these differences to the foreclosure inventory rate for nonprime loans in 2001 peaking at 9 percent. The latest numbers tell a good story about lenders' ability to manage risk and the wherewithal of nonprime borrowers. In any case, those who would fix on a relatively low foreclosure rate as a reason for over-regulating the nonprime market risk denying the overwhelming majority of nonprime borrowers the prospect of homeownership.

MBA's National Delinquency Survey showed that the delinquency rate on one-to-four unit residential properties stood at 4.39 percent at the end of the second quarter of 2006, down 2 basis points from the first quarter, and up 5 basis points from the second quarter of 2005.

MBA also found that the economy and housing market decelerated in the second quarter of 2006. Although labor markets remained strong, the pace of job growth slowed, as did the home price appreciation rate, which has decreased in response to higher interest rates and rising inventories of unsold homes. In fact, some states experienced home price declines in the second quarter.

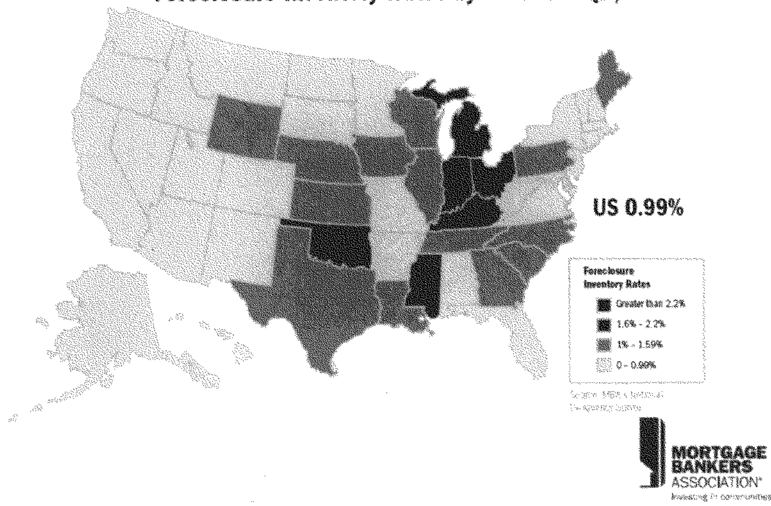
In previous quarters, MBA indicated that a number of factors, including the aging of the loan portfolio, increasing short-term interest rates, and high energy prices had been putting upward pressure on delinquency rates. To this point, generally healthy economic growth and labor markets have kept delinquency rates from rising. However, we are seeing increases in delinquency rates for nonprime loans, particularly for nonprime ARMs. Again, it is not surprising that nonprime borrowers are more susceptible to these changes.

Going forward, MBA expects some further slowing in the economy and the housing market. As a result, MBA expects modest increases in delinquency and foreclosure rates in the quarters ahead.

State- to-State Differences

There are significant differences in foreclosure rates among the states reflecting local economic conditions including job losses as illustrated by the map below.

Foreclosure Inventory Rates by State for Q2, 2006



IV. Conclusion

Mortgage credit is the lifeblood of the housing industry. Artificially constraining this flow will reduce the ability of prospective homeowners to purchase homes. Absent overregulation and the imposition of unworkable solutions, the range of mortgage products and the "risk-based" pricing prevalent in the mortgage lending industry will continue to expand access to credit and continue to contribute to the highest levels of home ownership in American history. At the same time, a dynamic and competitive market will continue to provide ample borrowing opportunities.

To reiterate, MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest in connection with all mortgage products. At the same time we also believe that it is equally essential to assure a regulatory environment that serves and does not stem innovation in the industry. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. Any rules in this area, therefore, must balance all of these imperatives to truly serve the public interest.

As I said at the beginning of my testimony, our message is that the mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from unparalleled choices and competition resulting in lower prices and greater opportunities than ever before to build the wealth and well being that homeownership brings to our families and communities. It must be permitted to continue to do so. Any consideration of new requirements in this area must be judicious and any such requirements very carefully conceived. We must also do our best to assure that borrowers fully understand the choices available to them and take full advantage of the market.

The market is working but it is not invincible. There is a very real conflict between any potential benefits of state and local regulation of this sector of the economy, and the many benefits that have already been achieved through vigorous competition among lenders active in this sector. Additional restrictions impose a cost. They reduce the flow of credit and the array of choices to borrowers who would otherwise have access to them, by reducing the ability or willingness of some lenders to lend, reducing competition and its benefits.

Again, I appreciate the opportunity to testify and I look forward to answering your questions.

National Association of Mortgage Brokers

Prepared Testimony of

George Hanzimanolis, CRMS, NAMB President-Elect

National Association of Mortgage Brokers

on

"Calculated Risk: Assessing Non-Traditional Mortgage Products"

before the

Subcommittee on Housing and Transportation

and

Subcommittee on Economic Policy

Committee on Banking, Housing and Urban Affairs

United States Senate

Wednesday, September 20, 2006

Good morning Chairman Allard, Chairman Bunning, Ranking Members Schumer and Reed, and Members of the Subcommittees, I am George Hanzimanolis, CRMS, President-Elect of the National Association of Mortgage Brokers ("NAMB"). Thank you for inviting NAMB to testify today on nontraditional mortgage products. In particular, we appreciate the opportunity to address the need to: (1) evaluate the risks presented by nontraditional mortgage products to the housing industry, (2) educate consumers to the risks, as well as benefits, posed by these products, and (3) reform the current disclosure scheme to make the information imparted about nontraditional mortgage products more meaningful to consumers.

NAMB is the only trade association exclusively devoted to representing the mortgage brokerage industry and speaks on behalf of more than 25,000 members in 50 states and the

District of Columbia. Our members are independent, small business men and women that adhere to a strict code of ethics and best lending practices when taking consumers through the loan process. We typically maintain business relationships with various lenders to provide consumers with numerous financing options. These partnerships allow our members to offer consumers the most competitive mortgage products available.

Today, we believe that 85 to 90% of loans are "brokered" loans, which includes mortgage brokers, correspondent lenders, and any lender that does not service the loan for a period longer than three months.[1] As the principal conduit for bringing an array of innovative loan products developed by both federally- and state-regulated lenders directly to the consumers, NAMB has a vested interest in addressing the issues raised by the growing nontraditional mortgage segment of the market.

We commend the Subcommittees for holding this important hearing to address risk management and consumer protection practices with respect to the growing market of nontraditional mortgage products. We appreciate the salient concerns raised by this topic, such as risk layering and borrower knowledge, and welcome the opportunity to discuss and comment on these issues.

Earlier this year, NAMB also took the opportunity to submit comments and recommendations to the Federal Banking Agencies,[2] as well as the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") on the Interagency Guidance on Nontraditional Mortgage Products released in December 2005 ("Proposed Guidance"). In our letter, we expressed support for those elements in the Proposed Guidance that address consumer knowledge of nontraditional mortgage products and cautioned against efforts that would eliminate viable loan products or unduly restrict innovation. We look forward to working with the Federal Banking Agencies, CSBS and AARMR to address the safety and soundness issues presented and to implement policy decisions that will aid in consumer education and knowledge about the risks and benefits posed by these products.

NAMB believes that to effectively address the issues posed by the nontraditional mortgage market, we must have a joint effort from all three components of the marketplace—the industry, the consumer, and the government.

First, NAMB believes all mortgage originators should be knowledgeable about the benefits and risks posed by the nontraditional mortgage products they offer. Second, consumers should possess the necessary financial knowledge to carefully evaluate the risks and rewards of these products. Financial literacy is the tool that consumers need to make an informed decision as to whether a particular product—traditional or nontraditional—meets their needs. Third, disclosures should impart information that is meaningful and that does not otherwise

[1] Most lenders fund loans with the intent to resell to the secondary market within three months or less and in many cases, within a few days.

[2] "Federal Banking Agencies" include the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System.

mislead or deceive the consumer. To facilitate meaningful comparison shopping, all distribution channels must provide the same disclosures in the same manner. Last, a comprehensive approach to the issues raised by nontraditional mortgage products requires that we include not only originators in the discussion, but also those who fund, service and collect on mortgage loans. Origination is one step in the process of how a consumer obtains and secures financing to achieve and maintain homeownership.

I. The Knowledgeable and Ethical Originator

We have witnessed a great growth in our mortgage finance industry—expanding product choice and distribution channels, adding robust competition and great pricing options. Innovations in mortgage financing have increased the number and type of loan products available to consumers dramatically. Nowhere has this been more apparent than in the nontraditional mortgage segment of the market.

The growth in nontraditional mortgage products is the market's solution to two basic dynamics in the marketplace: i) lack of affordable housing, especially in major metropolitan areas and coastal cities; and ii) a lack of affordable financing options.[3] The secondary market, along with innovative banks and lenders, aptly responded to the need for consumers to find affordable financing options so that they could obtain homeownership in high-cost areas. The secondary market broadened the parameters of their risk profiles, and interest-only, adjustable-rate, and pay-option ARMs (*i.e.,* "exotic loans"), which have existed since the early or mid-1980s, increased in availability and popularity. Today, nontraditional mortgage products can be effective financing tools—affording consumers the flexibility to invest, manage their wealth, manage uneven income flows, and lower their monthly payments if necessary.

Unfortunately, this expansion of market and product choice has led also to a corresponding rise in the number of unlicensed and uneducated originators entering into the marketplace. While states are increasing requirements for mortgage brokers, they continue to exempt officers of banks and lenders from important standards. Additionally, government disclosures have not kept pace leading to increased consumer confusion about certain products, especially when working with exempt distribution channels.

Mortgage brokers are governed by a host of federal and state laws and regulations. For example, mortgage brokers must comply with the following federal laws: The Real Estate Settlement Procedures Act (RESPA), The Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), Gramm-Leach-Bliley Act (GLBA), and the Federal Trade Commission Act (FTC Act), as well as fair lending and housing laws. We are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC), and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board (Board), the Internal Revenue Service, and the

[3] We support increased access to affordable mortgage financing options. This can be accomplished through comprehensive Federal Housing Administration ("FHA") reform that allows for increased mortgage broker participation in the FHA program.

Department of Labor. These agencies ensure that we comply with the aforementioned federal laws, as well as small business and work-place regulations such as wage, hour and overtime requirements, the do-not-call registry, and can-spam regulations to name a few.

Mortgage brokers are also licensed or registered, and comply with any required pre-licensure and continuing education requirements and criminal background checks, in 49 states, and actively support licensing of all mortgage originators in the last remaining state of Alaska. Not only are our entities licensed, but in approximately half of these states our loan officers must also be licensed or registered. This is not true for the loan officers employed by mortgage bankers and lenders. As small businessmen and women, mortgage brokers comply with numerous state predatory lending and consumer protection laws, regulations and ordinances (*i.e.*, UDAP laws). On the state level, mortgage brokers are subject to oversight, audit and/or investigation by their mortgage regulator, the attorney general, or their state agency, and in some instances all three.

Consumers often do not know the difference between a mortgage broker, mortgage banker, lender or even a depository institution. This is because there is little substantive difference between them—we are all competing distribution channels. For this reason, NAMB has always advocated that *every single mortgage originator* be licensed and required to complete both pre-employment and continuing education requirements. It is imperative that all mortgage originators possess up-to-date knowledge about the risks and benefits of the loan products they offer and relevant laws as the industry continues to evolve. Consumers deserve a knowledgeable originator regardless of the distribution channel chosen.

A. *All Customers Should Benefit From Working With a Knowledgeable Mortgage Originator, Regardless of Distribution Channel or Product Complexity.*

Education must be the cornerstone of any effort to improve customer knowledge of available loan products and prevent abusive lending practices. The key to a consumer understanding a particular loan product, whether traditional or nontraditional, is <u>education</u>—not only for the potential borrower, but also for the mortgage originator that offers the product to the consumer. NAMB wholeheartedly agreed with the Federal Banking Agencies' comment in the Proposed Guidance that "[l]ending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner." (*See* Proposed Guidance, p.35). NAMB has long advocated for uniform licensure, education (including ethics training) and criminal background checks for each and every individual that handles a 1003 application,[4] *i.e.* every mortgage originator.[5]

All consumers should benefit from receiving timely and useful information about a loan product regardless of which distribution channel they use. Education of each and every mortgage originator helps to accomplish the objective of ensuring that consumers are well-educated to make an informed decision about a particular loan product. In addition, ensuring

[4] A Form 1003 is a Uniform Residential Loan Application.
[5] The basic requirements of education, continuing education, ethics training, written exams, and criminal background checks can be found in NAMB's ongoing work and commitment on the Model State Statute Initiative (MSSI) that NAMB began in 2002.

that all distribution channels provide the same disclosures helps to eliminate confusion and facilitate meaningful comparison shopping. To better illustrate the need to educate all mortgage originators, as opposed to just one subset, it is useful to understand that the actions of any originator can be divided into two categories: unintentional acts that can result in harm to a borrower and intentional acts that have similar results.

B. Education of All Mortgage Originators.

1. Educated Mortgage Originators Are Less Likely to Commit Unintentional Acts That Can Harm a Borrower.

Unintentional acts include those mistakes made by a mortgage originator that result from lack of knowledge about a loan product, the mortgage process or relevant laws and regulations. These are mistakes that *any* mortgage originator can make, even those employed by banks and other non-depository entities.

NAMB believes that the best solution to unintentional mistakes on the part of mortgage originators is a national, minimum requirement of pre-licensure education and continuing education. Pre-licensure and continuing education requirements are effective measures in protecting consumers throughout the mortgage origination process. To ensure the existence of a minimal level of expertise, all mortgage originators should receive pre-licensure education. Mortgage originators should not only understand the features of the loan products they sell and be able to communicate such information to a borrower, but also have sufficient knowledge of the laws and regulations that govern the loan origination industry. To maintain this competency and enhance the expertise of the industry, all mortgage originators should also be required to comply with continuing education requirements. Pre-licensure and continuing education courses should also include studies on State laws, federal statutes, and ethics.

NAMB is committed to ensuring that all originators are knowledgeable about the range of loan products available in the marketplace and understand the features, risks and benefits of the loan types that they offer. This is why NAMB encourages states to adopt minimum standards relating to pre-licensure and continuing education requirements. In addition, as part of NAMB's commitment to mortgage origination education, we have taken steps to add to our already extensive array of available education courses, a course focused solely on nontraditional mortgage products. NAMB believes that Congress should support uniform education standards for all mortgage originators that offer these nontraditional mortgage products.

2. Criminal Background Checks of Every Mortgage Originator, in Addition to Education Requirements, Will Weed Out the Bad Actors That Commit Intentional Acts.

Intentional acts are certainly the most grievous acts committed by mortgage originators against consumers. An example of an intentional act is a mortgage originator using personal financial information provided by the consumer during the mortgage loan process illegally, *i.e.,* falsifying income on a loan application.

While pre-licensure and continuing education requirements further ensure that a consumer works with a knowledgeable originator, the consumer also deserves to know he or she is not working with an individual who has been convicted of a financial crime, such as fraud. If an originator has been convicted of a financial crime, he or she should not be dealing with consumers in their financial matters.

A valuable tool for protecting consumers from such intentional bad acts of mortgage originators is the criminal background check. Criminal background checks create a barrier to entry into the mortgage origination system by those convicted of financial and other crimes. Criminal background checks conducted periodically throughout employment also ensure that an originator who has unfettered access to sensitive financial information of consumers continues to be licensed, educated and ethical. In short, criminal background checks should be required of all mortgage originators and be a barrier to employment, in certain circumstances, to help weed out the bad actors that engage in abusive lending practices. Moreover, criminal background checks ensure that bad actors can not move freely from one segment of the mortgage origination market to another unchecked.

II. Financial Literacy and the Consumer

As stated previously, NAMB believes that consumer education is the cornerstone of any effort geared to address the issues facing the mortgage industry today, especially those posed by the nontraditional mortgage market. No law or regulation should ever require any mortgage originator to supplant the consumer's ability to decide for him or herself what is or is not an appropriate loan product. As the decision-maker, the role of the consumer is to acquire the financial acumen necessary and take advantage of the competitive marketplace, shop, compare, ask questions and expect answers. Financial education and uniform disclosure of information are the tools that will help consumers take these steps and make sound and informed financial decisions.

Regardless of how knowledgeable a mortgage originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a loan product that can match his or her financial needs. Borrowers must possess the financial literacy tools to properly evaluate the risks and benefits of nontraditional mortgage products that have been highlighted and communicated by the educated mortgage originator. For this reason, NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school level so that consumers are educated about the financial decisions they make and retain their decision-making ability.

NAMB has always been a staunch supporter and advocate for consumer financial literacy. Our firm belief that an educated borrower is significantly less likely to fall victim to any abusive lending practice is demonstrated by our active involvement in various consumer education efforts. For example, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently being managed by NAMB state affiliates in California, Florida and Texas. NAMB partnered with United Guaranty in 2003 to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low-to-moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more.

NAMB appreciates the call by the Federal Banking Agencies, the consumer groups, and the industry as a whole to focus on the use of disclosures to inform the borrower, and in fact, is in favor of a constructive and useful disclosure scheme which we discuss in further detail below. But a consumer that is not well-versed in financial literacy will never be able to fully reap the benefits of a disclosure no matter how well-constructed.

We recommend Congress to put forth measures and explore those avenues that outreach to borrowers and provide meaningful education to them in a timely fashion rather than just at the time of application or at the closing table. Possessing a fundamental understanding of the mortgage lending marketplace and the loan product types available will empower borrowers to comparison shop, ask meaningful questions and make financial decisions that advance their personal life objectives. Again, NAMB strongly believes that because financial education is the key to choosing the right loan product and protecting oneself against fraud, the consumer education process should begin at a young age.

III. Revamp and Consumer-Test Disclosures

NAMB wholeheartedly supports the concept of clear and consistent communication with the consumer from the shopping stage through consummation, and afterwards throughout the life of the loan (*i.e.,* monthly statements). We believe that disclosures can aid in the effort to alert potential borrowers of not only the benefits, but also the risks presented by nontraditional mortgage products. Therefore, NAMB supports the use of a uniform, industry-wide required brochure on nontraditional mortgage products that is provided to the potential borrower at the shopping stage upon inquiry about a particular loan product or no later than at the time of application.

Before we discuss the need for uniform and consistent disclosures, we wish to emphasize a few critical points.

First, any disclosure, whether new or existing, can only *aid* in the effort to inform consumers on the risks and benefits of nontraditional mortgage products. As stated above, NAMB firmly believes that an ill informed mortgage originator can not communicate, and a borrower not well-versed in financial literacy can not understand, complex information provided in any disclosure format, whether simple or not. A disclosure by itself is insufficient to accomplish the stated objective of ensuring that a borrower is aware of the risks and benefits of the nontraditional mortgage product. This is because the inherent complexities of such products require explanations that will be too overwhelming and detailed in a written context. For this reason, education of loan officers, in addition to consumers, must operate in tandem with any mandatory disclosure scheme. Once the mortgage originator and the borrower possess the financial literacy tools necessary to understand the information imparted throughout the loan origination process, the disclosure becomes an invaluable communication tool.

Second, for disclosures to be meaningful to consumers they must be uniform, consistent and well-tested. Regardless of the distribution channel chosen, each consumer should receive the same disclosures in the same format for any particular loan product type or transaction, giving meaning to the ability to "comparison shop."

There are numerous market players in the industry today. A consumer can get a loan from a "mortgage banker type", a "mortgage lender type", a "mortgage broker type", a "credit union type", a "banker type", a "homebuilder type", a "real estate agent type", an "internet type", and the list goes on. Because these market participants compete directly with one another, consumers are best served when all disclosures are the same regardless of the originator "type."[6] Regrettably for consumers, this is not true today,[7] and recent proposed disclosures created nothing but consumer confusion.[8]

Last, NAMB believes that any disclosure requirement should refrain from being unduly burdensome on industry and should strive to complement, rather than be redundant, of information already provided to the consumer today. Simultaneously, NAMB agrees with the

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[6] It has been argued previously that because mortgage lenders hold their loans in portfolio, they absorb a higher level of risk and therefore, function differently than mortgage brokers who do not fund their originated loans. As a result, mortgage lenders assert that they should not be subject to the same requirements placed on mortgage brokers. Some twenty plus years ago—prior to the advent of the secondary market that we have today in America—this may have been true. But today, the line between mortgage brokers and mortgage lenders has been blurred. Today, mortgage lenders operate functionally in the same manner as mortgage brokers—they present an array of available loan products to the consumer, close the loan and then, almost instantaneously sell the loan to the secondary market. No practical difference exists in the services that many mortgage lenders provide to consumers or in the level of risk retained as compared to mortgage brokers. In fact, industry statistics show that over 85% of residential mortgage loans are originated by a mortgage broker or a lender acting as a mortgage broker for an investor.

[7] For example, today, only mortgage brokers disclose on the good faith estimate ("GFE") that they earn indirect compensation when a loan closes. The truth is that ALL originator types – brokers, bankers, lenders, credit unions, etc.—receive direct compensation, indirect compensation or a combination of both. However, with all these other originator types, the back-end compensation that they all earn is not disclosed. Again, to make comparison shopping meaningful, all channels must provide the same disclosures.

[8] The well-documented 2004 study by the Federal Trade Commission on a proposed GFE released by HUD in 2002 clearly demonstrated that many consumers would choose a higher cost loan from a direct lender over a mortgage broker loan because they were confused by the format of the disclosure which emphasized solely broker's indirect compensation. See The Effect of Mortgage Brokers Compensation Disclosures on Consumers and Competition: A Controlled Experiment, The Federal Trade Commission, Bureau of Economics Staff Report (Feb. 2004), at http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

Federal Banking Agencies' suggestion in their Proposed Guidance that the disclosure should provide the consumer with enough information to "prudently consider the costs, terms, features, and risks of these mortgages in their product selection decisions." (*See* Proposed Guidance, p.31).

A. A Simple, Plain Language Brochure on Nontraditional Mortgage Products That Consolidates Information Will Be A Meaningful and Useful Information Source to the Consumer.

With these principles in mind, NAMB respectfully makes the following two suggestions with respect to disclosing information to borrowers about nontraditional mortgage products: (1) update the Consumer Handbook on Adjustable Rate Mortgages ("CHARM Booklet") to include information about nontraditional mortgage products,[9] and (2) coordinate the update of the CHARM booklet with HUD so that it can also update the HUD-required booklet entitled "Buying Your Home: Settlement Costs and Helpful Information" ("Special Information Booklet") to include a discussion on the recent innovations and new loan products types that have developed in the mortgage industry, such as interest-only and pay option ARMs.

1. <u>Create a New and Revised CHARM Booklet and Special Information Booklet That Includes Information About the Features, Risks and Benefits of Nontraditional Mortgage Products.</u>

The Board and the Office of Thrift Supervision ("OTS"), at the behest of the House Committee on Banking, Finance and Urban Affairs over twenty years ago, developed what is commonly referred to as the CHARM Booklet. This booklet fully explains an adjustable rate mortgage ("ARM")—its definition, features, risks and benefits. The booklet also provides ways that a consumer can lessen his or her exposure to the risk presented by an ARM. The booklet advises the consumer to "ask for all the information the lender has on the loan you are considering" and to "understand [the] index rates, margins, caps, and other ARM features like negative amortization." Significantly, this booklet *already* addresses many of the topics the Federal Banking Agencies list in the Proposed Guidance and recommend that regulated entities focus upon throughout their communications with borrowers, such as payment shock, negative amortization, and prepayment penalties. Although not a one-page form, the CHARM booklet is invaluable because it provides consumers with a one-stop source for ARM information, advises consumers on the inherent risks of ARMs, and recommends specific steps consumers can take to ensure that they choose the loan product that match their financial needs.

In its comments to the Federal Banking Agencies, NAMB urged the Board to update this CHARM booklet to include the recommended information relating to the features, risks and benefits of nontraditional mortgage products, such as the interest-only, pay option ARMs, and negative amortization loans. (*See* Proposed Guidance pp.31-33). NAMB specifically suggested that the updated booklet include the following information pertaining to such

[9] NAMB is pleased to learn that the Federal Reserve Board ("Board") has moved forward in updating the CHARM booklet. NAMB has agreed to participate, as part of an industry working group, in the review and update of the CHARM booklet.

nontraditional mortgage products: (1) a brief definition of the loan product type, including some basic FAQs; (2) a delineation of the material risks presented by the loan product type; (3) a simple, brief discussion on who can benefit and therefore, should consider, this type of loan product; (4) a list of questions that a consumer should ask his or her mortgage originator before choosing this type of loan product; (5) clear examples of several nontraditional loan product types that present a "worst case scenario" and fully demonstrate how interest rates and monthly payments may change throughout the life of the loan; and (6) a sample monthly billing statement that reflects a payment schedule for the selected loan product under the "worst case scenario." Also, to ensure that a consumer has received all the required information for the selected loan product, NAMB suggests that both the mortgage originator and the borrower be required to initial the section that details the "worst case scenario" for the selected loan product type.

Again, NAMB believes that all consumers should benefit from any proposed construct that is designed to educate, inform and assist in the selection of a loan product, regardless of distribution channel. The CHARM booklet is already a universal requirement of every lender, whether federally or state-regulated, and therefore, it is a well-suited medium to provide uniform information about nontraditional mortgage products to every consumer, regardless of distribution channel. In this spirit, NAMB also believes that the Federal Banking Agencies should consult and endeavor to work with HUD to update the Special Information Booklet to reflect the new loan products types that have developed in the mortgage industry. The Special Information Booklet should contain information similar to that which would be included in the updated CHARM Booklet.

2. <u>Consumer Test the New and Revised CHARM Booklet and Special Information Booklet to Ensure Its Utility and Effectiveness as an Information Source for Consumers.</u>

NAMB also strongly recommends consumer testing of any proposed or revised disclosure, such as the updated CHARM booklet, to better glean the utility and effectiveness of such a disclosure format. As stated by Julie L. Williams, Former Acting Comptroller of the Currency, in a speech before Women in Housing and Finance and The Exchequer Club, "There's a critical element that's been missing from our consumer disclosure rulemaking processes—testing *how consumers interpret* particular disclosures and how to make disclosures *usable* to them."[10] Only consumer input can shed light on whether the information provided is too dense, too complex, insufficient or in need of further explanation. Without consumer testing, a new and revised booklet will be just another paper added to a pile of disclosures that is already largely ignored by consumers.

During the consumer testing phase, the entity responsible for oversight should also be required to consider whether the proposed or revised disclosure: (1) presents information in a "user friendly format"; (2) provides the borrower with sufficient information without being overwhelming, and (3) deters the consumer from reading it in the first place by using complex

[10] *See* Remarks by Julie L. Williams, Acting Comptroller of the Currency Before Women in Housing and Finance and The Exchequer Club, Washington D.C. (January 12, 2005).

"legalese." Consumer testing can also provide insight as to whether the current disclosure regime is in need of an update and how technology can be used to improve the disclosure process.

3. Consult with a Task Force That Represents The Current Mortgage Marketplace and Obtain Both Industry and Consumer Input When Revising the CHARM Booklet and the Special Information Booklet.

Over twenty years ago, the Board and OTS created the CHARM booklet in consultation with input from a number of different industry and consumer organizations. NAMB urged in its letter to the Federal Banking Agencies that the Board should again consult with industry and seek input on any proposed update to the CHARM booklet, or other proposed disclosure schematic. The mortgage industry has evolved significantly since that time and the mortgage broker is now a principal fixture in the loan origination process. Mortgage brokers offer an array of loan products that may meet the financial needs of consumers and inform homebuyers throughout the home buying process. As the segment of the mortgage industry that originates the majority of mortgage loans, NAMB respectfully requested that it be an integral part of any task force that may be assembled for purposes of advising on the update of the CHARM booklet and Special Information Booklet, as well as other matters relating to educating borrowers or mortgage originators about nontraditional mortgage products. NAMB was pleased to be invited by the Board to be part of an industry working group that will review and comment on an updated CHARM booklet. NAMB looks forward to working with the Board, as well as with other entities, that endeavor to re-examine and re-evaluate their disclosure scheme in an effort to make it more meaningful and useful to the consumer.

B. Enforcement of Existing Laws Is Needed to Effectively Eliminate Deceptive or Misleading Marketing Practices and Communications With Consumers.

With respect to the need to increase borrower knowledge and awareness of nontraditional mortgage products, we have conveyed the importance of education for the mortgage originator and the consumer. We have also commented on the need for an improved, updated disclosure schematic that is useful and consumer-tested to advance consumer awareness as it relates to nontraditional mortgage products. We would be remiss, however, if we failed to mention that one of the most powerful tools in the arsenal of consumer protection is enforcement of existing laws.

NAMB shares the Federal Banking Agencies concern that "marketing and promotional practices. . . [may] emphasize potential benefits without also effectively providing complete information about material risks." (*See* Proposed Guidance, p.29). Likewise, we agree that communications with consumers, which would include promotional and marketing materials in addition to monthly statements, should fairly reflect the loan's products terms and payment structures. NAMB strongly believes that there should be increased enforcement of existing laws that target deceptive or illegal marketing and promotional practices, such as Section 5 of the FTC Act.

As the primary federal law that prohibits unfair or deceptive acts or practices and unfair methods of competition in or affecting commerce, the FTC Act is an invaluable consumer protection statute.[11] The FTC Act, which the FTC and the Federal Banking Agencies have the authority to enforce,[12] can be used to address "unethical" or otherwise "bad" business practices, such as deceptive marketing, that may not necessarily fall directly under the purview of a specific banking or consumer finance law. Many states also have "mini-FTC Acts" that operate in a fashion similar to the federal law and which are enforceable by the state attorney general. NAMB strongly encourages Congress to allocate resources to, and urge the increase use of, these consumer protection laws to ensure that marketing and promotional materials used to promote nontraditional mortgage products, as well as communications with consumers, are clear, balanced and not otherwise deceptive or misleading.

IV. Safety and Soundness Matters Relating to Nontraditional Mortgage Products

Mortgage brokers bring an array of loan products directly to the consumer. Mortgage brokers also focus on providing assistance to the consumer throughout the home financing process so that the consumer can find and then choose a loan product that meets their financial needs. Clearly, the business operations of the mortgage brokerage industry are not centered on product development, underwriting, or risk management of loan products. Still, as stated previously, the mortgage origination industry is inter-dependent in nature. For this reason, NAMB takes this opportunity to comment briefly on safety and soundness matters relating to nontraditional mortgage products.

A. Maintain an Innovative and Free Marketplace.

First and foremost, NAMB encourages Congress to maintain the benefits of innovation, an expansive range of financing options, and low cost of credit that can be provided only by an open and free mortgage marketplace. Overly strict, prescriptive laws and regulations that attempt, either directly or indirectly, to control product innovation and availability in the marketplace could result in unintended consequences. Many innovative loans products, such as the interest-only ARM or the 40-year mortgage, have contributed to the greater availability of diverse loan products and enhanced consumer choice, which has directly resulted in increased competition and more affordable credit.

Second, NAMB believes that innovation and technological advancement in the mortgage marketplace has occurred because the market has been free to identify market needs and develop loan products to satisfy that need. Government regulation of this innovative spirit, whether in the area of pricing, compensation, or in product development, will only result in firm boundaries that will prevent the marketplace from adequately responding to consumer needs in the future.

B. Do Not Eliminate Viable Loan Products That Serve a Real Customer Need.

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[11] 15 U.S.C. § 41 *et seq.*
[12] On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks, by Julie L. Williams and Michael S. Blysma, *The Business Lawyer*, Vol. 58 (May 2003).

As noted previously, nontraditional mortgage products such as interest-only loans, pay option ARMS, and negative amortization ARMs have been in existence, in some form, for decades. These products have presented consumers with a range of financing options to allow for flexible payment schedules and the ability to manage wealth. Because of their long-term existence, the market already has seasoned experience dealing with the risks presented by these types of loan products. Therefore, it would seem that the current concern by many is with the increased use of these products by the "average borrower," and the ability to combine these products with features that present several layers of risk.

NAMB shares the concern over the increased use of nontraditional mortgage products, such as interest-only and pay option ARMs that are, at times, being underwritten with either reduced documentation requirements or no documentation requirements (*i.e.,* risk-layering). However, we remind Congress that, as distribution channels, mortgage originators deliver these "exotic" loan products to the consumer. Indeed, these product types, and their availability to the average consumer, operate in direct relation to the risk tolerances first established by the secondary mortgage market investors. Credit scores and automated underwriting systems have moved the decision of whether or not a consumer is approved for a nontraditional mortgage loan away from the "point of sale" upstream to the point where the decision to invest in that particular "risk profile" is first made by private investors. Again, as mentioned previously, to resolve the concerns raised by the nontraditional mortgage loan segment of the market, we must include all the players and address all components in the process. Origination represents only one function of the mortgage financing market, which also includes time of funding, servicing and collection. This means we must add those who provide the liquidity, those who service and those who collect on mortgage loans to the conversation and include all the same to any proposed solution.

NAMB cautions against measures that could result in purposeful elimination of viable loan products that have served in the past, and continue to serve today, a real customer need. Nontraditional mortgage products offer consumers flexibility in managing their assets, as well as flexibility in managing uneven income streams or temporary periods of financial difficulty. For borrowers residing in high-cost areas, nontraditional mortgage products are often the only means available to obtain homeownership. The bottom line is that unwarranted tightening of underwriting guidelines could hurt the robust housing industry and deny deserving consumers the chance at homeownership.

All loan products present some degree of risk. Rather than taking measures designed to eliminate risk, care should be taken to understand and empower both lenders and consumers to manage the risk. NAMB believes that if a lender—federal or state-regulated—desires to offer a specific, or range of, nontraditional mortgage products, then they should not be prohibited simply out of fear of a raising interest rate environment or a falling real estate valuation market, *i.e.,* theoretical risk. As long as the lender maintains sufficient capital and loss reserves to adequately mitigate risks, then the offering of innovative, "exotic" loan products should be left to the business decisions of the lenders' executives and management.

Accountability and enforcement will be much more effective mechanisms in controlling the risk associated with nontraditional mortgage products than prescriptive laws, regulations or guidance which may do nothing more than hamper innovation and limit consumer choice. Caution should be exercised in applying any law, regulation or guidance to theoretical risk *versus* actual risk. Likewise, we should refrain from restricting access to these products and stifling innovation of future loan products and keep instead the principles of balance and flexibility as central tenets to any law, regulation or guidance that addresses underwriting or risk management.

Summary and Conclusion

NAMB believes that consumers should be: (1) educated about various loan products to better appreciate the range of choice available; (2) provided with information that highlights not only the benefits but also the risks presented by nontraditional mortgage products; and (3) not be misled or deceived by advertisements that promote nontraditional mortgage products.

NAMB also believes that education of every mortgage originator, in addition to consumer financial literacy, must work concomitantly with any uniform, industry-wide mandated disclosure on nontraditional mortgage products to achieve the objective of a well-informed consumer. A brochure, even one that is revised and consumer-tested, is by itself insufficient to alert a consumer to all the features, risks and benefits of any nontraditional mortgage product. A mortgage originator well-versed in the complexities of the loan product type can, and should, convey the more detailed aspects of the loan to the consumer directly. This requires, of course, that every mortgage originator be well-educated on the nontraditional mortgage products that they offer. With respect to safety and soundness issues relating to underwriting guidelines and risk management practices for nontraditional mortgage products, NAMB urges flexibility and balance as the central tenets of any proposed law, regulation or guidance.

Again, thank you for the opportunity to appear before this joint subcommittee today to discuss this timely issue. I am happy to answer any questions that you may have.

Statement of William A. Simpson Vice President, Mortgage Insurance Companies of America Before the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy
September 20, 2006

I am William A. Simpson, Chairman of Republic Mortgage Insurance Company, headquartered in Winston Salem, North Carolina and Vice President of the Mortgage Insurance Companies of America (MICA), the trade association representing the mortgage insurance industry. MICA is pleased to provide you with information on the non-traditional mortgage market. In MICA's testimony I will first explain the role mortgage insurance (MI) plays in the mortgage market and then discuss data on the scope of the market for non-traditional mortgages. Finally I will discuss solutions to the problems caused by non-traditional mortgages that MICA believes are important. MICA supports the pending guidance on non-traditional mortgages proposed by the bank regulatory agencies.

The Role of Mortgage Insurance

The mortgage insurance industry was founded in 1957. Since then we have helped over 25 million families become homeowners by enabling them to buy homes with a very little down payment.

Mortgage insurers provide credit enhancement - that is credit-risk mitigation - to ensure that lenders and investors such as the government-sponsored enterprises (GSEs) are protected in the event of borrower default. This means, in essence, that after the borrower we stand first in the line of fire on mortgage related risk. If borrowers default, we take much of the loss, ensuring that investors such as the GSEs are protected. Because of the high capital requirements and stiff regulation governing mortgage insurers, the industry is well positioned to take on this risk. Currently, the members of MICA have $635 billion of insurance in force and approximately $16.8 billion in capital.

We take a conservative view of mortgage risk because of our first loss position. However, we also have a historical perspective. We were there when the mortgage markets turned sharply down during the mid-1980s especially in the oil patch and the early 1990s in California and the Northeast. The MI industry paid approximately $15 billion in claims in the 1980s and 1990s primarily covering the losses to federally insured banks, savings association and the GSEs.

We act as review underwriters for the credit and collateral risks related to individual loans and we assess the local, regional and national economic risks that could increase mortgage defaults. This role of review underwriter not only protects the investor in the loan but the homebuyer as well. The mortgage insurer and the homebuyer share a common interest in the mortgage transaction because they both have the greatest risk of loss in the event of default. Upon default, the borrower will lose his or her home and the equity invested in it, and the mortgage insurer will incur a loss by paying a claim. Thus, the insurer and the borrower are both concerned that the home is affordable not only at the time of purchase, but throughout the years of homeownership.

Non-traditional Mortgages

<u>What are non-traditional mortgages?</u>

The usual definition of non-traditional mortgages include the following: 1)option arms where the borrower may skip a payment for any reason or not pay the full interest rate, which in both cases results in negative amortization; 2)interest only loans where the borrower only pays the interest on the loan and none of the principle for a period of time; 3)piggy back mortgages where the borrower takes a first mortgage on the property for 80 percent of its value and simultaneously takes a second mortgage on the property often for the remaining value of the property so that the borrower has no equity in the home; 4)loans with a 30 year fixed term, which are amortized over 40 years, reducing the borrower's monthly payment but often resulting in a lump sum remaining principal payment due at the end of a defined period less than the amortization period. For these non-traditional mortgages the loan may come due in a balloon payment in just a few years and/or interest rates may reset very quickly, exposing the borrower to additional risk resulting from potentially, sharply, higher monthly payments and/or refinancing costs. 5) An increasingly large number of non-traditional loans also now come with "teaser" features (very low initial interest rates and payments) that either create "negative amortization" or large increases in loan payments too soon after the closing both of which can create defaults by the borrower.

<u>Data on non-traditional mortgages</u>

There is not much available data on the size, characteristics, and rate of growth of the non-traditional mortgage market. Below is some current public data from private and government sources.

- *Size of market - Inside Mortgage Finance* (July 14, 2006 edition), a mortgage industry publication, noted that data through mid-2006 shows non-traditional mortgages represent 37 percent of current originations. A July 2005 Federal Reserve Board (FRB) senior loan opinion survey found that "[m]ore than one half of respondent banks indicated that the share of nontraditional residential mortgage originations over the past twelve months was higher than it had been over the previous twelve-month period. Twelve percent of respondents noted that this share was substantially higher."

- *Interest Only (IO) Mortgages* - IO mortgages remain a significant part of the non-traditional sector. No data is available on the number or percentage of IO mortgages originated, but the *Inside Mortgage Finance* study concluded that they comprise 26 percent of private mortgage back securities issued during the first half of 2006. In testimony before this committee last week the Federal Deposit Insurance Corporation (FDIC) estimated that IO mortgages and option ARMs together appeared to make up as much as 40 to 50 percent of all loans securitized by private issuers of mortgage backed securities (MBS) during 2004 and 2005.

- *Piggyback Mortgages* - SMR, a private research firm, found that piggyback mortgages comprised 48 percent of all purchase money mortgages originated in the first half of 2005 and 38 percent of those loans had a combined loan-to-value ratio above 95 percent. Similarly, the FRB estimates that these loans accounted for 22 percent of purchase loans in 2005, up from 14 percent in 2004.

- *Option ARMs* - As noted above, the FDIC estimate suggests option ARMs combined with IOs comprise 40 percent to 50 percent of private MBS issuances. An August 2005 study by Standard and Poors concluded that about 75 percent of option ARM borrowers use negative amortization in any given month. Similarly, Bear Stearns estimated that about 65 percent of option ARM borrowers made payments that fail to cover the full amount of the interest owed and that half the option ARM borrowers make payments that result in negative amortization.

- *Characteristics of Non-traditional Market* - An August 2005 Office of the Comptroller of the Currency (OCC) survey found the first drop in overall credit underwriting standards in the eleven years the OCC had been conducting this survey. Looking specifically at the characteristics of the non-traditional market, the OCC found that "[h]igher credit limits and loan-to-value ratios, lower credit scores, lower minimum payments … less documentation and verification, and lengthening amortizations - have introduced more risk to retail portfolios." It also noted that "[b]ecause reduced payment requirements and extended amortization arrangements can mask credit risk, bankers need to develop broader, more discerning, and more forward looking approaches to measuring and monitoring risk in retail portfolios."

Consistent with the OCC study on the drop in credit quality is the *Inside Mortgage Finance* study mentioned above. It noted that much of the recent growth of non-traditional markets is coming from subprime borrowers with mortgages that amortize over 40 years but are payable in 30 years.

Market Trends

What should cause concern for the mortgage industry and policy makers is the combination of the size in the non-traditional market discussed above and the concentrated positions taken in them by insured depositories as well as the softening of the housing market (i.e. house prices leveling off or declining, inventories of unsold homes growing and interest rates rising). To be sure, traditional mortgages are still among the safest forms of credit and mortgage credit risk has been a safer bet than most. However, it is not always a certain one as the serious problems evident in the 1980s and 1990s made clear. Introducing the inherent risk in non-traditional mortgages in a soft market is a recipe for another debacle like the 1980s and early 1990s. Indeed, below MICA notes factors that make emerging trends still more worrisome. These include the following:

- The FRB recently found that 33.5 percent of assets in insured depositories - $3.1 trillion - is now concentrated in real estate risk. This is significantly up from the percentages in the 1980s and 1990s and is the highest percentage concentration reported by the FRB since 1973. Many lenders have double, triple or even more of their regulatory capital committed to this asset class. This creates what the banking agencies rightly call "concentration risk."

- Recent data released from the National Association of Realtors indicate that the volume of house sales has fallen from a year earlier and early indications are that house prices will dip in the future - if only temporarily. Other economists are forecasting reductions in regional house prices for 2007 with house prices remaining depressed for several years. The latest report from the Office of Federal Housing Enterprise Oversight (OFHEO) indicates that the average annualized increase in home prices in the second quarter of 2006 was 4.7 percent compared to 13.4 percent for all of 2005. The fact is, at this stage, no one knows for sure what will happen and for how long, but stagnant house price growth appears to be just around the corner.

MICA's concern about the mortgage market is not limited to these troublesome warning indicators. We also fear that vulnerable consumers may not either know or understand the real terms and conditions of these increasingly complex mortgage loans. Anecdotal evidence discussed in the cover story of the September 11, 2006 issue of *Business Week* supports this as it suggests some consumers do not understand the ramifications of their non-traditional mortgage. It is critical that borrowers get the right mortgage to ensure personal financial stability over the years. Higher foreclosure rates will result in more displaced families and poor credit will set these families back years from reaching goals like college education for their children. Similarly, when foreclosure rates rise, struggling neighborhoods can become blighted ones, which puts families at risk and creates undue cost for local, state and federal government agencies.

Solutions to the Problem

MICA supports the work being done by the bank regulatory agencies to ensure that non-traditional mortgages do not jeopardize the financial health of insured depositories and that consumers understand the nature of the loans they receive. The bank regulators have taken two important steps to curb the risks created by non-traditional mortgages. First, in mid-2005, they issued a final guidance on second mortgages. The guidance required sound underwriting standards and effective credit-risk mitigation on second mortgages. Part of the reason the regulators released this guidance was to ensure that borrowers who received piggyback mortgages were not at risk because the combined first- and second-liens were at or above the value of the underlying home. MICA's only complaint with the second lien guidance is that bank regulators have not adequately enforced it.

The second step the bank regulators have taken is to release a draft guidance on first mortgages which builds on the second-lien standards and addresses the broader risks posed by non-traditional mortgages. They did so in mid-December of 2005 and took the unusual step of asking for public comment on the draft. They have not yet issued a final guidance. We urge the agencies not only to quickly finalize the standards, but also to ensure that they and the prior second-lien guidance are backed by effective enforcement.

MICA supports the actions of the federal financial regulators because both the second- and first-lien guidance as proposed ensures that lenders practice prudential standards with the following features:

- *Regulatory capital will reflect real risk, including concentration risk.* It is dangerous to defer regulatory capital standards for mortgages until the Basel process is concluded in the U.S. sometime in the next few years. Current risk-based capital and leverage standards results in the holders being sharply under capitalized for their holdings in non-traditional mortgages, permitting institutions - including Fannie Mae and Freddie Mac - to look far more adequately capitalized than is actually the case.

- *Under the proposed first-lien guidance, clear, simple disclosures will be given to consumers at the time they are shopping for mortgages and again upon application.* One way to provide this disclosure would be for mortgage originators to have clear booklets or other materials that describe, compare and contrast non-traditional and traditional mortgage products over time and under various house price and interest rate scenarios. This has been done in the past with adjustable rate mortgages, where the FRB provided model disclosures. It should be done again for the broader range of non-traditional mortgages and brought quickly into the marketplace.

- *Lenders will be required to maintain appropriate prudential management standards and provide customers information on their mortgage whether the loans are held in portfolio or sold into the secondary market.* This requirement is in the proposed guidance because of the credit, legal and reputational risks associated with non-traditional mortgages. Secondary market investors also should hold sufficient capital and be subject to effective concentration risk standards to limit undue risk.

- *When piggyback loans are combined with other non-traditional features such as an interest only second lien, for example, the risk presented by this structure is significantly heightened and supervisory guidance will be stringent under the proposal.* Piggyback loans should be covered by appropriate regulatory capital requirements, concentration limits and prudential underwriting standards.

The banking agencies can govern only a limited segment of lenders. Many are outside their purview. The Federal Trade Commission (FTC) - which governs all other mortgage brokers and lenders – held a series of meetings earlier this year to evaluate the activities of entities outside the scope of the banking rules. We urge the FTC to quickly issue rules comparable to the banking agencies to ensure that all mortgage originators are under comparable standards thereby protecting all borrowers to the same degree.

MI and Non-traditional Mortgages

Historically, bank regulators have recognized the crucial role of MI and we are pleased that the proposed non-traditional guidance would continue this practice. As noted, MI puts a highly capitalized, well regulated intermediary between a lender and potential mortgage losses. Thus, banks can take on more credit risk - for example, by permitting lower down payments - when MI is in place. Importantly, MI also provides a critical underwriting discipline by putting an objective party into the lending decision. If an MI refuses to provide insurance, the lender has a sure and clear sign of the presence of unacceptable risk.

Finalize and Enforce the Second Lien and First Lien Guidance

Borrowers today are far more highly leveraged than they were twenty years ago on the eve of the savings and loan crisis. Never before have so many borrowers had second mortgages resulting in combined debt near the value of their home. That means that banks that hold these second mortgages - not just borrowers - bear the brunt of credit risk. We do not know what will happen in the mortgage market as house prices stagnate or decline - let alone if borrowers come under more economic stress. It is thus essential that bank regulators continue to take the most conservative view of these emerging risks to protect the deposit insurance fund. Non-bank mortgage originators should come under comparable rules to protect borrowers and the financial system more generally and OFHEO and the Federal Housing Finance Board should ensure that the government-sponsored enterprises do not take high-risk mortgages from the primary market without prudent credit risk mitigation and appropriate internal controls.

Testimony of Michael D. Calhoun,

President, Center for Responsible Lending

Before the Senate Committee on Banking, Housing and Urban Affairs

Subcommittee on Housing and Transportation and Subcommittee

on Economic Policy

Hearing On

"Calculated Risk: Assessing Non-Traditional Mortgage Products"

September 20, 2006

Chairmen Allard and Bunning, Ranking Members Reed and Schumer, and members of the Committee, thank you for holding this important hearing and for inviting me to testify. I represent the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and public policy organization dedicated to fighting abusive lending and an affiliate of Self-Help, a community development lender. Self-Help's experience as a lender and CRL's analytic resources provide me both with insight into the impact of non-traditional mortgages on homeowners and recommendations for mitigating the particularly harmful effects resulting from irresponsible subprime lending.

Discussions of the potential threat posed by the prevalence of nontraditional mortgages have been prominent in the last year. As of September 2005, adjustable rate mortgages (ARMs) accounted for roughly 70% of the prime mortgage products originated and securitized and 80% of the subprime sector.[1] CRL commends the federal Agencies for the proposed guidance that they have issued with regard to nontraditional mortgages and concurs with many of the concerns they have raised on this topic. At the

[1] *2006 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis*, FITCH RATINGS CREDIT POLICY (New York, N.Y), Jan. 17, 2006, at 12.

same time, while the Agencies have focused on products such as interest-only mortgages and option adjustable-rate mortgages (ARMs) originated by the entities they regulate, we urge the regulators and this Committee to broaden the scope of concern. Specifically, we encourage regulators to apply the same concerns to subprime finance companies that are not covered by the existing proposed guidance, and to address abuses in hybrid ARM lending in addition to those found in interest-only and option ARM products.

Subprime lending is not a small problem that affects only a few homeowners—one in every four home loans originated in 2005 was a subprime loan, a sector that has \$1.2 trillion of mortgages currently outstanding.[2] The vast majority of these loans are hybrid ARMs with a short initial period that offers an artificially low mortgage payment, followed by a significant payment shock for the borrower when the rates reset. Because many subprime lenders fail to consider whether the borrower will be able to afford the mortgage payment after the ARM adjusts, families with these loans are likely to face increasing rates of foreclosure and will lose significant accumulated equity in the coming years. And the impact will not only be on the families that lose their homes. In 2005, subprime originators made 4,225,426 loans totaling \$671.8 billion.[3] Our national economy is at significant risk if these loans fail in great numbers, as I fear they will.

The subprime market was designed to serve borrowers who have weaker credit, but by aggressively marketing high-risk ARMs, subprime lenders at a minimum trap their borrowers in a cycle of equity-stripping loans and worse, put vulnerable families at risk of losing their homes altogether. These loans will have a particularly damaging impact on communities of color. According to the most recent HMDA data issued by the

[2] Inside B&C Lending, 9/1/2006; *See also* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.
[3] *See* National Mortgage News Quarterly Data Reports, Quarters 1-4, 2005.

Federal Reserve, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[4] while four in ten loans to Latino[5] borrowers were higher-rate. Worse, many borrowers who receive subprime loans could have qualified for a more affordable and responsible product in the first place. Freddie Mac, for example, has publicly commented that one in five subprime borrowers in recent years could have qualified for a lower-cost conventional loan.[6]

In our testimony we will discuss the following four points:

(1) While nontraditional subprime mortgages such as interest-only ARMs and options ARMs are of concern, the even more common hybrid ARMs are "exploding ARMs" that operate as two-year balloon loans. Borrowers largely cannot afford to remain in these loans even if interest rates do not rise at all.

(2) Lenders are failing to consider the borrower's ability to repay the loan after the payment adjusts, and practices such as failing to escrow taxes and insurance or verify a borrower's income only increase the likelihood that the borrower will not be able to repay the mortgage;

(3) Because borrowers cannot repay their subprime loans, foreclosure rates will rise and families will lose significant equity;

(4) Federal regulators can and should address this problem now by requiring that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan.

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[4] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.
[5] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.
[6] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005).

The need to act is urgent, and the devastation caused by high-risk ARMs in the subprime market is real. As one example, we are familiar with a case now pending in the Eastern District of Missouri involving a thirty-five-year-old single mother of two children, a woman named Velma Vardiman. For several years, Ms. Vardiman faithfully made payments on her fixed-rate mortgage, which had an interest rate of 7.5 percent. In early 2005, Ms. Vardiman was diagnosed with cancer. She was forced to leave her job and apply for disability benefits.

It was during this vulnerable period when a mortgage broker contacted Ms. Vardiman and lured her into a 2/28 mortgage by touting the lower payments. This loan had many costly features: a prepayment penalty, a yield-spread premium, high fees that amounted to 11.5% of the loan amount. But the worst part was that the initial low monthly payments were only temporary, and they did not reflect all of her true housing costs, since the payments did not include the cost of taxes and insurance.

In November, Ms. Vardiman's mortgage will jump from 6.95% to over 11%. Over time, the interest can climb as high as 13.95%. She now faces a dilemma that is becoming all too common among homeowners in the subprime market with exotic ARM products. One option is to seek another refinance—a transaction that will cost her thousands of dollars and drain more of the equity she has worked hard to earn. Or Ms. Vardiman can struggle to keep the loan she has today—a loan that is unaffordable and, under any decent lending standard, never would have been offered to her. Ms. Vardiman has two children, and she is fighting hard to keep her home, but ultimately she may lose it.

This is a choice that homeowners should never have to face. As described in the remaining testimony, non-traditional mortgages in the subprime market are actually acting to reverse the traditional benefits conveyed by mortgages, leaving vulnerable families worse off rather than giving them the opportunity to become more financially secure.

I. "Exploding ARMs": Hybrid ARMs in the subprime market operate as two-year balloon loans.

The dominant product in the subprime market is an adjustable rate mortgage that effectively operates as a two-year balloon. Sometimes referred to as "exploding ARMs" due to the significant increase in the monthly payment after an introductory period with an artificially low payment, hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector."[7] Through the second quarter of 2006, 80.7% of subprime loans were adjustable rate loans, predominantly 2/28s.[8] 2/28s are one of the most common types of hybrid ARMs in the market—they include an initial short-term fixed rate for two years, followed by rate adjustments, generally in six-month increments for the remainder of the term of the loan.[9]

While interest-only loans are clearly of concern, representing one in four subprime loans,[10] the even more common 2/28 subprime mortgages themselves pose a significant risk to families as well as the industry as a whole. The low start rate virtually assures the payment will rise significantly when the rate resets, even if interest rates

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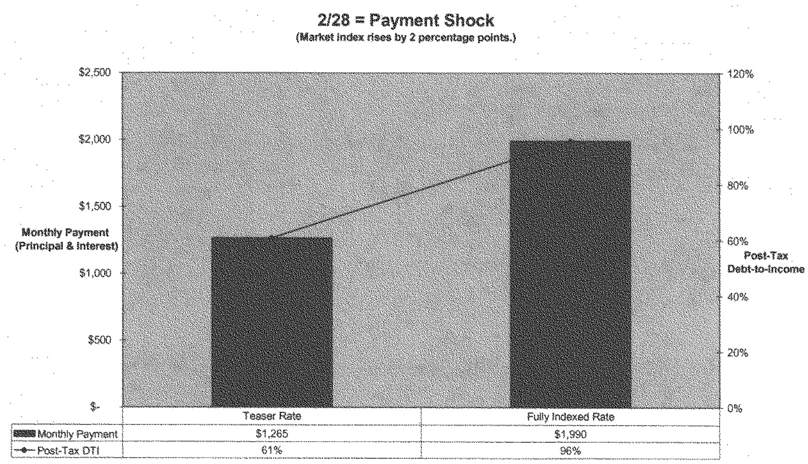
[7] Id.
[8] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.
[9] See, e.g. *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 2.
[10] Id.

remain constant and do not rise at all. Of course, if interest rates rise, the payment shock will rise as well.

The example below illustrates the severity of payment shock that can occur on the typical exploding ARM:

Figure 1



For the 2/28 ARM shown in the chart, we made conservative assumptions that correspond with typical mortgages of this type, including that the market index rises by two percentage points between origination and the expiration of the introductory rate.[11] At the end of the introductory rate period, the borrower's monthly payment jumps from around $1,265 to almost two thousand dollars ($1,990)—a large amount for most families, and certainly a significant amount for a family that already struggles with debt.

[11] Home value, $225,000; loan amount, $180,000; term 30 years; 2-year prepayment penalty; introductory teaser rate of 7.55%; fully-indexed rate of 13.25%. The hypothetical borrower had an annual income of $30,354 and post-tax income of $24,997, with those incomes selected to reflect the too common practice of underwriting subprime loans to 50% of the borrower's pre-tax income.

Even more striking, the debt-to-income ratio climbs to an astounding 96%, meaning that the homeowner would spend nearly all of his income on his home loan. Put another way, this mortgage payment would leave the borrower with $125 per month to pay for food, utilities, transportation, and all other essential expenses.

Payment shock for borrowers with subprime loans will be widespread in the next two years. According to Barron's, over the next two years, reset of two-year teaser rates on hybrid ARMs will lead to increased monthly payments on an estimated $600 billion of subprime mortgages.[12] Fitch Ratings has stated that in 2006 payments will increase on 41% of the outstanding subprime loans—29% of subprime loans are scheduled for an initial rate reset and another 12% of subprime loans will face a periodic readjustment.

II. Exploding ARMs violate the fundamental underwriting precept that lenders should consider the ability of the borrower to repay the loan.

Lenders who make exploding ARMs often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate and therefore monthly payment will rise significantly. For example, a recent prospectus shows that a large subprime lender, Option One underwrites to the lesser of the fully indexed rate or one percentage point over the start rate.[13] For a loan with a typical 2/28 structure, the latter would always apply. This practice means that at the end

[12]Jonathan R. Laing, *Coming Home to Roost*, BARRON'S (New York, NY), Feb. 13, 2006, at 26.
[13] *See* Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

of the introductory teaser rate on an ARM, borrowers face a shocking increase in costs, even if interest rates remain constant.

A lender's failure to account for the incredible payment shock that most borrowers with an exploding ARM will face is compounded by two other practices: failure to escrow property taxes and hazard insurance and limited documentation of income.[14]

Most subprime lenders sell loans based on low monthly payments that do not take taxes or insurance into account.[15] This deceptive practice gives the borrower the impression that the payment is affordable, when in fact, there are additional costs that the borrower will likely need to finance. When borrowers are hit with large tax and insurance bills they cannot pay, the original lender can realize a windfall by enticing the borrowers to refinance the loan, incurring additional fees as the borrower loses equity to pay for the new costs. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of their pre-tax income,[16] using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance virtually guarantees that a borrower will not have the residual income to

[14] *See, eg.,* " B&C Escrow Rate Called Low" *(February 23, 2005) Mortgage Servicing News Bulletin, July 23, 2005* "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments....Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[15] *See, eg.,* Chase Home Finance Subprime Lending marketing flier, *Attractive* ***Underwriting Niches,*** **at** www.chaseb2b.com (available 9/18/2006) stating " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower).

[16] *See, eg.,* OPTION ONE MTG LN TR ASSET BK SER 2006 2 424B5 Jun 28 2006 S.E.C. Filing 06929203 stating "The debt-to-income ratio is generally less than 55%."; *See also*, NEW CENTURY HOME EQUITY LN TR SER 06 2 424B5 Jun 27 2006 S.E.C. Filing 06926211 stating "The maximum debt service-to-income ratio is usually 50% unless the loan-to-value ratio is reduced." In a survey of the rate sheets of Top 10 B&C lenders (as of 9/19/2006), all ten report an allowable debt-to-income-ratio of at least 55%. Notably, Option One allows up to 60% DTI at their lower credit grades, C & CC.

absorb a significant increase in their mortgage payment after two years.[17] In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay.

Unfortunately, inadequate documentation of a borrower's income only compounds the problem of underwriting based on the borrower's ability to make payments before adjustment. Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50% of the subprime sector . . . ." [emphasis added]. [18] Similarly, others have observed that 37% of non-agency mortgage-backed securities were alternative documentation or no documentation loans in 2005.[19] Worse, in reviewing a sample of stated income loans, the Mortgage Asset Research Institute recently found that over ninety percent exaggerated income by 5% or more and almost 60% exaggerated income by over 50%.[20] While in the past a small number of self-employed borrowers used stated income loans, today's figures suggest that brokers and lenders are pushing the product on borrowers who could document their income because

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[17] A review of the Federal Reserve Board Consumer Finance Survey found that only 40% of lower income borrowers had escrow accounts and for loans with interest rates of 9% and above, only 12% of low income borrowers had escrow accounts, a much lower figure than the 26% of higher income borrowers with loan rates in the same range. The report posits that "Omitting escrow makes monthly payment burdens appear smaller, and therefore is more attractive to cash-strapped borrowers. However, borrowers who cannot afford a monthly escrow payment are also unlikely to be able to budget for payments for property taxes and property insurance." The report also uncovered a link between delinquencies/foreclosures and failure to escrow, and suggests that requiring escrow could have a positive impact on foreclosure rates and home retention, "As data from 311 line callers (discussed previously) began to suggest that tax and insurance payments are a contributing factor for as many as one in seven troubled borrowers, HOPI partners decided to focus on the use of escrow accounts.... [T]he preliminary research into this area suggests potential for affecting foreclosure rates through increasing the use of escrows." *See* Home Ownership Preservation Initiative, *Partnership Lessons and Results: Three Year Final Report* (July 17, 2006) at 31.

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

[19] *What Else Is New? ARMs Dominate Subprime Mix,* INSIDE B&C LENDING (Bethesda, MD), Jan. 20, 2006, at 4.

[20] Mortgage Asset Research Institute, Inc, *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association,* p. 12, *available at* http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

of the premiums that accompany these loans. The MARI report notes, "When these loans were introduced, they made sense, given the relatively strict requirements borrows had to meet before qualifying. However, competitive pressures have caused many lenders to loosen these requirements to a point that makes many risk managers squirm."[21]

Many have portrayed nontraditional subprime loans as "affordability" products, implying that interest-only features and other techniques are used to achieve monthly payments deemed affordable for a borrower with a given income. This notion of affordability is dangerously short-sighted if borrowers cannot sustain payment after adjustment.

Lenders and brokers are doing more harm than simply ignoring the impact of rate adjustments on a borrowers ability to repay. They compound that problem by failing to consider the devastating impact that prepayment penalties have when combined with these exploding ARMs – borrowers are stuck between a rock and a hard place. Approximately two-thirds of subprime loans also include a prepayment penalty,[22] a penalty for paying the loan off before a certain period, trapping the borrower in the loan when they might be able to refinance into a better product. A borrower who concludes that they would be better off to escape a subprime hybrid ARM (before the rate reset makes it unaffordable) and shift into a fixed rate product, for example, must sacrifice significant equity to pay off the penalty.[23] A study by the University of North Carolina suggests that many borrowers in fact pay the prepayment penalty on subprime ARMs,

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[21] Id.

[22] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

[23] Assuming, of course, that the borrower can muster up the cash to pay the prepayment penalty, or can get a new loan that includes that fee in the loan amount. Losing that equity can adversely impact the borrower's ability to afford the monthly payment amounts as well.

stating, "ARMs have 40 percent greater odds of prepayment than otherwise identical fixed-rate loans."[24] To date, it appears that most subprime lenders impose a prepayment penalty for the length of the teaser rate period (i.e., penalty for paying off the loan in the first two years on a 2/28 ARM, penalty for the first three years on a 3/27 ARM), but there is a small number of lenders who will impose the penalty beyond that period.

In addition, subprime loans are increasingly being made available with additional options that limit repayment of principal and equity accumulation (e.g., interest-only, 40/50 year terms, option ARMs that allow for payment of less than full amount due). These terms again facilitate deceiving the borrower into thinking that they are receiving a loan with a low monthly payment, when in fact the payment will adjust to a much higher amount in the future. Worse, the slow or negatively amortizing features of these loans means that when a borrower faces incredible payment shock, and dramatically increases the risk that they will not have the equity to support a refinance. In June of this year, Fitch noted that "in the subprime sector, 8% of the total volume were 2/38 hybrid ARMs, up from less than 1% for all of 2005."[25] Analyzing payment increases for subprime 2/38 hybrid ARMs, Fitch found the payment increase to be 5% higher than that of a 2/28 hybrid.[26]

Fitch also noted that approximately one quarter of subprime ARMs include an interest-only feature.[27] Interest-only features and longer mortgage terms reduce the amount of principal paid by the borrower for each payment in the early years of the loan.

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[24] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at 27.

[25] *See Structured Finance: 40, 45-, and 50-Year Mortgages: Option ARMS, Hybrid ARMS and FRMS,* FITCH RATINGS CREDIT POLICY (New York, N.Y), June 19, 2006, at 4.

[26] Id. at 2.

[27] *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 2.

With less equity accumulated during those first two to three years, the resulting attempt to refinance at payment reset is even more difficult for the borrower.

III. Because subprime lenders are placing borrowers in loans that they objectively cannot repay, families are losing their homes to foreclosure in ever greater numbers.

Lenders' failure to ensure that borrowers could afford their monthly payment once it increased significantly means that borrowers have one of three options when interest rates reset: refinance, sell the house, or face foreclosure. As families lose home equity and housing markets slow, foreclosure will become the only option for many.

There is already evidence that borrowers with subprime loans cannot sustain payments as rates reset. According to the Mortgage Bankers Association's (MBA's) National Delinquency Survey, in the fourth quarter of 2005 the delinquency rate (90+ days) for subprime ARMs was 2.71%, compared with 0.37% for prime ARMs, over 7 times higher. In addition, USA Today noted that according to MBA figures, "in 18 states, more than 15% of homeowners with subprime ARMs were behind in their payments in the second quarter."[28]

For subprime borrowers with hybrid ARMs who are unable to make payments when the interest rates increase, the repercussions likely will be grave, especially in those markets that have not experienced rapid house price appreciation. To date, a strong housing market and largely favorable interest rates have allowed borrowers with subprime loans to refinance when their payments rise. In this scenario, with each

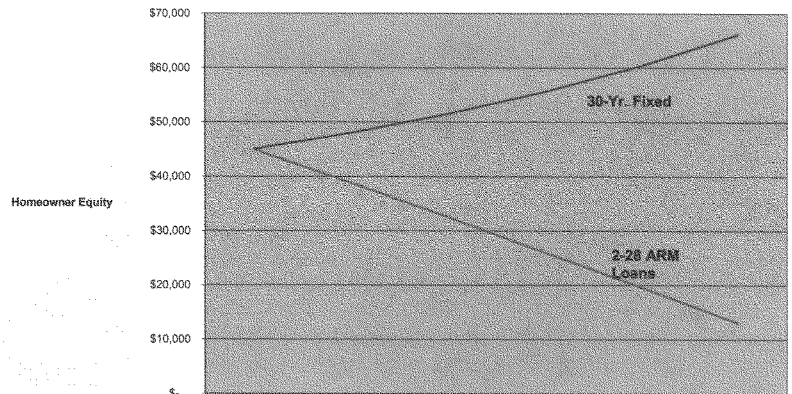
[28] Noelle Knox and Barbara Hansen, *More Fall Behind on Mortgages*, USA TODAY at B1 (September 14, 2006). The USA Today figures refer to total delinquency figures (30 days + delinquent through foreclosure).

refinance, the borrower loses significant equity as they incur a whole new set of lender fees, broker fees, and third-party closing fees with each loan. In turn, this loss of equity means that the borrower loses their single largest source of wealth and ends up trapped in a cycle of subprime loan after subprime loan.

The following figure contrasts the dramatically different ten-year equity-accumulation experience of borrowers who receive a 30-year fixed-rate subprime mortgage with borrowers who receive a series of 2-28 subprime mortgages that are serially refinanced after the expiration of the introductory rate. Borrowers with the 30-year fixed-rate mortgage slowly but surely accumulate equity, strengthening their financial position—by year ten, they have increased their equity from $45,000 to more than $66,000. In contrast, the 2-28 borrowers see their equity swirl down to $20,547—a net difference of more than $45,000. The figure assumes a neutral housing price environment while loan costs underlying this figure are set using identical borrower traits applied to the same lender pricing matrix, assuming 3.5% in lender fees, and $1,910 in third-party closing costs, consistent with bankrate.com's average closing costs.[29]

[29] *Fall 2003 Closing Costs Survey*, Bankrate.com (available at www.bankrate.com/brm/news/mortgages/closing_costs.pdf) (third-party costs include appraisal, attorney, credit report, flood certification, pest inspection, courier, survey, title insurance, and recording fees).

Figure 2: 2/28 = Lost Equity



	0	2	4	6	8	10
2-28 ARM	$45,000	$38,793	$32,490	$26,091	$19,593	$12,996
30 FRM	$45,000	$47,955	$51,442	$55,555	$60,409	$66,136

Time in Loan (Years)

When borrowers lose equity, they represent greater and greater lending risks since proceeds from foreclosure sales are increasingly unlikely to cover amounts owed and administrative costs. As a result, lenders are less willing to make loans available to borrowers in these positions. Today's subprime market has grown tremendously over one of the most favorable interest rate and housing price appreciation rates in recent memory. In fact, strong housing price appreciation has offset the equity-loss effects associated with repeat subprime borrowing, allowing borrowers to tap into equity and refinance time and time again to manage payment shocks and consolidate debt. Yet, as interest rates begin to increase and housing markets slow, the option to refinance is in danger of disappearing for many borrowers with subprime loans. Rather, as subprime ARMs begin to reset there is likely to be a significant rise in foreclosures in a market where, what may come to be seen as the best of times, one in five loans already entered foreclosure and one in eight finish the process within five years of origination.[30] The following figures demonstrate the close relationship between housing appreciation and foreclosures around the country.

The map below shows the cumulative foreclosure experience for subprime loans originated in 2000 based on performance through May 2005. Foreclosure rates vary dramatically across the country and are closely associated with changes in property values. For example, strong housing markets like California and New York experience relatively few foreclosures, while weak housing markets like those in the Midwest tend to experience higher foreclosure rates. Again, these data reflect experiences over a largely favorable interest rate environment. The concern today is that even the strong coastal housing markets are starting to ebb, a development that could send national subprime foreclosure rates soaring.

[30] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005).

Figure 3: Foreclosure Rates Vary with Property Values[31]

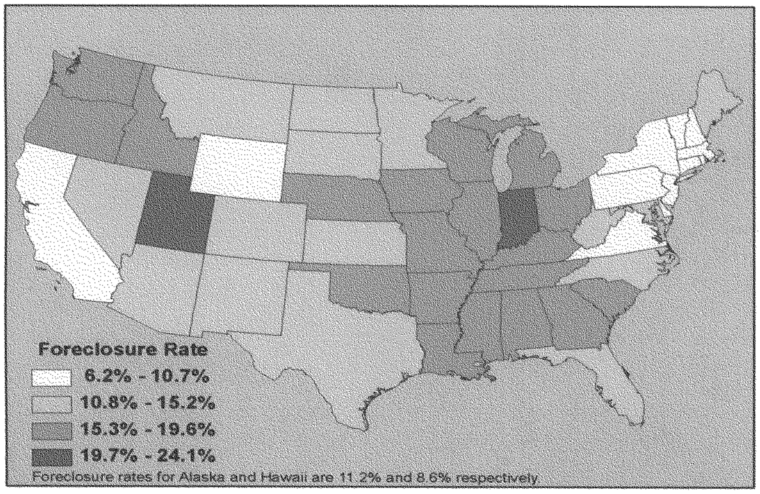
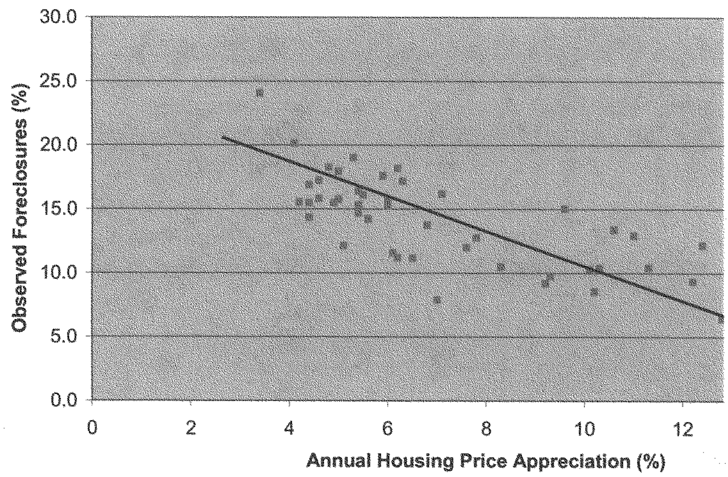


Figure 4 shows the relationship between state-level changes in housing prices and foreclosure rates among subprime loans originated in 2000 (based on performance through May 2005). Even on this elementary measurement, the results are stark, indicating an almost one-to-one relationship between changes in housing price appreciation rates and subprime foreclosure rates.[32]

[31] Source: CRL calculations on private proprietary dataset.

[32] OLS regression shows a highly significant relationship ($p < 0.01$) with an adjusted r-squared of 0.57 and coefficient of -0.92. In other words, for every percentage point decrease in appreciation rates, the model predicts a 0.92 percentage point increase in foreclosure rates. Mean foreclosure rate=13.57%,N=51.

Figure 4: Subprime Foreclosures versus Housing Price Appreciation (Performance of loans originated in 2000 through May 2005)[33]



While subprime foreclosure rates are already rising, rate resets for subprime ARMs will almost certainly contribute to higher foreclosure rates soon. For example, an astounding 11.32% of the subprime ARMs in Ohio were in foreclosure at the end of the second quarter of 2005.[34] UNC has shown that "ARMs' have a strong association with heightened foreclosure risk and potential loss of borrowers' homes," finding that subprime ARMs carried 49% greater odds of foreclosure than that of fixed-rate subprime loans after controlling for other differences in loan terms, creditworthiness,

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[33] Id.
[34] *See* MBA survey cited in Noelle Knox and Barbara Hansen, *More Fall Behind on Mortgages*, USA TODAY at B1 (September 14, 2006).

and economic conditions.[35] This relationship will be heightened as housing price appreciation slows.

While borrowers may have been able to offset lost equity from fees and prepayment penalties in the past by an increase in the value of their home and still afford a refinance, as home prices flatten, they will be more likely to lose the refinance option. With the sale and refinance options off the table, foreclosure is the only remaining one for borrowers who hit the rate reset wall.

IV. Regulators can and should ensure that subprime lenders only make loans that borrowers can repay in order to prevent significant losses of equity and devastating numbers of foreclosures.

CRL is pleased that the Agencies are addressing problems with nontraditional mortgages and generally supports the proposed guidance that they have issued. However, the agencies have the authority to expand this guidance to cover nontraditional mortgages made by subprime finance companies, including hybrid ARMs. We urge federal regulators to take the following steps to curb underwriting practices that lead to lost wealth and increased foreclosures:

- Make it an unfair or deceptive act or practice (UDAP)[36] to underwrite subprime ARMs without using the fully indexed interest rate.[37]

[35] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at 30 and 24.
[36] Note that for purposes of this testimony, CRL will not attempt to differentiate between practices that are unfair and those that are deceptive, but rather will recommend that the aforementioned underwriting practices be declared "unfair and deceptive." In general, the standards the Agencies and the FTC use to determine whether an act or practice is *unfair* is that: (1) the practice causes, or is likely to cause (2) substantial consumer injury (3) that is not reasonably avoided by consumers and (4) is not outweighed by countervailing benefits to consumers or competition. For an act or practice to be *deceptive*, the standard is

- Make it a UDAP to exclude hazard insurance and taxes from the analysis of the borrower's ability to repay a subprime home loan.
- Require that all subprime home loans provide for the escrow of payments for taxes and insurance.
- Require independent verification of income reported in low-documentation or no-documentation subprime home loans.[38]
- Increase enforcement against lenders and brokers whose underwriting practices are unsafe and unsound and harm homeowners.[39]

A CRL analysis of 2004 Home Mortgage Disclosure Act (HMDA) data shows that 58% of first-lien subprime home loans were made by non-supervised lenders that

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that (1) there is a representation, omission, act or practice that is likely to mislead; (2) the act or practice would be likely to mislead a consumer acting reasonably (if an act or practice targets a particular group, considering reasonableness from that group's perspective); and (3) the misleading representation, omission, act or practice is material.

[37] We support the principle in the Agencies' Guidance, which states: "For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The amount of the balance increase should be tied to the initial terms of the loan and estimated assuming the borrower makes only minimum payments during the deferral period." *See* Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,252 (proposed Dec. 29, 2005). *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/attachment.pdf

[38] *See* Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,252 (proposed Dec. 29, 2005). *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/attachment.pdf at 17-18 (cautioning institutions to consider whether verification practices are adequate and encouraging increasingly comprehensive verification as the level of credit risk increases).

[39] Additionally, regulators could facilitate better public information about the terms of subprime loans by requiring financial institutions to provide additional information, including loan-to-value ratio, among their Home Mortgage Disclosure Act disclosures.

reported their data to the U.S. Department of Housing and Urban Development (HUD).[40] In other words, a majority of subprime loans are made by lenders that will not be subject to safety and soundness oversight by the agencies. CRL strongly recommends that at least some of the underwriting standards apply to all mortgage lenders and brokers,[41] not only to depository institutions. To accomplish this goal, the FRB could exercise its discretionary authority under the Home Ownership and Equity Protection Act (HOEPA) which provides the Board with broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. Specifically:

> "(l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--
> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower."[42]

While this grant of authority occurs in HOEPA, Congress granted this authority to the Board for all mortgage loans, not just loans that are governed by HOEPA (closed end

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[40] The HMDA regulations applicable to loans originated in 2004 required lenders to report the difference between an originated first-lien home loan's annual percentage rate and the yield on U.S. Treasury securities of a comparable term if that difference was greater than or equal to three percentage points and the loan was subject to the Truth-in-Lending Act. This new reporting field was developed specifically to allow observers to understand subprime lending patterns. However, there is some evidence that this measure may still underestimate those loans that are subprime in the HMDA data set. For more information, see Avery, R.B., G.B. Canner, and R.E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (Federal Reserve Bulletin, Washington, DC), Summer 2004 at 344-394, *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf. For further explanation of the lenders that report HMDA data to HUD, see U.S. Department of Housing and Urban Development, Mortgagee Letter 05-17 (April 15, 2005) (detailing who must report HMDA data to the agency).

[41] Mortgage brokers accounted for 59.3% of subprime originations in 2005. *Brokers Flex Their Muscle in 2005, Powering Record Subprime Year*, INSIDE B&C LENDING (Bethesda, MD), Mar. 17, 2006. When a reporting institution makes loans through a mortgage broker, the institution rather than the broker reports the HMDA data. *A Guide to HMDA Reporting: Getting It Right!* (Federal Financial Institutions Examination Council Jan. 1, 2004), at 6.

[42] 15 USC Section 1639(l)(2).

refinance transactions) that meet the definition of "high cost". Each of the substantive limitations that HOEPA imposes refer specifically to high cost mortgages. By contrast, the discretionary authority granted by subsection (l) refers to "mortgage loans" generally.

Alternatively, the Agencies could work with the FTC to begin rulemaking proceedings to declare certain acts and practices related to underwriting of nontraditional mortgages to be unfair or deceptive acts or practices under Sections 18(a) & 18(f) of the FTC Act, 15 U.S.C. §§ 57a(a) & (f).[43] Section 18 of the Federal Trade Commission (FTC) Act directs the FRB, NCUA, and OTS[44] to "prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."[45] According to an article written by Julie S. Williams and Michael S. Bylsma of the OCC,

> Congress appeared to have had two primary goals when it amended the FTC Act in 1975. One goal was to strengthen consumer protection under the FTC Act by enhancing enforcement of the FTC Act *through rulemaking*. The other goal was to ensure that there would be *substantial similarity* in the FTC Act regulations that are applicable to banks and

[43] Given the need to address abuses related to nontraditional mortgages sooner rather than later, CRL recommends that the Agencies issue final Guidance *before* embarking on a rulemaking process with the FTC.

[44] Since the 1989 abolition of the Federal Home Loan Bank Board, to which Section 18 originally referred, the OTS has been the federal agency that determines for savings associations whether acts or practices are unfair or deceptive.

[45] The (FTC Act both bans unfair or deceptive acts or practices *and* instructs certain of the Agencies to issue regulations to prohibit *specific* unfair or deceptive acts or practices. Section 5 of the FTC Act (15 U.S.C. § 45) states that "unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." The OCC, the FDIC, and the FRB already have made clear that the general prohibition of Section 5 applies to the institutions they regulate and that they are authorized to enforce that law under Section 8 of the Federal Deposit Insurance Act. See 12 C.F.R. § 7.4008(c); Unfair or Deceptive Acts or Practices by State-Chartered Banks, FRB & FDIC (Mar. 11, 2004) (FRB-FDIC Guidance). See also Guidance on Unfair of Deceptive Acts or Practices, OCC Advisory Letter AL 2002-3 (Mar. 22, 2002); FDIC Financial Institution Letter, Guidance on Unfair or Deceptive Acts or Practices, FIL 57-2002 (May 30, 2002); Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to Rep. John J. LaFalce (May 30, 2002). CRL requests that the Agencies not rely simply on Section 5 of the FTC Act, but rather that authorized agencies issue regulations under Section 18.

> those that are applicable to other companies (after concluding that the FRB—not the FTC—would be best suited to develop regulations that are appropriate to banking functions).[46]

Congress clearly has instructed the FRB, NCUA, and OTS to address unfair or deceptive acts or practices through specific regulations.

Promulgating unfair or deceptive acts or practices (UDAP) regulations that address some of the worst abuses associated with underwriting of nontraditional mortgages under Section 18(f) also would help "level the playing field" between depository institutions and non-depository institutions. The proposed Guidance as drafted by the Agencies would apply to banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Other mortgage lending institutions would not be subject to the Guidance.[47]

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[46] Julie L. Williams & Michael S. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 BUS. LAW. 1243, 1248 (May 2003) (emphasis added).

[47] CRL notes that if Fannie Mae and Freddie Mac incorporate the final guidance into their own securitization standards, and if the ratings agencies rate favorably only those loan portfolios that comply with the Guidance, then the Guidance probably would have a significant indirect effect on institutions to which the Guidance did not apply directly. Still, regulations would provide for broader and more certain coverage.

Conclusion

Until recently, homeownership has served as a life-line for families to gain security and financial stability, but high-risk nontraditional mortgages are seriously eroding the traditional benefits of owning a home. As we have shown here, the problems are not confined to interest-only and option ARMs. Through hybrid ARMs, families in the subprime market are essentially receiving temporary unstable financing. Even if market interest rates do not rise, these loans can quickly become unaffordable or result in a downward spiral of repeated refinances that drain equity and increase the risk of foreclosure.

Mortgages are complex financial transactions, and the most important one that most families enter. If brokers and lenders are permitted to market high-risk products without considering the homeowner's ability to repay, there are serious consequences for individual families. Ultimately, these consequences will affect entire communities – and entire communities will be left out in the cold.

We respectfully submit that federal regulators *can* and *should* address this problem now by <u>requiring</u> that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan, and also by <u>strengthening</u> <u>enforcement</u> against unscrupulous actors who convince homeowners to accept these loans that set homeowners up to fail.

TESTIMONY OF ALLEN J. FISHBEIN

DIRECTOR OF HOUSING AND CREDIT POLICY,
CONSUMER FEDERATION OF AMERICA (CFA),
ON BEHALF OF CFA AND NATIONAL CONSUMER LAW CENTER (NCLC)

BEFORE THE

SUBCOMMITTEE ON HOUSING & TRANSPORTATION AND SUBCOMMITTEE
ON ECONOMIC POLICY

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U.S. SENATE

REGARDING

CALCULATED RISK: ASSESSING NON-TRADTIONAL MORTGAGE PRODUCTS

SEPTEMBER 20, 2006
WASHINGTON, DC

Good morning Chairmen Allard and Bunning, Ranking Members Reed and Schumer, and members of the Committee. My name is Allen Fishbein, and I am director of Housing and Credit Policy for the Consumer Federation of America. My testimony is presented on behalf of both CFA,[1] and the low income clients of the National Consumer Law Center.[2] We appreciate the invitation to appear here today to present our views concerning non-traditional mortgages and commend the two subcommittees for holding hearings on this important and timely subject.

Non-traditional mortgage are complex loan products that have enabled lenders to maintain high numbers of loan originations even in a rising interest rate environment. The initial low monthly payments are attractive to borrowers who want to leverage their purchasing power in a rapidly appreciating housing market. Unfortunately, many non-traditional borrowers may not fully understand the changing payment schedules,

[1] The Consumer Federation of America is a nonprofit association of about 300 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through research, advocacy and education. CFA published a research report, entitled: Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders (see www.consumerfed.org).

[2] The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. This testimony is co-written by Alys Cohen and Margot Saunders.

especially the sharp monthly payment increases that are common in non-traditional mortgages. Unsuspecting borrowers could face considerably higher monthly payments than they can afford. In the explosive housing market of the past five years, price appreciation created growing equity that protected the borrower, allowing them to refinance into a more practical mortgage. In a cooling market, stretched borrowers can simultaneously become upside down in their mortgages and have steeply rising monthly payments.

As housing prices have soared in recent years, non-traditional mortgage products, such as interest only mortgages and payment option adjustable rate mortgages (ARMs), have grown increasingly prevalent. These types of loans were less than one percent of mortgages in 2000, yet according to some they comprised a third or more of new loans made last year. In addition, lenders are increasingly combining these products with other higher-risk practices, such as simultaneous second-lien mortgages and stated income and other reduced documentation requirements to qualify borrowers for loans. Federal banking regulators, consumer advocates, and some in the industry all have expressed concerns that non-traditional mortgages, or "exotic" mortgages as they are also known, and these layered risk combinations may be too exotic for many that have taken them out. Ultimately, consumers may not adequately understand how the monthly payments on these newer, more complex loans will change over the life of the mortgage nor may they be able to afford the changing payment schedules, which could put their homeownership and financial stability in jeopardy. The delinquencies and foreclosures that result from unsustainable loans will have extremely negative implications for the credit ratings of borrowers that could prevent or make refinancing or a subsequent home purchase prohibitively expensive.

Non-traditional mortgages have existed in some form for many years. Interest only mortgages allow borrowers to pay interest but no principal in the loan's early years. Payment option ARMs offer borrowers multiple payment choices and often feature a low introductory rate, but can lead to a rising loan balance (also known as negative amortization) should the borrower choose the minimal payment option. Simultaneous second mortgages, or "piggyback" loans, combine a mortgage with a home equity loan or line of credit, allowing borrowers to finance more than 80 percent of the home's value without private mortgage insurance. Stated income or reduced documentation features are used by lenders to accept reduced or minimal standards to substantiate borrower income and assets and are used to qualify borrowers unable to meet traditional underwriting standards.

Traditionally, these types of loans were niche products that were offered to upscale borrowers with particular cash flow needs or to those expecting to remain in their homes for a short time. They typically feature lower initial monthly payments compared with traditional fixed rate and adjustable rate loans, but only for a limited period of time.

What has changed is that today non-traditional mortgages are aggressively mass marketed to a much broader spectrum of borrowers and are of used for borrowers who need to stretch their incomes to afford the higher prices of homes. These products may help some people buy homes at prices they could not otherwise afford using traditional mortgages. At the same time, non-traditional mortgages expose borrowers to near certain significant monthly payment increases when loan terms reset after a brief period, usually two or three years. Borrowers could be vulnerable to "payment shocks," making their homes suddenly unaffordable and potentially ruining their finances. As the FDIC pointed out in a consumer brochure last year, "Many new loan products are being widely offered that could benefit some people but be huge mistakes for others."[3]

Many, including the federal banking regulators, are justifiably concerned that non-traditional mortgages are being offered to many borrowers who may not adequately understand the additional risks they carry or for whom these products simply may not be appropriate. As such, the rapid proliferation of new mortgage products as affordability tools pose a serious threat to sustaining home equity and homeownership, particularly for more vulnerable borrowers – highly leveraged first time homebuyers, modest and fixed income households, and those that rely on higher price subprime loans face financing additional risks from these products. Rising interest rates and a softening housing market could make these loans difficult, costly or impossible to refinance for some portion of borrowers. These borrowers could find themselves in the untenable position of owing more than their home is worth, being unable to afford the higher monthly payments and potentially face foreclosure. The resulting foreclosure stress also makes it more likely that they will fall victims of predatory and unscrupulous lenders.

[3] FDIC, "A Shopper's Guide to Bank Products and Services," *FDIC Consumer News*, Summer 2005.

This testimony describes the changing face of the mortgage market and the rise of non-traditional mortgage market; the characteristics of non-traditional mortgage borrowers that demonstrates that they are no longer solely the affluent money managers they once were; the increased default and foreclosure risk these newly prevalent mortgages can pose to some borrowers; the lack of consumer understanding of the complexity of these new mortgage products; the impact that changing underwriting standards have on borrowers and on lenders; the relation between these new mortgages and the housing market; and presents the additional protections that consumers need in a changing mortgage market.

The Face of the Changing Mortgage Market

It is difficult to estimate with complete accuracy what the full range of nontraditional products represents as a share of the mortgage market. However, industry analysts have projected significant numbers of ARMs (including traditional ARMs – one-quarter of all outstanding mortgages) are due for interest rate resets over the next four years. Many of these are in the form of payment option mortgages and include interest only features. During 2006, $400 billion in ARMs are scheduled to readjust for the first time, and in 2007, $1 trillion to $2 trillion in ARM mortgages will readjust.[4] Already some industry

[4] Jaffe, Chuck, "Painful ARM Twisting," MarketWatch, August 2, 2006; Elphinstone, J.W., "Foreclosures May Jump as ARMs Reset," *Associated Press*, June 19, 2006.

analysts predict that higher monthly payments resulting from these resets are likely mean that one in eight or more of these loans will end up in default.[5]

Of particular concern, are the 2/28 hybrid ARMs that are the predominate form of subprime mortgages that were originated in 2004 and 2005. These loans carry an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments for the remaining life of the loan. In essence, these mortgages are another form of non-traditional mortgage in that they offer the prospect that monthly payments may explode after the initial rate period expires. In 2005 subprime mortgages constituted about 25 percent of all mortgage originations and it is estimated that over 80 percent of these were adjustable rate loans. Already there are signs that many will have great difficulty in making these significantly higher payments. The concentration of ARMs and hybrid ARMs among subprime borrowers has additional risk of payment shock because these borrowers already have higher interest rates, so subsequent increases will be more difficult to afford.[6]

The Characteristics of Non-Traditional Mortgage Borrowers

Non-traditional mortgage borrowers generally have been portrayed as wealthier, financially sophisticated consumer, with better credit profiles than the typical mortgage borrower. In fact, the burden of these riskier mortgages is falling on many middle and

[5] Knox, Noelle and Barbara Hansen, "More Fall Behind on Mortgages," USA Today, September 14, 2006.
[6] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 4.

moderate income borrowers. Recent CFA research analyzed the data for some 100,000 mortgages found:[7]

- **Significant shares of non-traditional mortgage borrowers earn less than $70,000 annually.** More than one-third (36.9 percent) of interest only borrowers earned below $70,000 annually and about one in six (15.6 percent) earned $48,000 annually. More than one third (35 percent) of payment option borrowers earned under $70,000 annually and about one in eight (12.1 percent) earned under $48,000. ($70,000 a year was about the median income for Atlanta, Philadelphia and Chicago, and $44,300 is the national median. However, $70,000 is below the area median income for many markets that have experienced rapid home price appreciation such as Washington, DC, Boston, MA, Long Island, NY, and San Francisco and San Jose, CA.[8])

- **Many non-traditional mortgage borrowers have credit scores below the national median.** More than one-half of payment option ARM borrowers and 38 percent of interest only mortgage borrowers had credit scores below 700 (723 is the median Fair Isaac Company score.) More than one fifth (21.4 percent) of payment ARM borrowers and about one in eight (12.1 percent) of interest only mortgage borrowers had credit scores below 660.

[7] Fishbein, Allen J. and Patrick Woodall, Consumer Federation of America, "Exotic or Toxic: An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders," May 2006 at 22-26.
[8] *See* Federal Financial Institutions Examination Council, Department of Housing and Urban Development, Estimated MSA/MD Median Family Incomes for 2005 CRA/HMDA Reports.

- **Borrowers of Color are More Likely to Receive Non-Traditional Mortgages:** African Americans were more likely than non-African Americans to receive interest only loans and payment option mortgages. Latinos were nearly twice as likely as non-Latinos to receive payment option mortgages.

Thus more borrowers may be vulnerable to the payment shocks resulting from non-traditional products than often portrayed. For example, most payment-option mortgages permit borrowers to choose what they want to pay per month for a preset period, ranging from a fully amortizing standard payment to an interest-only payment to a rock bottom minimum payment even lower than the interest-only option. It is estimated that up to 70 percent of payment-option borrowers go with the minimum payment.[9] That, in turn, causes them to increase their principal debt through a process known as negative amortization. Thus borrowers are allowed to increase their original loan by 10 to 25 percent before they must begin paying down the principal with significantly higher payments. The Comptroller of the Currency reports that half of the least creditworthy option ARM borrowers have mortgage balances that exceed their original loan amount.[10] One lender that specializes in option ARMs, Golden West Financial's Herb Sandler, noted recently that some lenders are not fully explaining or disclosing the risks of option ARMs and "are clearly faking their borrowers out."[11]

[9] Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal,* November 29, 2005.
[10] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 7.
[11] Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.

Prospects for Increased Non-Traditional Mortgage Defaults and Foreclosures

Delinquency and foreclosure rates for subprime ARMs demonstrate the huge risk posed by non-traditional products. Over twenty local studies attribute a significant fraction of the increase in local foreclosure rates since the mid-1990s to subprime lending, especially subprime ARMs. Non-traditional interest only and payment option mortgages, with similar payment shocks, are potential ticking time bombs for borrowers as well. In addition, a subprime borrower who refinances with an adjustable rate loan instead of a fixed rate mortgage is 25 percent more likely to experience foreclosure than a borrower whose loan has an extended prepayment penalty.

The recasting interest rates for ARMs and resetting payment structures for non-traditional mortgages will generate significant payment shocks for many borrowers. Nearly three quarters (70 percent) of subprime loans issued since 2001 are scheduled to see their interest rates reset between 2006 and 2007.[12] For borrowers in typical $200,000 ARM mortgages, payments could increase by 25 percent when the ARM interest rates resets from 4.5 percent to 6.5 percent, or a monthly payment rise from $1,013 to $1,254.[13] For hybrid 2/28 ARMs issued in 2005 and that recast in two years the increasing interest rate environment is expected to increase monthly payments by more than $300 for 2/28 ARMs and $500 for 2/28 interest only ARMs.[14]

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[12] Bajaj, Vikas and Ron Nixon, "For Minorities, Signs of Trouble in Foreclosures," *New York Times*, February 22, 2006.
[13] Bajaj, Vikas and Ron Nixon, "Re-Refinancing, and Putting Off Mortgage Pain," *New York Times*, June 23, 2006.
[14] FitchRatings, "Rating Subprime RMBS Backed by Interest-Only ARMs," March 9, 2006 at 10.

Although the super-heated housing market and rapidly escalating home prices in recent years has suppressed delinquencies and foreclosures, there are early signs this may be changing as the housing market cools. Already, the recasting ARMs are impacting delinquency rates. In 2006, delinquencies on ARMs have increased 141 percent over 2005 levels according to analysis by Credit Suisse.[15] More recently originated ARMs are more likely to be delinquent. ARMs that were originated in 2005 were three times more likely to be delinquent than ARMs that were originated between 2003 and 2004.[16] One in twenty (5.14 percent) of subprime 2/28 ARMs that were originated in 2005 were delinquent, a 35 percent increase over the previous year.[17] During the second quarter of 2006, about one eighth (12.2 percent) of subprime borrowers were late paying their mortgages and in 18 states more than 15 percent of homeowners with subprime ARMs were behind in their payments.[18] In 2006, the number of subprime mortgages that had at least one missed payment in the first three months after origination increased by14 percent.[19]

Many borrowers in default will ultimately slide into foreclosure and lose their homes and damage their credit ratings for years. Seasonally adjusted subprime foreclosures increased between the fourth quarter of 2005 and the first quarter of 2006 from 1.47

[15] Simon, Ruth, "Homeowners Start to Feel the Pain of Rising Rates," *Wall Street Journal*, August 11, 2006.
[16] Simon, Ruth, "Late Payments on Mortgages Rise," *Wall Street Journal*, May 18, 2006.
[17] *Ibid.*
[18] Knox, Noelle and Barbara Hansen, "More Fall Behind on Mortgages," USA Today, September 14, 2006.
[19] Wei, Lingling, "Subprime Mortgages See Early Defaults," *contra Costa Times*, August 30, 2006.

percent to 1.62 percent.[20] A recent study by First American Real Estate Solutions reported that $368 billion in adjustable rate mortgages that were originated in 2004 and 2005 are sensitive to interest rate adjustments that would lead to default and $110 billion are expected to go into foreclosure.[21] To put this in perspective, this represents 1.84 million defaults and 550,000 foreclosures of median priced homes (nationally, about $200,000).

Moreover, although many borrowers had been relying on escalating housing prices to allow them to refinance their subprime mortgages as an escape valve from payment shocks, as the housing market cools, this escape will no longer be available to many borrowers. Because many borrowers have little or no equity in their homes, refinancing may not be a viable option. Nearly a third (29 percent) of borrowers who took out loans in 2005 had no equity in their homes or owed more than their homes are worth – this is nearly a three-fold increase over the 11 percent of 2004 borrowers who had no equity in their homes.[22] Homeowners who used simultaneous second mortgages to finance 100 percent of their home's value are unlikely to be approved for a refinance mortgage. In markets where prices stagnate or decline, borrowers may not be able to refinance their mortgages and might be unable to sell their homes before going into foreclosure.[23]

[20] *Ibid.*
[21] Cagan, Christopher L., First American Real Estate Solutions, "Mortgage Payment Reset: The Rumor and the Reality," February 8, 2006 at 38.
[22] Simon, Ruth, "Late Payments on Mortgages Rise," *Wall Street Journal*, May 18, 2006.
[23] Elphinstone, J.W., "Foreclosures May Jump as ARMs Reset," *Associated Press*, June 19, 2006.

Additionally, the increasing interest rates combined with the cooling housing market creates an environment that drives more homeowners into foreclosure. The ARMs that were issued in 2003 and earlier had their rates reset as interest rates were falling and home prices were increasing, which lowered the interest rates and reduced monthly payments and rising home equity also allowed borrowers to refinance their loans.[24] The number of existing home sales in 2006 is projected to drop 7.6 percent below 2005 sales.[25] Sales prices are projected to rise modestly by 3.5 percent, but are far below the 12 and 13 percent price increases in 2004 and 2005 respectively.[26] Rising interest rates and stagnant or falling housing prices inverts the trends of a few years earlier. Rather than being cushioned by falling rates and rising prices, recent ARM borrowers are likely to be punished by rising interest rates and declining housing prices.

Consumers Do Not Understand the Risks Associated with Non-Traditional Mortgage Products

We are concerned that many borrowers using non-traditional mortgage products are not fully aware of the financial implications and potential hazards these products entail. It is easy to understand why. Consumers today face a dizzying array of mortgage products that are marketed and promoted under a range of products names. While the number of products has exploded, there appears to be little understanding by many borrowers about

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[24] FitchRatings, "Rating Subprime RMBS Backed by Interest-Only ARMs," March 9, 2006 at 2.
[25] "Realtors Slash Home Sales Forecast," *Reuters*, September 7, 2006.
[26] Izzo, Phil, "Housing Slowdown Takes Its Toll," *Wall Street Journal*, September 8, 2006.

key features in today's mortgages and how to compare or even understand the differences between these products.

A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage.[27] According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate from 6 percent to 8 percent by approximately 30 percent. Younger, poorer, and less formally educated respondents underestimated by a much as 50 percent.

The results of a recent Federate Reserve survey of ARM borrowers provides further indication that many borrowers are unfamiliar with even the basic terms of their mortgages. The survey found that 35 percent of them did not know the maximum increase that their interest rate can rise at one time, 44 percent were unsure of the maximum rate they can be charged, and 17 percent did not know the frequency with which their rate could change.[28]

Public Opinion Strategies, a nationally known polling organization, last year convened a focus group comprised of recent non-traditional mortgage borrowers. It also found that when consumers are shown the rate sheet with the various mortgage options they are

[27] CFA, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.
[28] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.

surprised by the magnitude of the payment shock. Although upper-income focus group participants are less surprised, lower-income participants described the payment shock on the rate sheet as "shocking" and they were largely unaware of the size of the payment shock.[29] These lower-income consumers were also less informed about the payment increases and debt risks of non-traditional mortgages, with some noting the "wish they had known more." All of the lower-income segment in one of the studied cities said that the higher payments after the mortgage recast would create a financial hardship for their families, and three quarters of them were concerned about their ability to make the monthly mortgage payments when the payments increased after the loan recast.

Monthly Loan Payments for Different Types of $200,000 Mortgages

Interest Rate	30-Year Fixed	5/1 ARM	5/1 Interest-only ARM	Option Arm
5.00%	$ 1,104	$ 1,074	$ 875	$ 643
6.50%	$ 1,104	$ 1,244	$ 1,350	$ 1,472
Monthly Increase	$ -	$ 170	$ 475	$ 829
	0.0%	15.8%	54.3%	128.9%
8.00%	$ 1,104	$ 1,422	$ 1,544	$ 1,652
Monthly Increase	$ -	$ 348	$ 669	$ 1,009
	0.0%	32.4%	76.5%	156.9%

5/1 ARMs are at 5.25% for first 5 years then reset to scenario rate, Option ARM has a 1-month teaser rate of 1.0%, then resets to scenario rate. Payment option rate capped at 7.5% and negative amortization limit of 110%.

These payment shocks can be severe. For a $200,000 loan, the monthly payment increase for different loan products can vary significantly when the loan is recast at higher interest rates. Monthly payments on a payment option ARM with a 5.00% interest rate would more than double if the interest rate were reset at 6.50% and would be one and a half times higher if the note were reset at 8.00%,

[29] *See* Fisbein and Woodall, CFA, "Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders," May 2006 at 21-21.

an interest rate that was seen as recently as 2000. Monthly payments on a 5/1 interest-only ARM would rise by half at 6.5% and rise by three quarters if the note were reset at 8.00%. Monthly payments for a 5/1 ARM without non-traditional features would nonetheless increase by 16% if the loan were reset at 6.5% and rise by one third if the note recast at 8%.

It is likely that this lack of knowledge has helped encourage borrowers to take out loans based on their initial repayment schedule without appreciating the possible risk of rising interest rates and increased monthly costs.[30] The lack of consumer understanding, especially among financially unsophisticated consumers, could set borrowers up to fail. Borrowers that do not fully appreciate the extent to which their notes will be recast or interest rates re-adjust will be ill-prepared to face the likely payment shock and could face losing their homes and their financial well being.

Concerns About Weaker Underwriting Practices on Non-Traditional Mortgages for Consumers

A basic premise in the mortgage lending industry has always been that adequate underwriting is necessary to protect the lender from loss. Indeed, evaluating the borrower's ability to repay the loan has historically been the basis for assurance against loss to the lender. Evaluation of the borrower's ability to repay the loan provides

[30] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 2.

protections for both the lender and the borrower. It assures the borrower that someone schooled in the business of lending has determined that the borrower can afford to repay the loan. This underwriting process is essential for the borrower, who generally does not have the expertise to assess this question. However, in recent years the subprime mortgage industry has developed mechanisms to avoid the consequences of bad underwriting and still make substantial profits from mortgage lending. Neither the lenders nor the investors bear the risks that arise from the lack of underwriting or poor underwriting, as practical matter.[31] The industry and investors have developed a myriad of ways to protect themselves from themselves. The real risk of loss due to lender misconduct is now borne almost exclusively by the homeowner.

Risk to consumers is vastly different from risk to industry. Virtually all business risk can be protected against by a mortgage lender: more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way, insurance against loss can be purchased, securitized pools of mortgage loans can be overcapitalized. It is all a matter of numbers and actuarial acumen to the lending industry. However, to consumers, some risks cannot be measured simply in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon. It is not a risk that this nation's policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy does. Current policy permits mortgage products on

[31] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (working paper 2006), available at www.ssrn.com (hereafter "Engel & McCoy").

the market that are known to lead to foreclosure for a substantial number of borrowers. While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The subprime mortgage industry has a business model of making loans that have a 20 percent chance of going into foreclosure within the first five years after origination, and a 60 percent chance of being refinanced.[32] Researchers have consistently marveled at the prevalence of refinancing of subprime mortgage loans, even when there are prepayment penalties present.[33] Despite the costs to the homeowners of these refinances, the lenders use this tool to transform a non-performing loan into a performing one.[34] These forced refinances are one way that the subprime mortgage industry ensures itself against loss: so long as there is sufficient equity in the home, regardless of the homeowner's ability to make the payments, there is unlikely to be a loss to the investor. Rather, because of the nature of the security – the family home – the debtor will go to great lengths to avoid that loss and will refinance, if at all possible.

[32] *See* Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005. http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf. Tables 7 and 8. Each table shows that five years after a subprime loan with various characteristics typical in subprime mortgage loans (adjustable rates, prepayment penalty, balloon term), that loan would have over a 20 percent chance of being in foreclosure at some time in this five years, and a 60 percent chance of being refinanced in this five year period. Only approximately 19 percent of subprime loans were still in active five years after origination.

[33] *Id.* at Executive Summary.

[34] Vikas Bajaj, *Mortgages Grow Riskier and Investors are Attracted*, New York Times, *Sept. 6, 2006 at C1* (investors are increasing exposure in mortgage backed securities despite rising default rates and serious concerns by regulators about faulty underwriting in non-traditional mortgages).

The current structure of the regulatory environment for mortgage lending is based on the premise that efficient financial markets, with sufficient disclosures, and open access to choices, will produce equitable and appropriate products for consumers. Yet, as we have demonstrated, this is clearly not the case in the non-traditional and subprime mortgage market. Instead, the conversation continues to be about appropriately managing risk, *i.e.*, losses to the industry and investors, not losses to homeowners.

A recent article illustrates how the process of securitizing home mortgage loans facilitates the lack of underwriting – and thus the prevalence of predatory mortgages.[35] As the authors point out: "Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans."[36] This is the case because:

> [i]nvestment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from virtually all of the credit and litigation risk associated with predatory loans. Market and legal forces provide additional protections to investors.[37]

The mortgage industry protects itself from anticipated defaults and foreclosures by charging everyone a higher price, by securitizing loans in pools with less risky loans, and

[35] Engel & McCoy, *supra* note 16.
[36] *Id.* at 3.
[37] *Id.* at 3-4. It is pointed out later in the article that lenders are essentially indifferent to the deceit of mortgage brokers about default risks because they can shift the risk of loss to the secondary market. *Id.* ata 15 n. 52.

by adding credit enhancements.[38] That is fine as a business model for those in the mortgage industry. However, it is bad policy for this nation because it fails to account for the externality costs of the loss of homeownership and to communities into equation. The losses to the homeowner, the family, and the community from forced equity stripping refinancings and foreclosures are simply devastating.

Concerns About Improper Underwriting of Non-Traditional Products and Exploding ARMs for Lenders

Non-traditional mortgages require more assiduous underwriting to account for fluctuating payment schedules over the life of the mortgage. Non-traditional loans generally are suitable for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or for investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes, and those with fluctuating incomes do not see substantial upswings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan.

Banking regulators have been warning mortgage lenders about the consequences for improperly underwriting non-traditional loans without adequate consideration of the borrower's ability to pay back these loans. Mortgage risk is increasingly dispersed

[38] *Id.* at 23-29.

among a variety of market participants who may either underestimate or simply be willing to price for the greater risks of default and foreclosure that these loans entail in ways that the individual consumer cannot.

Because many non-traditional mortgage products and adjustable rate mortgages are made without adequate underwriting, they potentially present major risks to consumers and to the economy. The growth of ARMs and interest-only products in a low-rate environment means that interest rate increases could potentially lead to significant increases in defaults and foreclosures. Such a result would devastate individual consumers, their families, and communities. Moreover, consumers show extreme sensitivity to interest rate variations; upward adjustments in rates often result in unaffordable monthly payments. Because consumers are a major stabilizing force in the economy, a sharp upswing in rates leading to a significant decline in household spending and significant rise in defaults could have broad implications for economic instability.

Non-traditional mortgages also may present underwriting concerns and credit risks for lenders since there is little long-term experience with the current concentration of non-traditional mortgages. Although some thrifts have experience with some of the non-traditional loan products, the broader lending industry has never marketed the current volume or concentration of non-traditional mortgage products. The new mortgage products "have the potential to take risk to a higher level than bank managers may be accustomed to" because of their inexperience with the new mortgage products over time, according to FDIC Director John M. Reich.[39]

Additionally, because of the intense competition for borrowers after the steep decline in refinancing demand when interest rates rose, lenders have been willing to accept more risk to drive originations. The overcapacity in the lending industry has encouraged the mortgage lenders to weaken their lending standards to compete for borrowers.[40] Accurate assessment of credit risk of financial institutions is vital, because credit risk has been the leading cause of bank failures and remains the largest risk for most financial institutions.[41]

Non-traditional mortgages require much more extensive application of meticulous underwriting standards, especially assessing the borrower's long-term ability to afford monthly payments.[42] The concentration of non-traditional mortgages by some lenders and the application of layered risk (notes with more than one non-traditional mortgage characteristic) requires lenders to assess borrower risk more carefully and to monitor the loans over time to ensure that borrowers' risk profile and underwriting has not worsened. Non-traditional mortgage products combined with loosened underwriting standards pose higher risks for default. There are concerns that lenders are focusing on credit scores

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[39] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 4.
[40] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 5.
[41] Remarks by Federal Reserve Governor Susan Schmidt Bies, At the National Bankers Association Annual Convention, Beverly Hills, October 12, 2005.
[42] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 8.

alone to assess the creditworthiness of borrowers without taking into account the borrower's ability to repay the note over the length of the mortgage.[43]

Non-Traditional Mortgages Contribute to Affordability Problems and the Housing Bubble

The presence of non-traditional mortgage products has facilitated the escalating cycle of rising home prices over the previous five years. Although non-traditional mortgages have been marketed in part as an affordability tool for borrowers to become homeowners despite record-high housing prices, the ability of borrowers to leverage their purchasing dollars with non-traditional mortgages contributed to the rising housing costs. Buyers with non-traditional mortgages could either purchase larger homes than they might be able to afford with a fixed rate mortgage or bid up the home prices. As these buyers put upward pressure on the price of their home purchases, other home sellers increased their asking price and even more borrowers needed non-traditional mortgages in order to afford their home purchases. *USA Today* editorialized at the end of 2005 that "When exotic loans become routine, the economics of housing becomes anything but. These loans add something new and troubling. One might call it a bubble."[44]

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[43] Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 6.
[44] Editorial, "As Risky Home Loans Rise, House-Price 'Bubble' Inflates," *USA Today*, December 28, 2005.

Essentially, wider access to credit, including non-traditional mortgages, created an arms race between the credit and real estate industry. Rising prices stimulated the demand for more complex credit mortgage vehicles, which in turn increased demand for higher-priced homes. As San Francisco Federal Reserve Senior Economist noted:

> Rapidly rising stock and house prices, fueled by an accommodative environment of low interest rates and a proliferation of "exotic" mortgage products (loans with little or no down payment, minimal documentation of income, and payments for interest-only or less) have sustained a boom in household spending and provided collateral for record-setting levels of household debt relative to income.[45]

It is unquestionable that the housing and real estate market was extremely strong over the past decade. Between 1997 and 2005, home sale prices nationally rose by 55 percent after adjusting for inflation and these increases have added $6.5 trillion in household wealth.[46] In 2005, the number of home sales hit a fifth consecutive record year and home price appreciation was steady across the country, with many metropolitan areas having annual price increases above 10 percent.[47] Silver Spring, Maryland-based mortgage

[45] Lansing, Kevin J., "Spendthrift Nation," *FRBSF Economic Letter*, Federal Reserve Board of San Francisco, No. 2005-30, November 10, 2005.
[46] Baker, Dean and David Rosnick, "Will a Bursting Bubble Trouble Bernanke? The Evidence for a Housing Bubble," Center for Economic and Policy Research, November 2005 at 3.
[47] National Association of Realtors Research Division, "The 2005 National Association of Realtors Profile of Real Estate Markets: The United States of America," December 2005 at 2.

trainer Christopher Cruise noted that "These types of products have been enablers when it comes to allowing home prices to rise."[48]

In 2006, there have been signs that the housing market is beginning to cool, with fewer sales and housing prices rising at much lower rates than in previous years. In some markets where non-traditional and hybrid ARMs have become a significant share of the market, housing prices have even begun to fall. The homeowners who will be most severely hurt by any downturn in the housing market are the non-traditional borrowers who have purchased the most recently with the least equity in their homes.

Conclusion: New Consumer Protections Are Needed

We believe that more has to be done to ensure that consumers are adequately aware of the financial risks associated with the complex and potentially exploding payment products being offered in the mortgage market. Yet the plain fact is that these products simply may not be appropriate for all borrowers who receive them. Thus, we offer these recommendations:

First, we believe that consumers must receive timely, clear, and balanced loan disclosures to help them make wise choices. Loan disclosures mandated under the Truth in Lending Act (and implemented by Regulation Z) should be revised and made more specific and more comprehensive. Borrowers should be provided with information about the

[48] Downey, Kirsten, "Regulators to Issue Mortgage Warning," *Washington Post*, April 7, 2006.

maximum payment permitted under the contract. Yet improved disclosures are only a piece of the puzzle and, in and of themselves, are unlikely to be sufficient for many borrowers.

Nor do we believe that enhanced financial literacy alone is an adequate answer – the system is too complex and the bargaining power too diverse. Further compounding the problem is that many borrowers over-rely on loan originators to judge mortgage products for them even though mortgage brokers and lenders typically are not obligated to provide borrowers with the best loan. Industry best practices also are not an adequate answer. To the extent that some best practices can be agreed to, they are not enforceable by consumers and regulators cannot examine for them since they are not binding. Rogue lenders can simply ignore them.[49] Regulation plays the important role of creating a level playing field for consumers and responsible lenders which does not countenance rogue players.

Second, adoption without further delay of the Proposed Federal Guidance on Non-Traditional Mortgage Products[50] would help to send the message that depository lenders, such as banks, thrifts, and their lending affiliates should place sufficient emphasis on the borrower's debt repayment capacity over the life of the mortgage. The guidance was first published for comment in December 2005, but has yet to be finalized by the banking

[49] Just one example of a set of the industry best practices which have been resoundingly ignored are those entered into by Ameriquest Mortgage Corp., which is the subject of a multi-district litigation proceeding in the Northern District federal court in Illinois. *See, e.g.* In re Ameriquest Mortgage Co., 2006 WL 1525661 (N.D.Ill.) May 30, 2006).

[50] See, Interagency Guidance on Nontraditional Mortgage Products, 70 Federal Register, 77249, December 29, 2005.

regulatory agencies. While adoption of strong new federal agency policy in this area would help, it will not apply to the many independent mortgage lenders, Wall Street investment houses, and other important actors that are active in the non-traditional mortgage market. Nor does the guidance alone provide consumers with any new rights and protections to ensure that lenders adhere to the principles adopted. Moreover, the guidance should encompass hybrid ARMs, such as the 2/28 product.

Third, tweaking the few federal laws that we have on the books that govern a small piece of the mortgage market – like the Home Ownership and Equity Protection Act (HOEPA) – is also not a complete answer. The mortgage marketplace has grown and developed in the 14 years since HOEPA was passed. The problems have become much worse. We need a more wholesale and comprehensive approach to protecting consumers seeking mortgage credit.:

1. To maintain homeownership and to maintain the strength of home equity as a primary savings tool, the mortgage industry must be required to underwrite subprime mortgage loans to ensure that the loan is an appropriate loan for this household. To accomplish this, we need strong but flexible standards, like suitability, to apply to all mortgage loans. Congress should adopt a duty of good faith and fair dealing applicable to the non-traditional, hybrid adjustable rate and subprime market.[51] This duty would:

51 A suggested definition of a subprime or "covered home loan" is provided in Section II of these comments.

A) Require all originators to provide a loan which is suitable for the borrower's purpose based upon:

1) the borrower's circumstances, including the amount of other debt, the reliability of income, the expectations of changes in income borrower's age and plans and the number of dependents;

2) the borrower's objectives in obtaining the loan, such as the desire to lower payments, to pay off other debt, to reduce remaining term of loan, to reduce interest rate and to pay off loan early and to maximize home equity savings;

3) the borrower's ability to repay the loan, including the available income in the household, and the residual income after all debt is paid,

B) Require all lenders to consider the maximum payments possibly due under the loan, all of the borrower's reasonably anticipated expenses, and the borrower's actual residual income when determining the borrower's ability to repay the loan.

C) Prohibit steering borrowers into costlier loans than the borrower's qualification would require.

2. All players involved in the mortgage loan must be part of the solution – just as they are now part of the problem – and there must be full assignee liability applied to mortgage loans. The industry and the secondary market all argue strenuously against assignee liability of any sort, citing, among other things, a series of terrible events that will befall the mortgage industry if full assignee liability is applied.[52] The best answer to all of these concerns is to look at what happened after 1975 when the Federal Trade Commission passed the *Preservation of Consumers Claims and Defenses Rule*.[53] That rule applies full liability in most circumstances to assignees of loans used to purchase goods and services. The automobile dealers and other sellers of goods, among others, argued that if the rule passed that the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.[54] The finance companies and the banks argued that they did not want the responsibility of policing sellers and that sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and that the rule would interfere with free

[52] This "sky is falling" list includes – a dramatic decrease in the availability of credit, particularly effecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans as the process is so routinized and involves so many loans at any one time, that a careful review of each loan would be near impossible and would dramatically increase the cost of credit.
[53] 16 C.F.R. § 433, 40 Fed Reg. 53506 (Nov. 18, 1975).
[54] 40 Fed Reg. 53506, 53517 (Nov. 18, 1975).

competition.[55] However, there are absolutely no indications that the passage of this FTC rule has had any impact whatsoever on the availability of or cost of credit. Indeed, it appears that credit availability has continued to expand since the passage of this rule.[56]

3. Congress should enact a duty of good faith and fair dealing in the making of appraisals to support home loans, requiring appraiser's bonds, and the prohibition of communication to the appraiser about the desired appraised value, and a procedure to rewrite the loan amount if a retrospective appraisal shows the original appraisal was inflated.

4. Congress should establish a requirement of good faith and fair dealing in loan servicing, providing, among other things –

- Limits on fees and charges that can be assessed a homeowner after loan closing;
- Strict protections against the use of forced-placed insurance;
- A comprehensive right to cure defaults – to avoid foreclosures;

[55] *Id* at 53518.

[56] In 1970, the total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s and by December 1980, the total non-revolving credit in the US was approximately $297 billion. This growth continued notwithstanding the announcement and final promulgation of the holder rule. Source: Federal Reserve Statistical Release G.19 1970 through 1980.

- The requirement that alternatives to default ("work-out options") be evaluated before a foreclosure can be initiated.

5. Congress should establish a Home Preservation Loan Fund to be implemented by state housing finance agencies, which would provide money to homeowners for whom the payment of the mortgage arrearage would avoid a foreclosure, but who have the wherewithal to maintain their mortgage payments once the mortgage arrearage is paid. The funds for the payment of these arrearages would operate as "silent seconds," only required to be repaid once the first mortgage is paid off.

Borrowers with risky adjustable rate mortgages and nontraditional loans that will face steep payment increases over the coming year combined with the cooling housing market threaten to create a perfect storm that could significantly increase foreclosure rates over the next few years. Should this occur, the costs will be borne not just by homeowners, lenders, and investors but also by the communities where these loans are concentrated. Concentrated foreclosures can erode property values and put additional pressure on nearby homeowners who can see their home equity dissolve before their eyes leading to a cascade of neighborhood foreclosures. Policymakers at every level of government, the mortgage industry, and consumer and housing organizations all have a common stake in seeking workable solutions to mitigate this growing problem. The actions taken by these parties in the months ahead will determine much about whether homeownership continues to be a path for wealth building and financial stability for many borrowers. We would be delighted to work with this Committee to frame solutions to help address these concerns.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ORICE WILLIAMS

Q.1. Mortgage brokers are playing a larger role in the market today. Recent statistics show that independent brokers are responsible for about 50 percent of all originations and over 70 percent of subprime originations. Brokers definitely serve the overall market by helping consumers work with multiple lenders; however, they share little risk. Many brokers find it in their financial interest to get the borrower into a loan, regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect both consumers and lenders? What can be done to better share risk and ensure brokers are not just looking out for their own best interests?

A.1. GAO response

Certain federal consumer protection laws, including the Truth in Lending Act and the act's implementing regulation, Regulation Z, apply to all mortgage lenders and to those mortgage brokers that close loans in their own name. Regulation Z requires these creditors to provide borrowers with written disclosures describing basic information about the terms and cost of their mortgage. In our recent study on interest-only loans and payment-option adjustable rate mortgages (payment-option ARMs), we reviewed current Regulation Z requirements and found that they are generally not designed to address these complex alternative mortgage products (AMPs). For example, AMP disclosures that we reviewed did not always fully or effectively explain the risks of payment shock or negative amortization for these products and lacked information on some important loan features, both because Regulation Z does not require lenders to tailor this information to AMPs and because lenders do not always follow leading practices for writing disclosures that are clear, concise, and user friendly. As AMPs are more complex than conventional mortgages and advertisements sometimes expose borrowers to unbalanced information about them, it is important that the written disclosures that they receive about these products provide them with comprehensive information about the terms, conditions, and costs of these loans. Borrowers who do not understand their AMP may not anticipate the substantial increase in loan balance or monthly payments that could occur, and would be at a higher risk of experiencing financial hardship or even default. The Federal Reserve has recently initiated a review of Regulation Z that will include reviewing the disclosures required for all mortgage loans, including AMPs. We support this initiative, and in our report entitled *"Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could be Improved,"* (GAO–06–1021), we recommended that the Federal Reserve consider as part of its reforms requiring (1) disclosures to include language that explains key features and potential risks specific to AMPs, and (2) effective format and visual presentation.

We did not undertake a review of other federal or state laws and regulations that govern broker conduct as part of our work. However, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have publicly committed to working with state regulatory agencies to distribute guidance to licensed residential mortgage lenders and brokers that is similar to the recently issued federal interagency guidance on nontraditional mortgages. The state-based guidance will focus primarily on residential mortgage underwriting and consumer protection.

Q.2. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? If these investments cease to be worthwhile because of a housing slowdown, are we going to see large number of defaults on these loans?

A.2. GAO response

Mortgage delinquency and default rates are typically higher for borrowers who use mortgages for investment purposes than for borrowers who use them to purchase their primary residences. However, we are not in a position to comment on the likelihood of defaults related to AMPs for these borrowers in the event of a housing slowdown. Federal banking regulatory officials said that they are concerned that some recent borrowers who used AMPs to purchase homes for investment purposes may be less inclined to avoid defaulting on their loans when faced with financial distress, particularly in those instances where the borrower has made little or no down payment. Data on recent payment-option ARM securitizations indicate that 14.4 percent of AMPs originated in 2005 were used by borrowers to purchase homes for purposes other than use as a primary residence, up from 5.3 percent in 2000. However, these data did not show the proportion of these originations that were used to purchase homes for investment purposes as compared to second homes and did not indicate the size of the down payment the borrower had made.

Q.3. Are borrowers who have taken non-traditional mortgages in recent years using these products to buy bigger and better homes than they otherwise could afford or are they using these products simply to be able to get into the market? In other words, are the mortgages being used to finance basic needs or luxury desires?

A.3. GAO response

No data are available that would allow us to discern the number of borrowers that were using AMPs for one purpose or the other. However, officials from the Federal Deposit Insurance Corporation have reported anecdotally that some borrowers, often first time homebuyers, used these products to purchase higher priced homes than they could have qualified for using conventional mortgages. As discussed in greater detail below, AMP lending has been concentrated in those regional real estate markets where homes are least affordable.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market, because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas of suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in the coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. GAO response

We found that AMP lending has been concentrated in the higher-priced regional markets on the East and West coasts, where homes are least affordable and prices have appreciated more rapidly than in other areas of the country. Although the inability to make higher monthly payments could cause AMP borrowers to default on their loans, job loss, divorce, serious illness, and a death in the family are commonly identified as the major reasons borrowers default on their mortgages, as in each of these examples, the borrower can experience a major drop in income, or a major increase in expenses. To the extent that any regional markets with high concentrations of AMP lending experience a local recession, local AMP borrowers may be more vulnerable to default than other borrowers. For example, these borrowers may not have funds to meet the higher monthly payments or enough equity in their homes to refinance or sell if local housing prices drop and they have borrowed with little or no down payment or have allowed their loans to negatively amortize.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SANDRA BRAUNSTEIN

Q.1. Mortgage brokers are playing a larger role in the market today. Recent statistics show that independent brokers are responsible for about 50 percent of all originations and over 70 percent of subprime originations. Brokers definitely serve the overall market by helping consumers work with multiple lenders; however, they share little risk. Many brokers find it in their financial interest to get the borrower into a loan, regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share risk and ensure brokers are not just looking out for their own best interests?

A.1. The Federal Reserve Board held hearings in 2006 on the home equity lending market, which included testimony from consumer advocates, mortgage brokers and lenders about consumers' view of the role mortgage brokers play in offering mortgage products and whether consumers' understanding of that role has been furthered by state-required mortgage broker disclosures. In answering your questions, I would like to share with you some highlights of the testimony and public comments regarding the adequacy of current and potential steps for improving consumer protection. Efforts to regulate mortgage brokers at the federal level should include a careful consideration of the issues raised at these hearings.

At the hearings, many consumer advocates questioned the adequacy of current law governing mortgage brokers. They testified that while brokers may provide a valuable service to consumers and lenders, some brokers steer consumers to loans that provide the most compensation for the broker, regardless of the consumer's needs. Furthermore, advocates testified, consumers generally do not understand that brokers are independent agents and are not required to find the best loans for consumers. They stated that in the subprime market, consumers tend to rely on a "trusted advisor" when making decisions about which loan to select, and may follow a mortgage brokers' recommendation without doing independent research. Representatives of mortgage brokers testified that the growth of the mortgage broker industry has expanded product and pricing options for many consumers, but has also led to an increase in the number of uneducated and unlicensed loan originators, including brokers. Mortgage broker trade associations indicated that they have developed best practices and a code of ethics to address these concerns. Brokers also testified that state and federal agencies have not adequately enforced existing laws against the "bad actors" in the mortgage market, in part because funds for enforcement are inadequate.

Consumer advocates offered varying solutions to revise laws to address concerns about mortgage brokers, including requiring brokers to be the exclusive agent of the borrower in all cases. Some advocated suitability standards to counter a broker's incentive to sell consumers loans that do not necessarily fit the consumer's needs and financial situation. Mortgage broker representatives rejected the notion that a broker should be the agent or fiduciary of the consumer and should select the best loan for the consumer. They noted that a broker may not have access to the best product available in a given market and argued that only consumers can determine the best loan for themselves.

There was also testimony from state officials on state efforts to regulate and license mortgage brokers. For example, Pennsylvania officials described their efforts to regulate and license brokers and other loan originators and to cooperate with other states to monitor broker activity. Brokers expressed strong support for state licensing efforts and advocated criminal background checks for all mortgage loan originators including brokers and employees of banks and mortgage companies. Lenders testified that they support current efforts by the states to license and monitor brokers. State-required mortgage broker disclosures have helped somewhat, according to lenders who addressed the question, but they also noted that consumers are already confronted with too many documents throughout the mortgage process for disclosure to have much impact.

Some lenders also stated that consumer education about the loan shopping process is the best way to overcome confusion about mortgage brokers' roles. In addressing concerns about mortgage brokers, some lenders emphasized the need for a uniform federal response rather than enacting different state laws.

Q.2. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? If these investments cease to be worthwhile because of a housing slowdown, are we going to see large numbers of defaults on these loans?

A.2. The portion of home sales accounted for by investors, as opposed to owner-occupants, has risen in recent years. According to data collected under the Home Mortgage Disclosure Act, the share of reported mortgage loans (both traditional and nontraditional) associated with nonowner-occupied properties hovered between 5 and

6 percent in the first half of the 1990s but has climbed fairly steadily since and reached 17 percent in 2005.

Some of the recent increase in the investor share of the residential housing market has undoubtedly been spurred by the expectation that prices would continue to rise rapidly rather than by an interest in retaining the property over time for rental income. Past loan performance has indicated that investors are more likely than owner-occupants to default on a loan when house prices decline. As a result, there may be some deterioration in the credit quality of mortgages extended to investors now that house prices are no longer rising as rapidly as they had been. As yet, though, delinquency rates for mortgages (both traditional and nontraditional) on nonowner-occupied properties remain low. That said, the Board is, of course, watching for signs of an increase in defaults among investors, and we have urged lenders to recognize the risks associated with such an increase.

Q.3. Are borrowers who have taken nontraditional mortgages in recent years using these products to buy bigger and better homes than they could otherwise afford or are they using these products simply to be able to get into the market? In other words, are the mortgages being used to finance basic needs or luxury desires?

A.3. The required monthly payment associated with a nontraditional mortgage can be substantially lower than the payments would be for a more traditional mortgage loan of similar size, at least for some period. Thus, as I noted in my testimony, nontraditional mortgage products have allowed some borrowers to purchase homes that they otherwise might not be able to afford. However, the Board is not able to judge, nor should it judge, whether a particular home satisfies a basic need for a given household or whether it represents a luxury item for that household, as that question involves far-reaching issues about appropriate standards of living in our country.

What is important to the Board is that consumers fully understand the commitments they make when taking on nontraditional mortgages and the risks they could face in light of deferring principal and/or interest payments. For this reason, the Board is actively engaged in efforts to enhance the information available to borrowers regarding these loans. The various initiatives I discussed in my testimony—the Board's review of federally required disclosures on mortgages, its public hearings on home equity lending, its planned and completed revisions to consumer education publications, and elements of the interagency regulatory guidance on nontraditional mortgage products—are all examples of these efforts.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market, because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. Many factors can contribute to borrowers defaulting on their mortgages, including house price declines, disruptions to income, and changes in required mortgage payments for which borrowers are unprepared. The first two of these factors are often concentrated in certain regions and thus mortgage-related distress has also often been concentrated.

Nontraditional mortgages have become more prevalent throughout the nation. It is also the case that nontraditional mortgages are likely to lead some households into financial distress through the last of the channels mentioned above—large changes in required payments. However, changes in required payments on nontraditional mortgages are unlikely to pose a large threat to the national economy or to the financial system overall. One factor limiting the risks is that, in most cases, the payment changes will not occur for some time; for example, industry reports suggest that most interest-only mortgages do not start requiring repayment of principal for at least five years, if not ten or fifteen years. Many borrowers will have sold their homes or refinanced into a different mortgage by this time. In addition, efforts to raise consumer awareness of the terms and features of nontraditional mortgage payments, such as those being undertaken by the Board that I mentioned in my testimony, should encourage households who retain their nontraditional mortgages to make active efforts to prepare for major scheduled increases in their payments.

Of course, certain nontraditional mortgages have not been tested in a stressed environment. Given this newness, the Board is closely watching for signs that household financial distress is becoming more widespread as more borrowers face increases in the required payments on their nontraditional mortgages.

Q.5. Again, I would like each of you to answer this question quickly: Will the proposed guidance in combination with an update of Regulation Z be enough to stop overly risky lending practices? Or is something stronger needed?

A.5. The nontraditional mortgage guidance advises institutions to ensure that their risk management and consumer protection practices adequately address the risks discussed in the document. Through the examination process, the Board and the other federal bank and thrift agencies will review institutions' risk management and consumer protection practices, and institutions that do not adequately address these risks will be asked to take remedial action. An institution that follows the principles outlined in the guidance should be operating within acceptable boundaries of risk. However, many institutions that originate residential mortgages are not federally regulated and are not covered by the guidance. In an attempt to level the playing field between federally and non-federally regulated institutions, the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators released similar guidance. Each state banking agency must decide whether or not to enforce those guidelines or make changes.

The nontraditional mortgage guidance's recommended practices for marketing such mortgages to consumers should help consumers get the information they need at critical decisionmaking times so that consumers can make informed choices about mortgage products. To supplement the guidance, the agencies are seeking comment on proposed illustrations that show how an institution might inform consumers about the features and risks of nontraditional mortgage products.

The Board's upcoming review of Regulation Z's mortgage disclosure rules will aim to improve the information that lenders must provide to consumers. In addition, the Board's staff is working with staff at the Office of Thrift Supervision to finalize revisions to the Consumer Handbook on Adjustable Rate Mortgages (the CHARM booklet) to include information about alternative mortgage products. The CHARM booklet is an effective means of delivering information to consumers, because Regulation Z requires that all creditors—not just those supervised by the bank and thrift agencies—provide the CHARM booklet or a suitable substitute to each consumer who receives an application for an ARM. The Board and the Office of Thrift Supervision plan to issue the revised CHARM booklet later this year. Finally, on October 19, 2006, the Board and the other federal bank and thrift agencies issued a brochure, Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You? to help consumers make more informed choices when considering nontraditional mortgage loans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SANDRA BRAUNSTEIN

Q.1. The importance of actual verification of a borrower's income, assets, and outstanding liabilities increases as the level of credit risk increases. When is reduced documentation underwriting appropriate, if at all? What mitigating factors should be in place?

A.1. Mortgage lenders are increasingly relying on reduced documentation, particularly unverified income, to underwrite nontraditional mortgages as well as other types of loans. The industry states that automated underwriting systems that incorporate credit scores, employment history, loan-to-value (LTV) and debt-to-income (DTI) ratios, among other borrower and product attributes have become a strongly predictive indicator of creditworthiness while eliminating the potential for bias in the underwriting decision. Through the development of technology, automated underwriting systems and other credit scoring models have become more robust and predictive allowing lenders to streamline the underwriting process and lower costs to borrowers while effectively managing risk.

The final nontraditional mortgage guidance provides that when lenders rely on reduced documentation, automated underwriting systems, and credit scoring models, there should be mitigating factors that support the decision. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other factors.

Q.2. How will the federal agencies implement this guidance in a consistent manner and how will you coordinate with your state counterparts?

A.2. I anticipate that the agencies will coordinate their implementation of the guidance through the Federal Financial Institutions

Examination Council (FFIEC), which was created to ensure uniformity in supervision of federally supervised financial institutions. The Financial Services Regulatory Relief Act of 2006 requires the current State Liaison Committee to the FFIEC to elect a Chairperson, and to add this Chairperson as a full voting member of the FFIEC. This should help to ensure coordination with state agencies.

Q.3. The proposed guidance strongly encourages institutions to increase monitoring and loss mitigation efforts (i.e., establishing portfolio limits, measuring portfolio volume and performance, providing comprehensive management information reporting). How do you respond to lenders who argue that such increases would restrict lender flexibility and reduce consumer choice? Will these increased efforts potentially drive up banks' underwriting costs, which will hurt consumers?

A.3. Because lenders do not have significant experience with nontraditional mortgage products in a stressed economic environment, they should have prudent risk management practices in place to ensure that these portfolios are administered in a safe and sound manner. As home price appreciation slows and interest rates increase, the potential for defaults caused by lack of sufficient borrower equity and payment shock is also increasing. Nontraditional mortgage portfolios may behave differently when compared to more traditional portfolios that do not contain as many embedded risks. Systems should be in place to determine how severely a stressed environment could affect borrowers and portfolios. Strategies should be developed to minimize the effect of deteriorating conditions on borrowers identified as at risk. Institutions involved in the origination and servicing of nontraditional mortgages should ensure that risk management practices keep pace with the growth and changing risk profile of their portfolios. These increased efforts should minimize defaults and losses which will benefit both lenders and borrowers and result in lower costs and increased product choice in the long run.

Q.4. The GAO found federally-regulated institutions today already underwrite option ARMs at the fully indexed rate. That is good, but isn't it better to also consider the potential balance increase associated with the negative amortization feature? How many of the institutions are considering this in their underwriting?

A.4. While most institutions underwrite option ARMs at the fully indexed rate, very few, if any, institutions also consider the potential balance increase associated with the negative amortization feature. Institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the full amount of credit that may be extended. The final nontraditional mortgage guidance advises institutions that their analysis of a borrower's repayment capacity should also be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.

Q.5. Should lenders be required to underwrite the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule? If not, why and what circumstances would prevent them from doing so?

A.5. Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. An institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value ratios, high debt-to-income ratios, and low credit scores. To account for this, the nontraditional mortgage guidance advises that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. Recognizing that an institution's underwriting criteria are based on multiple factors that may vary by a product's attributes and borrower characteristics, the guidance advises that an institution may develop a range of reasonable tolerances for each underwriting factor.

Q.6. The GAO recommends improved consumer disclosure by requiring language with an effective format and visual presentation that explains key features and potential risks specific to nontraditional lending products. What else could be done to improve the clarity and comprehensiveness of nontraditional mortgage products to consumers?

A.6. As part of its review of the effectiveness of closed-end credit disclosures under Regulation Z, including disclosures for nontraditional mortgages, the Board will be conducting extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what language and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload. To that end, the Board will be using design consultants to assist in developing model disclosures that are most likely to be effective in communicating information to consumers. The Board also plans to use consumer testing to assist in developing model disclosure forms. Based on this review and testing, the Board will revise Regulation Z within the existing framework of TILA. If the Board determines that useful changes to the closed-end disclosures are best accomplished through legislation, the Board would develop suggested statutory changes for congressional consideration.

Q.7. Most recently issued nontraditional lending products do not reset until 3 to 5 years after origination and have not yet reached their reset period. The payment shock for option ARMs can be substantial if interest rates stay flat and much worse if rates increase. When underwriting, what interest rate scenarios are banks using: flat, rising, declining, or all combinations? How are the various rate scenarios described to consumers during both the origination and repayment phases?

A.7. Currently, our supervisory experience and research show that most institutions that originate option ARMs are underwriting these loans at the fully indexed interest rate. The rate is determined using data available at the time of origination with no projection of future interest rates. However, and with respect to all types of ARMs, this practice can change based on lenders' view of the future path of interest rates. In the past, during times of rapidly increasing interest rates, many lenders chose to underwrite ARMs at a rate above the then current fully indexed rate. Their decisions with respect to the appropriate underwriting rate are based on a number of factors including capital market preferences, the outlook for interest rate increases or decreases, and other lenders' practices. Over time, underwriting practices have changed to conform to market conditions and it is reasonable to expect that this will continue.

Q.8. What issues regarding nontraditional mortgage products have come up since your draft guidance was issued or do you believe have not been addressed by your guidance? What, if any, plans do you have to address these issues in the future?

A.8. Following your hearing, the agencies issued final guidance on September 29, 2006. The agencies also supplemented the guidance by publishing for comment illustrations showing how institutions might provide consumers with information recommended in the guidance. The public comment period ended on December 4, 2006, and the agencies are reviewing the public comment letters.

Since the guidance and illustrations were published, lenders and community groups have expressed concerns about whether the guidance applies to certain hybrid ARM products that are prevalent in the subprime market (i.e., "2/28" and "3/27" loans in which the rate is fixed for two or three years at a discount substantially below the current index and margin). The agencies are discussing whether those products warrant further guidance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SANDRA THOMPSON

Q.1. Mortgage brokers are playing a larger role in the market today. Recent statistics show that independent brokers are responsible for about 50 percent of all originations and over 70 percent of subprime originations. Brokers definitely serve the overall market by helping consumers work with multiple lenders; however, they share little risk. Many brokers find it in their financial interest to get the borrower into a loan, regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share the risk and ensure brokers are not just looking out for their own best interest?

A.1. The FDIC also is concerned about protecting the interests of consumers and lenders. It is troubling that a broker may benefit from placing a borrower into a loan that he/she cannot afford, while both the borrower and the lender may suffer a loss.

The Interagency Guidance on Nontraditional Mortgage Products (NTM Guidance) stresses, among other things, the need for federally regulated lenders to implement strong control systems over third parties involved in the lending process. Undertaking due diligence to ensure that mortgage brokers are properly licensed is a basic step in a control system. Also, oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's own internal lending standards and are in compliance with applicable laws and regulations. To do this, institutions should track the quality of loans by mortgage broker, which will help management identify problems with a particular broker. If loan documentation, credit problems, or consumer complaints are discovered, the institution should take immediate action. Corrective action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third party relationship. Finally, institutions are expected to design their third party compensation agreements in a way that will avoid providing incentives for originations that are inconsistent with the applicable guidance, laws, and the institution's own lending standards.

Mortgage brokers do not come under the purview of the federal banking agencies, but they are regulated by certain state organizations. The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) have distributed guidance to state agencies that regulate residential mortgage brokers. The CSBS/AARMR guidance substantially mirrors the interagency NTM Guidance, except for the deletion of sections not applicable to non-depository institutions.

This guidance will help state regulators promote consistent regulation in the mortgage market and clarify how non-depository institution providers, including mortgage brokers, can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume. CSBS is working with the state regulatory agencies to adopt this guidance for the non-federally insured organizations they regulate.

CSBS and AARMR also are developing a national licensing system for the residential mortgage industry that will enhance consumer protection and streamline the licensing process for regulators and the industry. Among other things, this system will provide public access to a central repository of licensing and publicly adjudicated enforcement actions. The system will increase the accountability of mortgage companies and mortgage professionals and assist the regulatory agencies in keeping bad actors out of the mortgage business.

Q.2. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? If these investments cease to be worthwhile because of a housing slowdown, are we going to see large numbers of defaults on these loans?

A.2. At this point, it is impossible to predict which of these loans may default since many factors affect loan performance. To date, these types of loans have not resulted in large numbers of defaults. However, many of the loans have low initial interest rates and reset dates in later years that may create payment stress for some borrowers in the future. There is a greater risk of default by investors than by individuals financing their residence.

Q.3. Are borrowers who have taken non-traditional mortgages in recent years using these products to buy bigger and better homes than they otherwise could afford or are they using these products simply to be able to get into the market? In other words, are the mortgages being used to finance basic needs or luxury desires?

A.3. Both the rate of homeownership and levels of new home construction have reached all-time highs in recent years. It is reasonable to conclude that low mortgage interest rates and greater flexibility in mortgage terms and structures allowed more households to buy their first homes and allowed others to afford larger and higher-quality homes than would otherwise have been the case. However, trying to differentiate these purchases into "needs" versus "wants" is a more difficult question.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market, because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in the coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. As Mr. Brown testified, FDIC analysts have found that true metro-area housing price "busts" resulting in severe credit losses for mortgage lenders have been relatively rare historical events. Almost exclusively, these episodes occurred in areas that have experienced severe local economic distress, such as the "oil patch" in the late 1980s. There is some indication that this historical trend is continuing. While the prevalence of nontraditional mortgages has generally been higher in the coastal boom markets, the most significant credit distress to this point has been observed in the upper Midwest, where home prices have not boomed and where nontraditional mortgages remain less prevalent. These observations tend to support the notion that local economic conditions will continue to be the most important determinants of home prices and mortgage credit defaults.

The most common aftermath of local housing booms has been an extended period of price stagnation. This period of stagnation may be associated with small price declines and is usually stressful for homeowners, home builders, and real estate professionals. But stagnation is not usually associated with severe losses for mortgage lenders. In such an environment, most homeowners have little incentive to sell their home at a loss or default on their mortgage and will typically wait out the down market.

While a further increase in delinquency and foreclosure rates can reasonably be expected over the next few years, massive defaults appear unlikely. A national analysis of mortgage payment resets undertaken by First American Real Estate Solutions puts the volume of potential loss associated with interest rate resets into perspective, finding that the volume of ARM defaults is likely to remain relatively small compared to overall mortgage originations.

Q.5. Again, I would like each of you to respond quickly: Will the proposed guidance in combination with an update in Regulation Z be enough to stop overly risky lending practices? Or is something stronger needed?

A.5. The NTM Guidance clarifies the federal banking agencies' expectations with respect to underwriting these mortgages, as well as the information that consumers should receive so that they understand the potential risks. In addition to the NTM Guidance, the agencies proposed Illustrations of Consumer Information for Nontraditional Mortgage Product Risks for comment. The Illustrations are intended to assist institutions in implementing the consumer information portion of the NTM Guidance. Coupled with strong supervisory oversight, the Illustrations, the NTM Guidance, and an updated Regulation Z should preclude the need for additional legislation or regulation,

Q.6. In your testimony, you talk about lenders reducing their risk by selling mortgages on the secondary market. First, who has been buying these non-traditional mortgages on the secondary market? And second, have insured institutions reduced their risk to a safe-enough level?

A.6. A strong appetite for U.S. mortgage instruments on the part of U.S. and global investors has been a key to the expansion of this market. These investors have been willing to purchase mortgage asset-backed security issues all along the risk spectrum, which has been critical to banks' ability to securitize nontraditional mortgage debt. This securitization has done a great deal to diversify the risks of nontraditional mortgage loans to investors around the world, including investors who are better able to bear these risks than are FDIC-insured institutions. At the same time, there is a risk that at some point this strong appetite for U.S. nontraditional mortgage paper could wane, which may make these mortgages less available to consumers.

Banks and thrifts are actively engaged in virtually every facet of mortgage lending, as originators, as servicers, and as holders of mortgage loans. In this latter capacity, lending institutions can face significant challenges in managing both credit risk and interest rate risk. They typically address these challenges by applying strong underwriting guidelines, seeking geographic diversification, and, in some cases, by using interest-rate swaps and other tools to manage interest rate risk.

Securitization represents an important tool that mortgage lenders can use to manage credit and interest rate risks. Moving mortgage assets off the balance sheet into structured pools allows securitizers to create credit enhancements, achieve geographic diversification, and more finely manage the maturity structure of mortgage obligations.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SANDRA THOMPSON

Q.1. The importance of actual verification of the borrower's income, assets, and outstanding liabilities Increases as the level of credit risk increases. When is reduced document underwriting appropriate, if at all? What mitigating factors should be in place?

A.1. The NTM guidance does not limit reduced documentation loans to any particular set of circumstances. The final guidance recognizes that mitigating factors, such as higher credit scores, lower loan-to-value and debt-to-income ratios, significant liquid assets, mortgage insurance, or other credit enhancements may determine whether such loans are appropriate.

Q.2. How will the federal agencies implement this guidance in a consistent manner and how will you coordinate with your state counterparts?

A.2. As deposit insurer, the FDIC works with all of the agencies to ensure that risk to the deposit insurance fund is minimized. We regularly coordinate our examinations closely with state banking supervisors and we are able to participate in any examination where risk to the fluid may be elevated. This close coordination with the other agencies allows us to ensure that the NTM Guidance is implemented consistently.

Further, the FDIC, the Federal Reserve, and the state banking authorities utilize common examination procedures and documentation tools, which will aid in the consistent application of this guidance. Additionally, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) have issued similar guidance for non-bank financial service providers under state jurisdiction to address the potential for inconsistent regulatory treatment of lenders based on whether or not they are federally regulated. CSBS is working with states to adopt the guidance for the non-federally insured organizations they regulate

Q.3. The proposed guidance strongly encourages institutions to increase monitoring and loss mitigation efforts (i.e. establishing portfolio limits, measuring portfolio volume and performance, providing comprehensive management information reporting). How do you respond to lenders who argue that such increases would restrict lender flexibility and reduce consumer choice? Will these increased efforts potentially drive up banks' underwriting costs, which will hurt consumers?

A.3. The regulatory agencies believe that the NTM Guidance provides adequate flexibility in the methods and approaches to mitigating risk while simultaneously promoting prudent underwriting practices and informed consumer decision-making. The principles in the guidance are basic tenets of sound underwriting, which the agencies have long emphasized.

The NTM Guidance is intended to encourage institutions to communicate clearly with consumers. These increased efforts should not drive up underwriting costs and may minimize consumer complaints and foster good customer relations. In the long run, accurate communication may translate into reduced overall costs.

Q.4. The GAO found federally-regulated institutions today underwrite option ARMS at the My-indexed rate. This is good, but isn't it better to also consider the potential balance increase associated with the negative amortization feature? How many of the institutions are considering this in their underwriting?

A.4. The NTM Guidance specifies that federally regulated institutions should qualify borrowers at the maximum amount of principal that could accrue through negative amortization. The amount of potential negative amortization depends on the spread between the introductory rate and the index or accrual rate. A small spread could cause the potential negative amortization to be less than the limit established by the negative amortization cap. The borrower should be qualified based on this lower maximum loan balance than the full amount specified per the negative amortization cap.

The Call Report information that institutions provide on a quarterly basis does not distinguish between traditional and nontraditional adjustable rate mortgage (ARM) home loans. Therefore, it is not feasible to identify with absolute certainty how many banks are offering these products. Beginning in March 2007, the Call Report will be changed to include information on payment option ARMs, which will allow us to identify with certainty the institutions that are offering those products.

Based on examination activities, the FDIC has very few institutions offering payment option ARMs. A recent review of institutions with total assets of $1 billion or more and located in areas experiencing rapid home price appreciation identified only two FDIC supervised institutions that offer payment option ARMS. Both of these banks have conservative underwriting standards, adequate compliance programs, and overall satisfactory ratings.

Q.5. Should lenders be required to underwrite the borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule? If not, why and what circumstances would circumvent them from doing so?

A.5. Prudent lending practices generally dictate that borrowers should be qualified for a loan on the fully-indexed interest rate and on a fully amortizing basis. However, it also is reasonable to qualify borrowers for products and terms that meet their specific financial needs. For example, institutions may want to qualify borrowers with unique cash flow circumstances or short-term residency needs (i.e., anticipate moving in two to three years), on an interest-only basis.

Q.6. The GAO recommends improved consumer disclosure by requiring language with an effective formal and visual presentation that explains key features and potential risks specific to nontraditional lending products. What else could be done to improve the clarity and comprehensiveness of nontraditional mortgage products to consumers?

A.6. Efforts in several areas could help improve the clarity of information that consumers receive about nontraditional mortgages. The Federal Reserve Board's review and update of the Truth in Lending regulation (Regulation B) will be a critical component for ensuring that consumers receive clear information about key features of these and other mortgage products. The current regulation was designed at a time when products were much simpler. An updated regulation is needed to address the complexities of new mortgage products and to provide for changes in the future.

In addition, state regulation of mortgage brokers is essential. Many consumers rely on brokers for advice and assistance in obtaining and understanding home loans. The FDIC and other banking regulators will work with our state regulatory counterparts to find ways to ensure that brokers provide fair and accurate information. In addition, as we indicated in the NTM Guidance, we will ensure that banks properly oversee third parties with which they do business -including molt e brokers—to ensure that those parties adhere to the same standards we expect of banks.

Q.7. Most recently issued nontraditional lending products do not reset until 3 to 5 years after origination and have not yet reached their reset period. The payment shock for option ARMs can be substantial If Interest rates stay fiat and much worse if rates increase. When underwriting, what interest rate scenarios are banks using: Hat, rising, declining, or all combinations? How are the various rate senarios described to consumers during both the origination and repayment phases?

A.7. Loan originators use current market interest rates when underwriting borrowers and do not forecast what the index rate will equal at the time the loan recasts. The NTM guidance specifies that federally-insured institutions should qualify borrowers on a fully-indexed, fully amortizing basis. This prudent underwriting practice ensures a borrower has the capacity to repay the loan based on the current index rate rather than the introductory rate rather than the introductory rate or a projected index rate.

- Pursuant to the Truth in Lending Act, lenders must provide ARM pro disclosures when borrowers receive an application form or before they pay on-refundable application fee and then again during the repayment period.
- An institution's ARM program disclosures must provide an historical example (based on a $10,000 loan amount) illustrating how the payments and loan balance would have been affected by interest rate changes under the terms of the particular loan program. The illustration must be based on the program's index values over the previous 15 years.
- During the repayment period, disclosures must be provided when the interest rate adjusts, whether or not there is a payment change. Disclosures must be provided annually if there is not a payment adjustment. If there is a payment adjustment, disclosures must be provided at least 25 but no more than 120 days before a different payment amount is due.
- These disclosures provide the current and prior interest rates, the index values on which he interest rates are based, the extent to which the lender may have foregone rate increases, and the contractual effects of the interest rate adjustment (including the new payment due and the loan balance).
- If the payment due after the interest rate adjustment will not fully amortize the loan over the remainder of the loan team at the new interest rate, then there must be a statement of went would fully amortize the loan.

Q.8. What issues regarding nontraditional mortgage products have come up since your draft guidance was issued or do you believe have not been addressed by your guidance? What, if any, plans do you have to address these issues in the future?

A.8. At the September 20 hearing, the Center for Responsible Lending testified that certain loan products, particularly hybrid ARMs like so-called 2/28s, may carry the same potential for payment shock as nontraditional mortgages. While some of these loans do not seem to be included in our definition of nontraditional mortgages because there is some principal amortization, we nevertheless expect to direct our examiners to be alert for such products.

The agencies also are considering whether to issue additional guidance or other communications to address subprime products with the potential for significant payment shock such as 2/28s.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SCOTT ALBINSON

Q.1. Mortgage brokers are playing a larger role in the market today. Recent statistics show that independent brokers are responsible for about 50 percent of all originations and over 70 percent of subprime originations. Brokers definitely serve the overall market by helping consumers work with multiple lenders; however, they share little risk. Many brokers find it in their financial interest to get the borrower into a loan, regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share risk and ensure brokers are not just looking out for their own best interests?

A.1. Brokers are often the primary contact borrowers have when seeking a mortgage loan. Many federally regulated financial institutions rely on them to supplement their own loan production, and for some institutions, brokers are the primary production source. OTS requires savings associations to establish prudent written lending standards and to underwrite all loans in accordance with those standards. This is the requirement regardless of the origination source of a loan.

For loans originated by mortgage brokers, institutions are also expected to monitor broker performance and consumer complaint activity associated with individual brokers on an ongoing basis. Federally-regulated financial institutions are expected to evaluate all loans supplied to them by brokers. For loans purchased from a broker, we expect institutions to ensure that the broker has abided by all applicable laws, regulations, and policy guidelines, including prudent underwriting standards as well as consumer protection and disclosure information (Regulation Z, RESPA, Fair Lending, and other disclosure requirements that all mortgage lenders must abide by).

While we expect thrifts to monitor the lending activity of brokers with respect to the loans they purchase from a broker, institutions cannot monitor or control loans a broker originates for nonregulated lenders and brokers. State regulatory authorities typically supervise these activities. Better coordination between Federal and state regulators may be helpful in ensuring greater consistency in regulatory oversight and control of predatory mortgage brokers and serve to reign in self-serving brokers. To this end, OTS maintains working relationships with state regulatory authorities and frequently consults with the Conference of State Bank Supervisors in this and similar areas of regulatory and supervisory overlap.

Q.2. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? If these investments cease to be worthwhile because of a housing slowdown, are we going to see large numbers of defaults on these loans?

A.2. Investors have played a role in the housing market for many years. In recent years, however, there has been an increase in less sophisticated investors purchasing properties with the intention of flipping them as prices increase. In some markets, this influx of "new" investors has reportedly fueled part of the rise in home prices over the past few years. Although investor-owned mortgages have remained steady since 1991 at approximately 4 percent of total mortgages, that level has gradually increased from 3.93 percent in June 2002 to 4.76 percent in June 2006.

Loan performance data show that investor-owned mortgages have performed on par with owner-occupied mortgages. For example, before the 2000–2006 real estate boom, owner-occupied properties performed somewhat better than investor properties. Since the boom, investor mortgages have outperformed owner-occupied mortgages. In June 2006, the ratio of seriously delinquent investor-owned mortgages was 0.41 percent, and seriously delinquent owner-occupied mortgages was 0.46 percent of total mortgages, respectively. While the levels have varied since 1991, the variance has remained very low.

The highest levels of investor-owned mortgages are in several Western states. The largest increases were in Nevada, Hawaii and Idaho. California investor-owned mortgages grew from 5.7 percent to 6.4 percent since 2000. Nevada, however, went from 4.7 percent to 8 percent in the same period. The Midwest region of the U.S. had the lowest overall levels of investor-owned mortgages.

The states with the highest levels of investor-owned properties all experienced the lowest delinquencies. Nevada's investor-owned mortgage delinquency was at 0.13 percent, Idaho's was at 0.14 percent, Hawaii's was at 0.05 percent, and California's was at 0.07 percent.

While this data may seem counterintuitive, most federally regulated financial institutions, including thrifts, maintain more stringent underwriting requirements for loans secured by investor-owned properties than they require for owner occupant properties. These may include requirements for higher down payments, higher minimum credit scores, higher interest rates, and higher borrower income and liquidity.

Thus, on an industry wide perspective, we see minimal overall risk from investor-owed mortgages. Nevertheless, there are some regional variances and we are monitoring this activity carefully.

Q.3. Are borrowers who have taken non-traditional mortgages in recent years using these products to buy bigger and better homes than they otherwise could afford or are they using these products simply to be able to get into the market? In other words, are the mortgages being used to finance basic needs or luxury desires?

A.3. We do not have specific data that addresses borrower motivation. Loan documents typically only indicate the loan purpose ("purchase" or "refinance"). Borrowers have used non-traditional mortgages for different reasons:

- To provide payment flexibility when borrower income is not evenly distributed throughout the year;
- To purchase a more expensive home they would not have otherwise been able to afford;

- To purchase their first home in an expensive housing market; and
- To refinance an existing mortgage and possibly roll into the new first mortgage a second mortgage or other household debt.

The advantage to borrowers of most nontraditional mortgage loan products is the low initial monthly payments that can help with the borrower's cash flow and give the impression that the loan is more affordable. A large portion of option ARM loans are secured by expensive homes. Since 2000, 76.8 percent of option ARMs, 66.3 percent of ARMs, and 28.7 percent of fixed-rate mortgages were greater than $400,000, which is above the national median home price.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market, because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in the coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. To date, the economic data available to us support Mr. Brown's statement that it is unlikely that we have a nationwide crisis in the housing market. Historically, systemic market crashes have been preceded by high interest rates, high unemployment, and decreasing home prices. High unemployment reduces consumer demand; high interest rates make homes less affordable; and both contribute to the lower demand for new and existing homes. While such a confluence of events is possible, there are no current indicators that it is likely to occur on a nationwide basis.

Instead, it appears more likely that any upcoming housing market weakness will be limited to regions of the country where local housing prices have advanced beyond personal incomes and/or have overheated beyond where current buyers are willing to enter the market. Our loan performance data validates this. Except for the subprime mortgage market, mortgage loan performance has remained very strong throughout 2005 and 2006. For example, during the first half of 2006, delinquencies in prime mortgages were 0.47 percent, the lowest point in our 1991–2006 database. However, subprime mortgage delinquencies were 5.2 percent in September 2006, up from 3.6 percent a year ago.

Q.5. Again, I would like each of you to answer this question quickly: Will the proposed guidance in combination with an update of Regulation Z be enough to stop overly risky lending practices? Or is something stronger needed?

A.5. The Agencies issued the nontraditional mortgage guidance on October 4, 2006. It applies to all federally regulated financial institutions as well as their subsidiaries and affiliates. We believe the guidance, together with improved consumer disclosure and close supervision, will stem overly risky lending practices at federally-regulated financial institutions. The Conference of State Bank Supervisors (CSBS), whose members regulate state-licensed mortgage companies, issued similar guidance, along with the American Association of Residential Mortgage Regulators (AARMR), to its members on November 13, 2006. Thus, guidance on nontraditional mortgage lending products has been issued and is applicable to both state- and federally-regulated mortgage originators. The effectiveness of the guidance, of course, will depend on the application of the guidance by all regulators. It is our hope that similar guidance issued by both federal and state regulatory authorities will be effective in curtailing overly risky lending by all mortgage lenders.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SCOTT ALBINSON

Q.1. The importance of actual verification of the borrower's income, assets, and outstanding liabilities increases as the level of credit risk increases. When is reduced documentation underwriting appropriate, if at all? What mitigating factors should be in place?

A.1. We do not feel that reduced documentation loans are appropriate for many borrowers, especially salaried individuals and those with easily documented incomes. Reduced documentation was originally used for self-employed borrowers and those with irregular incomes who find it difficult to provide three years of tax returns, financial statements, and other documents typically needed for fully documented loans. Lenders found that it was less time consuming and less expensive to underwrite loans with less documentation, relying primarily on a borrower's stated income, credit history and credit score, in addition to other risk factors, such as the loan-to-value ratio, loan purpose, and debt-to-income ratios. Some institutions also require minimal documents such as the borrower's most recent payroll statement.

We are concerned that some borrowers may be pushed into reduced documentation loans because it is easier (and more lucrative) for brokers. And if reduced documentation loans will cost more than full documentation loans, borrowers should be informed of the difference and given the option to select which is best option for them.

Q.2. How will the federal agencies implement this guidance in a consistent manner and how will you coordinate with your state counterparts?

A.2. The guidance will be applied consistently among all the Federal financial institution supervisory agencies. In addition, CSBS and the AARMR have adopted similar guidance for the lenders their members supervise.

Q.3. The proposed guidance strongly encourages institutions to increase monitoring and loss mitigation efforts (i.e. establishing portfolio limits, measuring portfolio volume and performance, providing comprehensive management information reporting). How do you respond to lenders who argue that such increases would restrict lender flexibility and reduce consumer choice? Will these increased efforts potentially drive up banks' underwriting costs, which will hurt consumers?

A.3. These measures are typically required for most lenders based on the size, risk and complexity of their lending programs. Depending on how the loans are underwritten and structured, nontraditional loans could add an extra element of risk. Such risk management measures are necessary to allow institutions to identify, measure, monitor and control these additional risks.

Q.4. The GAO found federally regulated institutions today already underwrite option ARMS at the fully indexed rate. That is good, but isn't it better to also consider the potential balance increase associated with the negative amortization feature? How many of the institutions are considering this in their underwriting?

A.4. The Nontraditional Mortgage Guidance issued in October 4, 2006 requires all institutions to underwrite option ARM loans based on the potential balance increase that could occur if the borrower chose only to make minimum payments during the option period. As such, all institutions should now be taking steps to implement this standard into their underwriting policies.

Q.5. Should lenders be required to underwrite the borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule? If not, why and what circumstances would circumvent them from doing so?

A.5. Yes. This requirement is a longstanding OTS policy.

Q.6. The GAO recommends improved consumer disclosure by requiring language with an effective format and visual presentation that explains key features and potential risks specific to nontraditional lending products. What else could be done to improve the clarity and comprehensiveness of nontraditional mortgage products to consumers?

A.6. The OTS and the other federal banking agencies continue work on important consumer protection standards for lenders, advising institutions to provide information to consumers that: (1) aligns with actual product terms and payment structures; (2) covers risks areas (such as payment shock and negative amortization) and potential benefits (such as lower initial monthly payments) in a clear and balanced way; and (3) provides clear, balanced, and timely information to consumers at crucial decision making points.

Beyond the interagency guidance, the agencies are working on providing additional direction on ways financial institutions can provide useful information about the benefits and risks of alternative mortgages. Regulation X requires all lenders to provide the Consumer Handbook on Adjustable Rate Mortgages (CHARM brochure), which is published by the Federal Reserve Board and OTS. The OTS is collaborating with the Federal Reserve Board to update the CHARM brochures, which should be issued shortly. The updated brochure will continue to inform consumers about ARMs, including issues such as negative amortization and payment shock, and it will provide additional information on specific types of alternative mortgages, such as payment option and interest-only ARMs designed to help consumers make informed choices.

OTS is also working closely with all the federal bank regulatory agencies to develop a consumer publication focused on interest-only and option ARMs mortgages. This publication advises consumers on how these products work, the potential for large payment increases, and the impact of negative amortization. Additionally, we expect that the publication will provide consumers with a series of questions they can ask their lender to ensure that they clearly understand the terms of a mortgage loan product before agreeing to the mortgage.

Together, these initiatives should improve consumer understanding of the risks and benefits nontraditional mortgage products.

Q.7. Most recently issued nontraditional lending products do not reset until 3 to 5 years after origination and have not yet reached their reset period. The payment shock for option ARMS can be substantial if interest rates stay flat and much worse if rates increase. When underwriting, what interest rate scenarios are banks using: flat, rising, declining, or all combinations? How are the various rate scenarios described to consumers during both the origination and repayment phases?

A.7. Institutions should underwrite adjustable-rate mortgages based on current interest rates. Regulation Z requires lenders to disclose interest rates and loan fees to borrowers based on current interest rate assumptions; however, disclosures inform borrowers of the adjustable rate nature of the loan, the index that adjustments will be based on, the margin above the index, and the historical performance of the index. Borrowers are also informed of any per year or maximum interest rate caps that apply.

Q.8. What issues regarding nontraditional mortgage products have come up since your draft guidance was issued or do you believe have not been addressed by your guidance? What, if any, plans do you have to address these issues in the future?

A.8. The guidance does not specifically address certain loans, such as 2-28 ARMs, which have a low interest rate for the first two years, then an adjustable market rate for the remaining 28 years of the 30-year term. We are currently discussing this issue with the other federal banking agencies and are considering a range of supervisory responses appropriate to address this concern.

RESPONSE TO WRITTEN QUESTIONS OF SENATORS ALLARD AND BUNNING FROM FELECIA ROTELLINI

Q.1. Mortgage brokers are playing a larger role in the market today. Recent statistics show that independent brokers are responsible for about 50 percent of all originations and over 70 percent of subprime originations. Brokers definitely serve the overall market by helping consumers work with multiple lenders; however, they share little risk. Many brokers find it in their financial interest to get the borrower into a loan, regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share risk and ensure brokers are not just looking out for their own interests?

A.1. Regulation of the mortgage industry is rapidly evolving and improving. In addition to regulating banks, 49 states and D.C. currently provide regulatory oversight of the mortgage industry (Alaska has introduced legislation to license mortgage providers, and it is expected to pass in 2007). The Conference of State Bank Supervisors (CSBS) has been working in close coordination with the American Association of Residential Mortgage Regulators (AARMR) to improve state supervision. State supervision of the residential mortgage industry is evolving to keep pace with the rapid changes occurring in the market place. At present, state regulation is limited in its consistency. CSBS, however, is spearheading the effort to improve supervision to ensure that both consumers and lenders are protected.

The federal financial agencies released guidance on September 29, 2006 that will help ensure that consumers better understand some of the nontraditional mortgage products that are in the marketplace today and help to curb some of the more abusive practices. CSBS and AARMR partnered together to issue parallel guidance on November 14, 2006. As of February 21, 26 states and D.C. have adopted the guidance. All 50 states are expected to adopt the guidance in some form.

Additionally, CSBS and AARMR have been working together over the past two years to develop a national Residential Mortgage Licensing System that will create uniformity in mortgage licensing across states and improve state regulators' ability to identify and track mortgage brokers, lenders, and individuals across states. In this effort, states are working together to be an effective gatekeeper on behalf of the mortgage brokerage industry and to counter the effects of currently inadequate private market controls. This effort will raise the professionalism in the mortgage brokerage industry and keep out those who wish to slip easily into the industry to harm consumers in the pursuit of short-term financial gain.

Effective supervision, however, requires a coordinated effort among the federal financial agencies and the states. It is vital that the states are involved with coordinating policy, regulation and guidance. Therefore, the Regulatory Relief Bill which was recently signed into law is incredibly important, since it gave the states a vote on the FFIEC.

Further, we believe a dialogue on suitability is worth having. For example, what does suitability mean in the mortgage industry? Currently, we do not have a policy position on this issue, but we believe further discussion among the industry and our fellow regulators would be beneficial.

Q.2. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? If these investments cease to be worthwhile because of a housing slowdown, are we going to see large numbers of defaults on these loans?

A.2. The borrowers who have used nontraditional mortgage products as speculative tools have made an investment decision, which is different than a consumer making a housing decision. If there is a housing slowdown, I believe the market will adjust to ultimately correct this problem.

Q.3. Are borrowers who have taken nontraditional mortgages in recent years using these products to buy bigger and better homes than they otherwise could afford or are they using these products simply to be able to get into the market? In other words, are the mortgages being used to finance basic needs or luxury desires?

A.3. I think the products are being used for both purposes. In certain markets like D.C. where home prices are high, these products can legitimately be used to purchase a home. Certainly, some savvy and more knowledgeable consumers have used the nontraditional mortgage products to their advantage and have purchased larger homes. These consumers are aware of the inherent risks of nontraditional mortgage products, and have planned accordingly. A good portion of borrowers, however, have utilized nontraditional mortgage products to purchase their first homes, or homes that may be more expensive than they could afford with more traditional products.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market, because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in the coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. My fellow state supervisors and I are very concerned about the health and strength of the local economies of the communities we serve. A nationwide crisis in the housing market is a concern, of course, but my first priority is to the state of Arizona. I do not necessarily disagree with Mr. Brown regarding the possibility of a nationwide crisis, but my fellow supervisors and I are primarily concerned with localized recessions. It is the goal of CSBS to preserve the economic vigor of the local communities we serve. I believe we share that goal with every member of the Senate Committee on Banking, Housing, and Urban Affairs.

Q.5. Again, I would like each of you to answer this question quickly: Will the proposed guidance in combination with an update of Regulation Z be enough to stop overly risky lending practices? Or is something stronger needed?

A.5. The states recognize that something stronger than the guidance and an update of Reg. Z is needed. The interagency guidance and the parallel guidance developed by CSBS and AARMR and an update of Reg. Z are definitely steps in the right direction toward stopping risky lending practices, but more effective regulation of the mortgage industry is required. Industry licensing, effective supervision, examiner education, and improved disclosures are necessary to improve regulation.

State supervision of the residential mortgage industry is evolving to keep pace with the rapid changes occurring in the market place. At present, state regulation is limited in its consistency. CSBS, however, is spearheading the effort to improve supervision to ensure that both consumers and lenders are protected.

The parallel guidance released by CSBS and AARMR is one example of how the two organizations are working to improve supervision of the mortgage industry. As of January 25, 24 states and D.C. have adopted the guidance. All 50 states are expected to adopt the guidance in some form.

CSBS believes that the guidance, along with an update to Regulation Z, will be a major step towards protecting consumers. But these steps alone will only protect consumers if mortgage companies and loan officers abide by them. They will do nothing to stop those few bad actors who would knowingly ignore the guidance or Reg. Z or would intentionally manipulate consumers for financial gain. These bad actors require a mechanism that limits their entry to the industry, tracks them while they're in the industry, and when identified as a bad actor, kicks them out of the industry and informs the public of this action.

For this reason, the CSBS/AARMR Residential Mortgage Licensing System is crucial if consumers and communities are going to be afforded the protections they deserve when financing a home. The System will create a more level playing field in applying for a license, will track state-licensed lenders over time and across states, and will allow consumers to check the license status of any company or individual in the system and research any actions taken against them.

This kind of information is completely lacking in today's mortgage market. CSBS and AARMR are proud to be developing this project and providing state regulators and consumers with better information about the companies and individuals that finance one of the most important financial decisions families make. Such an effort ensures that those who decide to ignore the guidance or Reg. Z will have pay consequences that will stick with them for the rest of their corporate or professional life.

CSBS also offers a Residential Mortgage Examiner School designed for inexperienced state personnel who are responsible for licensing, examining, and investigating state mortgage company licensees and three additional education programs to state regulatory personnel, including Basic Examiner Training School: Fundamentals of Mortgage Banking; Advanced Examiner Training School: Federal Regulation Update; and Fraud School. In addition, CSBS is developing a certification program for state personnel who perform examinations of state mortgage company licensees.

Effective supervision, however, requires a coordinated effort among the federal financial agencies and the states. It is vital that the states are involved with coordinating policy, regulation and guidance. Therefore, the Regulatory Relief Bill which was recently signed into law is incredibly important, since it gave the states a vote on the FFIEC.

Q.6. The importance of actual verification of the borrower's income, assets, and outstanding liabilities increases as the level of credit risk increases. When is reduced documentation underwriting appropriate, if at all? What mitigating factors should be in place?

A.6. Historically, reduced verification was used for a certain type of specialized borrower. It should not be used as a method to evade underwriting standards for borrowers who may not otherwise qualify to own a home. Reduced documentation should be accepted only if there are mitigating factors, such as high credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. Also, borrowers should be aware that they are very likely paying a higher rate for stated income loans and should consider if this higher rate is worth the cost.

Q.7. How do you envision the federal agencies will implement their guidance in a consistent manner with their state counterparts?

A.7. The CSBS-AARMR parallel guidance was developed to promote consistent supervision of the residential mortgage industry. Since the majority of mortgages are originated by state-regulated entities, it is of vital importance that the lenders originating mortgages are all held to the same supervisory standards. Effective supervision of the mortgage industry requires a coordinated effort among the federal agencies and the states. Therefore, we see recent legislation that made the states a voting member of the FFIEC as absolutely necessary to promote consistent, reasonable and effective supervision of all financial service providers.

Q.8. The proposed guidance strongly encourages institutions to increase monitoring and loss mitigation efforts (i.e., establishing portfolio limits, measuring portfolio volume and performance, providing comprehensive management information reporting). How do you respond to lenders who argue that such increases would restrict lender flexibility and reduce consumer choice? Will these increased efforts potentially drive up banks' underwriting costs, which will hurt consumers?

A.8. The interagency guidance asserts sound lending principles that should be followed, not only to provide consumer protection, but for the institution's benefit, as well. The guidance does not negatively impact consumer choice but will help to educate the consumer so they can make more informed choices and understand the risks associated with nontraditional mortgage products. It also encourages lenders to utilize sound lending practices.

Q.9. The GAO found federally-regulated institutions today already underwrite option ARMS at the fully-indexed rate. That is good, but isn't it better to also consider the potential balance increase associated with the negative amortization feature? How many of the institutions are considering this in their underwriting?

A.9. I believe the guidance makes it clear the potential balance increases associated with negatively amortizing loans should be considered by lenders when underwriting a loan. Consumers must be fully aware of the characteristics of the product they are purchasing. The intent of the guidance is not to restrict consumer choice, but to ensure that lenders are providing information to consumers in a clear, concise manner and are utilizing sound underwriting principles.

Q.10. Should lenders be required to underwrite the borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule? If not, why and what circumstances would circumvent them from doing so?

A.10. The guidance asserts that a lender should underwrite the borrower's ability to repay the debt by final maturity at the fully indexed rate. Ultimately, however, the consumer must have the ability to choose their product. In order to do so, it is vital that the lender provides the consumer with information they can utilize to make a decision that is beneficial for their unique situation.

Q.11. The GAO recommends improved consumer disclosure by requiring language with an effective format and visual presentation that explains key features and potential risks specific to nontraditional lending products. What else could be done to improve the clarity and comprehensiveness of nontraditional mortgage products to consumers?

A.11. At the same time the federal agencies released the final guidance, they published proposed illustrations of consumer information for nontraditional products. CSBS, AARMR and NACCA support the proposed illustrations and believe they are a good first step towards improved disclosures across the financial industry. If the illustrations are finalized, CSBS, AARMR and NACCA believe they will also be suitable for use by state-supervised mortgage providers, and will encourage states to adopt the illustrations for use by their licensed entities. This is consistent with our determination to provide uniform supervision of mortgage lenders industry wide. Ultimately, however, the states hope to work with the federal agencies to develop a new system of disclosures that provides clear, easy to understand information to consumers.

Q.12. Most recently issued nontraditional lending products do not reset until 3 to 5 years after origination and have not yet reached their reset period. The payment shock for option ARMS can be substantial if interest rates stay flat and much worse if rates increase. When underwriting, what interest rate scenarios are banks using: flat, rising, declining, or all combinations? How are the various rate scenarios described to consumers during both the origination and repayment phases?

A.12. Consumers must be fully informed of the characteristics of their mortgage. Therefore, disclosures must be beneficial and should provide information regarding the possibility of payment shock, which would be magnified by an increase in the interest rate.

Q.13. What issues regarding nontraditional mortgage products have come up since your draft guidance was issued or do you believe have not been addressed by your guidance? What, if any, plans do you have to address these issues in the future?

A.13. 2/28s and similar types of loans were not specifically named in the guidance, and have recently received a great amount of attention. The mortgage industry is constantly changing and releasing new products. Trying to provide guidance for specific product-types would be inadequate and quickly outdated. Therefore, we believe that the guidance discusses principles which may be applied to all consumer credit products, especially those products that may incur payment shock. It is our intent to work together with the federal agencies to issue a declaration of principles that would encourage institutions and mortgage providers to carefully underwrite and provide clear information to consumers on any loan that has certain characteristics.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM WILLIAM SIMPSON

Q.1. In your written statement, you emphasize consumer education. Certainly that is an area for improvement. Before we seek the results of improved consumer education efforts, there will be a period when brokers will still be dealing with what many people have classified as an overwhelmed, confused borrower. Brokers share little of the risk that the borrowers or lenders assume. In fact, many have a financial interest in getting the borrower into a loan regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share the risk and make sure brokers are not just looking out for their own best interests?

A.1. The non-traditional mortgage guidance recently finalized by the banking agencies is an important step in addressing these concerns. However, as I noted during the hearing, it is important that state regulated institutions have similar standards applied to them. In this regard the state bank and mortgage lender supervisors announced this morning that they will take these needed steps. These efforts, if forcefully implemented by the respective regulators, should go a long way to protecting consumers.

Q.2. Can you tell if borrowers who have taken non-traditional mortgages in recent years are using the mortgages more often to buy bigger and better homes that they otherwise could or are they simply using these products to be able to get into any housing?

A.2. I have not seen any information breaking out these numbers. However, to an extent, these risky mortgages act to artificially stimulate the demand for housing, raising the price of housing for all home buyers regardless of whether or not they use a non-traditional mortgage. We know that in areas where house prices have been rising at very rapid rates at least some of the rapid price increases have been stimulated by greater demand from borrowers using these mortgages to qualify for larger loan amounts than they otherwise could afford. The problem arises when prices stop rising and the borrower is faced with higher mortgage costs resulting from the inherent risky nature of the non-traditional mortgage product.

Q.3. How much risk do you see from borrowers who have used these mortgages to speculate in the housing market? Should these investments cease to be worthwhile because of a housing slowdown, are we going to see large numbers of defaults on these loans?

A.3. Inevitably non-traditional mortgages pose risks to some borrowers when house prices stagnate or drop. When a borrower can no longer meet their mortgage payment because of readjustments built into the mortgage product itself—combined, perhaps, with personal hardship or loss of a job—then the market value of the house becomes a critical factor in determining whether a house sale or a mortgage default occurs. When the cost of keeping a mortgage becomes prohibitive to the borrower and the amount of the mortgage exceeds the market value of the house then mortgage defaults occur. To the extent that some high-risk non-traditional mortgages incorporate significantly higher interest rates or deferred payments for which a borrower may not be prepared means that these borrowers will be at risk of losing their homes and any home equity they may have accumulated over time.

RESPONSE TO WRITTEN QUESTION OF SENATOR REED FROM WILLIAM SIMPSON

Q.1. In your comments to the proposed guidance, you indicated that additional enforcement mechanisms could be added to strengthen the guidance. What mechanisms would you recommend?

A.1. First, as I noted in my testimony, I believe it important that state regulators quickly apply similar standards on state-regulated entities offering non-traditional mortgages to borrowers. The state bank and mortgage lender supervisors today released a similar guidance on non-traditional mortgages for the state institutions they regulate. Second, it is important that the bank and state regulators issue instructions to their examiners setting forth how the guidance should be enforced at the examiner level. Ambiguity exists in all government regulations and effective enforcement of the non-traditional mortgage guidance requires that bank and state examiners be given the necessary direction. Finally, I would hope that the banking agencies and state regulators effectively enforce the new guidance by bringing enforcement actions when a financial institution fails to comply with the details of the guidance as requested by its examiners.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MICHAEL CALHOUN

Q.1. In your written statement, you emphasize consumer education. Certainly that is an area for improvement. Before we see the results of improved consumer education efforts, there will be a period when brokers will still be dealing with what many people have classified as an overwhelmed, confused borrower. Brokers share little of the risk that the borrowers or lenders assume. In fact, many have a financial interest in getting the borrower into a loan regardless of whether the borrower can afford it. Are current laws and regulations strong enough to protect consumers and lenders? What can be done to better share the risk and make sure brokers are not just looking out for their own best interests?

A.1. The Home Ownership and Equity Protection Act of 1994 (HOEPA) was initially intended to address financial incentives that encourage lenders to put borrowers in home loans that they cannot afford and that strip equity from the home. In the twelve years since HOEPA was enacted, it has become clear that the law's application needs to be broadened and its provisions strengthened. Fortunately, HOEPA permits states to build upon minimum federal protections to tailor laws that suit the needs of their citizens. Those state laws have protected consumers while permitting the explosion in subprime lending that has occurred in recent years. HOEPA should be amended to adopt the measures that states have employed successfully. One of the most vital provisions, critical provisions, is a prohibition on loan flipping, or refinances that lack a reasonable, tangible net benefit to the borrower. Another critical element is a comprehensive definition of points and fees that includes the maximum prepayment penalty that the holder may charge a borrower and the yield spread premium—the amount the lender pays a broker in connection with an increase in the interest rate the borrower receives. In addition, new practices in the mortgage market require additional consumer protections in three key areas: (1) making it clear that mortgage professionals, including brokers, have a duty of good faith and fair dealing towards their customers; (2) requiring that loan originators ensure that a borrower is reasonably likely to be able to repay a loan as structured, without having to sell the home or refinance the loan; and (3) prohibiting brokers and lenders from steering borrowers into loans that are less advantageous than those for which the borrower qualifies.

Q.2. Can you tell if borrowers who have taken non-traditional mortgages in recent years are using the mortgages more often to buy bigger and better homes than they otherwise could or are they simply using [these] products to be able to get into any housing?

A.2. Housing affordability certainly is a concern nationwide. It is important to note, however, that much of the home loan market is a refinance market. In 2005, as many as 58% of securitized interest-only ARM originations were purchase loans, meaning 42% were refinance loans; 37% of securitized payment option ARMs were purchase loans, meaning 63% were refinance loans.[1] Through the third quarter of 2006, 55.6% of securitized subprime originations were refinance loans.[2] Though we do not know what percentage of these refinance loans provided a borrower with a reasonable, tangible net benefit, we do know that inappropriate refinance loans threaten, rather than promote, homeownership.

Note that weak underwriting contributes to skyrocketing housing prices. Mortgage professionals distort home prices when they originate unsustainable loans with a higher principal amount than the borrower could qualify for using a 30-year fixed rate mortgage. As lenders comply with guidance on prudent underwriting of nontraditional mortgages and as the housing market "corrects," borrowers may find that their homes are worth less than they owe on their home mortgage. This is especially the case for those consumers victimized by appraisal fraud. Unfortunately, the home loan market does not always operate at optimal efficiency. Reasonable regulation and oversight is necessary to ensure that consumers and the housing market as a whole are functioning appropriately.

Q.3. The National Association of Mortgage Brokers has taken the stance that instead of limiting risk to consumers, regulators and lenders should better educate consumers about risk. To a certain degree, do you think that consumers have chosen not to educate themselves about these products focusing instead on that low initial payment?

A.3. Certainly, the promise of low monthly payments is a key selling point for home loans. Still, CRL would not place blame for the

[1] Gov't Accountability Office, *Alternative Mortgage Products: Impact on Defaults Remain Unclear, but Disclosure of Risks to Borrowers Could Be Improved,* GAO–06–1210, 11 (Sept. 2006) (citing David Liu, *Credit Implications of Affordability Mortgages* (UBS Mar. 3, 2006)).

[2] Inside Mortgage Finance Mortgage-Backed Securities Database (Oct. 27, 2006).

proliferation of unsustainable or abusive loans at the feet of consumers. The Government Accountability Office (GAO) reported recently that the "alternative mortgage product" disclosures it reviewed

> did not always fully or effectively explain the risks of payment shock or negative amortization for these products and lacked information on some important loan features, both because Regulation Z currently does not require lenders to tailor this information to AMPs and because lenders do not always follow leading practices for writing disclosures that are clear, concise, and user-friendly.[3]

Furthermore, the GAO also has reported that its "review of literature and interviews with consumer and federal officials suggest that while tools such as consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending."[4]

CRL is pleased that the staff of the Board of Governors of the Federal Reserve System is working to revise Regulation Z's disclosure requirements to better inform consumers about products they are offered. In the meantime, however, loan originators should act responsibly and fairly by clearly informing borrowers about the costs and benefits of the various loans available to them. Furthermore, loan originators should give borrowers loans that are appropriate given their goals, credit history, and other relevant characteristics.

Consumers should be able to trust mortgage professionals to direct them to suitable loans. A consumer could read constantly and continuously without knowing all relevant information about the new products that financial institutions develop. Mortgage professionals themselves have trouble keeping up with the tremendous variety of products available on the market. Many such professionals learn to deal with a select few products—sometimes those that are most personally lucrative rather than most appropriate for a borrower—and deal only with those products. If we do not expect loan originators to know the intricacies of all available products, how can we expect more of consumers? Furthermore, loan officers and mortgage brokers use rate sheets to which the consumer lacks access, creating an information imbalance that leaves consumers at a disadvantage.

Also, a consumer who receives a solicitation for a loan rather than seeking a loan is less likely to have prepared for a loan transaction. Understandably, since the consumer did not initiate a search for a loan, he or she may rely unduly on the representations of the party marketing a product or products. Push-marketing is particularly common with refinance loans. Data collected pursuant to the Home Mortgage Disclosure Act showed that 53.6% of reported conventional first lien home loans originated in 2005 were refinance loans, compared to 42.6% home purchase loans and 3.9% home improvement loans.[5] Refinancing abuses hurt not only borrowers but also responsible lenders who see their borrowers refinance into riskier loans with worse terms based on misrepresenta-

[3] *Id.* at 21.

[4] Government Accountability Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending,* GAO–04–280 at 6 (2004).

[5] Calculated based on data provided in Glenn Canner et al., *Higher-Priced Home Lending and the 2005 HMDA Data,* Federal Reserve Bulletin at A135, tbl. 4 (2006) (Fed Bulletin).

tions by untrustworthy lenders. It is important for consumers to have a general understanding of home loans; it is critical for mortgage professionals to use their knowledge to assist borrowers rather than mislead them.

Q.4. In our last hearing, Mr. Brown from the FDIC suggested that we are unlikely to see a nationwide crisis in the housing market because the housing boom is concentrated in certain regions, and historically most housing failures have happened in areas suffering from localized recessions. As we all know, there is increased risk of massive defaults on these loans in coming years. Due to a nationwide trend of nontraditional mortgages being used as affordability products, would you disagree with Mr. Brown that upcoming housing problems will be isolated in certain regions?

A.4. The FDIC recently reported that five out of six Regional Risk Committees expressed concern that slowing housing appreciation would impact future performance of prime residential loans.[6] With respect to subprime home loans, the FDIC's recent report stated the following:

> There are emerging signs of potential credit distress among holders of subprime adjustable-rate mortgages (ARMs). Nationwide, foreclosures started on subprime ARMs made up 2.0 percent of loans in the second quarter, up from 1.3% in mid-2004. Subprime ARMs are experiencing stress in states as diverse as California, which has had rapid home price gains and solid economic performance, and Michigan, where house prices have been stagnant and the economy is weaker. This suggests that national factors, like interest rate increases, are important factors behind subprime mortgage credit stress, in addition to local economic or housing market conditions.[7]

The report also noted that households' high-leverage mortgages and use of nontraditional mortgage products could amplify the effects of a housing slowdown.[8]

In areas with housing appreciation, it may be possible for families with unaffordable loans to refinance if they have sufficient equity in their home. Such refinances are not costless, however; any prepayment penalties to exit one loan and points and fees paid to obtain a new loan are paid either out of borrowers' cash or their home equity. In areas with little or no appreciation in housing values, CRL expects that distressed borrowers will be less able to refinance and more likely to enter foreclosure.

Q.5. You both share a gloomy view of what is going to happen to many borrowers. Are the changes in the marketplace, particularly the rise of brokers and non-traditional mortgages, here to stay, and should we be worried about that?

A.5. We need not worry not about brokers and nontraditional loans per se, but rather about brokers who do not deal fairly with borrowers and with mortgage professionals who originate loans—traditional or nontraditional—even though a borrower cannot repay the loan as structured.

[6] *Economic Conditions and Emerging Risks in Banking: Report to the FDIC Board of Directors* (FDIC, Nov. 2, 2006) (FDIC Risk Report) at 6, available at *http://www.fdic.gov/news/board/nov062memo.pdf.*

[7] FDIC Risk Report at 6.

[8] FDIC Risk Report at 2.

The recently issued Interagency Guidance on Nontraditional Mortgage Product Risks directed institutions to avoid loan terms and underwriting practices that could heighten the need for a borrower to sell or refinance a loan when payments increase. The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators issued similar guidance as a model for state banking regulators. Without stifling innovation or preventing borrowers from obtaining nontraditional mortgages, banking regulators highlighted commonsense, prudent lending practices that are critical to the sustained viability of the home loan industry. Both safety and soundness and consumer protection considerations demand that mortgage professionals act in accordance with the level of trust that consumers and regulators place in them. Mortgage brokers who care more about commissions than about a loan's sustainability and those lenders who turn a blind eye to—or promote—abuses by brokers share blame for the loss of home equity or of a home itself that borrowers with an unaffordable loan experience.

It is likely that subprime borrowers will experience the greatest losses from unsustainable loans. Adjustable rate mortgages whose rates are fixed for 2 or 3 years dominate the subprime market. Those who originate these loans generally underwrite loans to an interest rate far below the actual rate a borrower reasonably can expect to pay when the interest rate adjusts. Weak underwriting and a loan structure normally inappropriate for troubled borrowers thus add an unnecessary layer of risk to these borrowers' loans. CRL urges regulators to require brokers and lenders to originate subprime loans that are sustainable and suitable for the borrower's purposes. Such a requirement would lead to the origination of far fewer subprime 2/28 and 3/37 adjustable rate mortgages.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MICHAEL CALHOUN

Q.1. Please comment on the assertion made during testimony at the hearing that interest only and option ARMs do not constitute greater risk for consumers than other mortgage products.

A.1. As the federal agencies noted in their recent guidance on nontraditional mortgages, interest-only and option ARMs pose "concerns from a risk management and consumer protection standpoint." The initial low monthly payment associated with these loans means that once the loan adjusts, the borrower can face significant payment shock. Additionally, the lack of principal amortization as well as the potential for negative amortization means that borrowers fail to build equity in their home. Taken together, these products present significant risk for borrowers in a slowing housing market, where a lack of equity will mean that borrowers cannot refinance in the face of payment increases. Of course, many of these risks exist with adjustable-rate mortgages that are not structured to allow deferment of principal or interest payments. Particularly risky are subprime 2/28 and 3/27 hybrid ARMs that are underwritten using weak standards that jeopardize subprime borrowers' ability to sustain homeownership and its benefits.

Q.2. What approximate percentage of nontraditional loan products are underwritten to the value of the home, rather than to the borrower's ability to repay? Is this practice restricted to the subprime market?

A.2. Current underwriting for nontraditional mortgages often is based on the value of the home, rather than the borrower's ability to repay the mortgage when payment increases occur. This presents serious risks, especially in a stagnant or declining real estate market, when home resale proceeds may not be sufficient to pay off the loan. Of even more concern is the fact that the majority of subprime lenders making ARM and/or interest-only loans underwrite only to the initial rate and not to the fully indexed and/or fully amortizing rate. Lenders who make these exploding ARMs often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate, and therefore the monthly payment, will rise significantly. For example, a recent prospectus shows that a large subprime lender, Option One, underwrites to the *lesser* of the fully indexed rate or one percentage point over the start rate.[9] For a loan with a typical 2/28 structure, the latter would always apply. This practice means that at the end of the introductory teaser rate on an ARM, borrowers face a shocking increase in costs, even if interest rates remain constant.

Q.3. Approximately 15 percent of borrowers with interest-only and option ARMs earn less than $48,000. How do you expect the borrowers with lower incomes to be affected by the resets we expect to see over the next several years?

A.3. Generally, low-income homeowners are less able to withstand increases in home loan payments. Even if the debt-to-income ratio is the same in a loan to a higher-income borrower and a loan to a lower-income borrower, high debt-to-income ratios may leave the lower-income borrower with insufficient residual income to pay for basic necessities. Furthermore, according to 2005 Home Mortgage Disclosure Act data, lower income borrowers were more likely than other borrowers to have high-cost loans.[10] A Federal Reserve study found that 40% of borrowers with income less than $50,000 did not know the per-period caps for the interest rate changes on their ARMs and 53% did not know the lifetime cap.[11] Low-income borrowers therefore may be more surprised by sharp payment increases.

The Consumer Federation of America has noted that "the homeowners who will be most severely hurt by any downturn in the housing market are the nontraditional borrowers who have purchased the most recently with the least equity in their homes."[12] Presumably, lower-income borrowers who have taken advantage of

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[9] Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5, S.E.C. Filing 05794712 at S–50 (May 3, 2005).

[10] Fed Bulletin at A156.

[11] Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* (Federal Reserve Board of Governors Jan. 2006) at 36 tbl. 5.

[12] Allen Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* 28–29 (May 2006).

programs that allow lower down payments and higher loan-to-value ratios will have less equity to use to pay the costs of refinance or of real estate commissions and other costs associated with home sales. If housing values decline, low-income and higher-income homeowners may find that their homes are worth less than they owe. A study commissioned by the U.S. Department of Housing and Urban Development found a high likelihood that low-income families would return to renting after owning a home.[13] Given those findings, the authors concluded that "policies designed to ensure that once households achieve homeownership, they remain homeowners (rather than reverting to rental tenure), and policies that enable families to transition to higher valued owned units over time will increase substantially their potential housing wealth accumulation." The study focused on data gathered before the proliferation of nontraditional mortgage products and the increased use of ARMs in the subprime market. Homeownership remains just as important as before, but as the use of adjustable rate mortgages and nontraditional mortgage products increases, homeowners bear more of the risks associated with home loans.

Q.4. What can Congress potentially do to protect consumers who may be unable to make their payments, refinance or sell?

A.4. Congress should require all lenders and mortgage brokers to adhere to the principle of the Interagency Guidance on Nontraditional Mortgage Product Risks—that borrowers be provided loans they can reasonably repay over the life of the loan without having to refinance or sell the house.

Second, Congress can ensure that any federal predatory lending law retains the assignee liability provisions of HOEPA. In 2005, almost 70% of HMDA-reported home loans originated were sold on the secondary market.[14] Assignee liability entitles victimized borrowers to recourse even if the original lender has sold the loan to another party. Without assignee liability, borrowers who were abused would not be able to defend against foreclosure.

Congress can also develop incentives that encourage lenders to provide loan modifications to borrowers who have received loans with significant payment shock, in lieu of foreclosing on or refinancing such loans. In conjunction with such incentives, it would be helpful to ensure that servicers do not impose unfair costs on borrowers when providing workout options.

In addition, Congress could create a homeowner assistance program to assist borrowers who cannot repay their loans. Pennsylvania has implemented a successful program to help borrowers who are facing foreclosure through no fault of their own. The commonwealth's Homeowners' Emergency Mortgage Assistance Program (HEMAP) provides loans to borrowers who show a reasonable prospect of being able to resume full mortgage payments. The program is funded through a small fee on all residential mortgage loans. Assistance is available for 24 months or until a certain dollar cap is reached, whichever comes first. Congress could develop a program

[13] Thomas P. Boehm & Alan Schlottmann, *Wealth Accumulation and Homeownership: Evidence for Low-Income Households* 33 (U.S. Dept. of Housing and Urban Development Dec. 2004).

[14] Fed Bulletin at A139. The bulletin notes that HMDA data tends to understate secondary market sales, in part because some sales will occur in years subsequent to the reporting year.

similar to the Pennsylvania HEMAP program to assist borrowers in need.

Q.5. What has been the effect of the recent changes in the bankruptcy laws on a consumer's ability to pay their reset mortgage payments?

A.5. According to a recent survey of members of the National Association of Consumer Bankruptcy Attorneys, the new bankruptcy provisions have increased the costs and paperwork required to file for bankruptcy without resulting in significant increases in the number of filers put into Chapter 13 repayment plans.[15] The creation of additional barriers to bankruptcy may push desperate people to deal with unscrupulous parties, such as those who perpetuate "foreclosure rescue" scams or lenders who refinance borrowers into less advantageous loans. In addition, the new law makes it much harder for families to use their limited resources to keep their mortgage current. Instead, credit cards and other unsecured debt require much of the families' income. To date, however, we have not formally studied a link between the 2005 bankruptcy amendments and an increase in abuses of homeowners in dire straits.

Even prior to the 2005 amendments, the Bankruptcy Code gave home mortgage lenders special treatment. Though bankrupt debtors have the right to modification of many secured claims, with some exceptions, they do not have a right to modification if the claim is secured by an interest in the debtor's principal residence. Congress intended for the home mortgage preference to promote constructive, not destructive lending. Home mortgage lenders who abuse consumers should not be given preferential treatment over responsible non-mortgage lenders when their victims are pushed into bankruptcy.

Q.6. Regarding non-traditional mortgage products, what issues do you believe have not been addressed in the proposed Guidance?

A.6. Now final, the nontraditional guidance represents a clear statement of prudent lending practices for home mortgages that permit deferment of principal or interest. However, borrowers with fully-amortizing ARMs, such as subprime 2/28 ARMs (fixed rate for 2 years and adjustable thereafter) and 3/27 ARMs (fixed for 3 years and adjustable thereafter), also can experience payment shock that leaves them unable to repay the loan. Likewise, subprime borrowers are vulnerable to risk layering through such practices as reduced documentation requirements. We urge the federal financial institution regulators to clarify the application of the underwriting standards set forth in the nontraditional mortgage guidance to subprime "exploding" ARMs such as 2/28s and 3/27s.

In addition, we note that, in contrast to common practice in the prime market, in the subprime market, loan originators tend not to provide for escrow of payments for property taxes and insurance. Excluding the cost of property taxes and hazard insurance from estimates of monthly payments misleadingly lowers the monthly payments such lenders quote. This trick may enable a loan originator

[15] Press Release, National Association of Consumer Bankruptcy Attorneys, *Survey: Bankruptcy Filings on the Rise Again, Likely to Return to Pre-2005 Law Levels During Next Year* (Oct. 4, 2006), available at *http://nacba.com/files/main_page/100406NACBAsurveynewsrelease.doc.*

to close a deal, but will leave borrowers who have not saved enough money to cover those costs with no option but to refinance or sell their home. Refinancing can cost homeowners valuable home equity, increasing the loan-to-value ratio on subsequent loans and thus increasing the interest rate, or even leaving borrowers unable to refinance. Frequent housing turnover destabilizes communities and increases opportunities for appraisal fraud.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

FORECLOSING ON THE AMERICAN DREAM / PART OF AN OCCASIONAL SERIES / NO MONEY DOWN: A HIGH-RISK GAMBLE

The Denver Post, Sunday, September 17, 2006

By Greg Griffin, David Olinger and Jeffrey A. Roberts, Denver Post Staff Writers

Monique Armijo expects to give birth to her fourth child, a girl, next month. She also expects to lose the house her family moved into just last year at an October foreclosure sale in Jefferson County.

She cannot bear to tell her three children, two 7-year-old boys and a 5-year-old girl, about the auction.

"When we moved in, I told them, 'We're never going to move again; this is where we'll stay,'" she said. "I love this neighborhood."

Monique and her husband, Anthony, are among the many Colorado residents who managed to acquire a house without a down payment, only to see it foreclosed on a year or two later.

Anthony, an independent carpet installer, met a real estate agent who assured the couple that shaky credit and lack of cash for a down payment were no longer barriers to homeownership. They ended up signing a loan that required them to pay off a $44,000 second mortgage in 14 months.

Once rare in the mortgage industry, nothing-down loans have become wildly popular in Colorado, where home prices rose rapidly during the late 1990s. And according to a computer-assisted Denver Post analysis, they are a leading cause of the state's foreclosure epidemic.

The Post examined nearly 1,000 foreclosures—every notice filed in August in three Colorado counties racked by troubled mortgages.

In Adams, Arapahoe and Jefferson counties, more than half of all foreclosures on home purchases involved no-down-payment loans. Excluding federally insured loans that require a small down payment, no-money-down loans accounted for more than 70 percent.

"Exotics" go mainstream

Nothing-down loans lead the list of higher-risk, alternative mortgages that many Coloradans are substituting for traditional 30-year fixed loans with at least 10 percent down. Buyers often compound their risk by combining 100 percent financing packages with interest-only loans, adjustable-rate loans that allow the borrower's debt to grow rather than decline and loans that require no proof of income.

These loans, known among lenders as "exotics," have moved from the fringes of the mortgage industry to the mainstream and now account for more than a third of all loans.

The growth has fulfilled a desire of lenders, borrowers and regulators alike to make homeownership accessible to more people. But the risks—some have relatively high monthly payments, while others start low and adjust rapidly upward—are more than many homeowners can manage.

In interviews with dozens of homeowners in foreclosure, The Post found that life events such as job loss, medical problems and divorce often precipitate a default. But lack of equity, which gives homeowners options when they face financial problems, was a factor in nearly all cases.

For the past six months, Colorado has had the highest foreclosure rate in the nation, according to RealtyTrac, a California firm that tracks foreclosures. Repossession proceedings were underway for one of every 158 Colorado homes during the second quarter.

It's no coincidence that Colorado homeowners have less equity in their properties, on a percentage basis, than nearly any other state—the result of a number of factors including the popularity of 100 percent financing.

"The bottom line is, people in Colorado are borrowing too much money on their homes," said Stuart Feldstein, president of SMR Research Corp., which tracks lending-industry trends.

Aggressive lending practices and poor consumer education also play a role, consumer advocates say.

"Seventy percent of the people who come in here got the wrong loan," said Zachary Urban, a counselor with Denver-based Brothers Redevelopment Inc., which helps people keep their homes.

Lenders say they're simply meeting customer demand for less restrictive loans.

"There are very few people who have 5 or 10 or 20 percent cash to put down. Or if they do, who want to," said Colorado Mortgage Lenders Association president Chris Holbert. "If you want 100 percent financing, and you qualify, can they turn you down because it's not a good idea?"

Many left second-guessing

Jose Garcia and Maria Vanderhorst put no money down in October when they bought a $200,000 patio home in a quiet central Aurora neighborhood.

Now fighting for their home as a foreclosure auction looms, the couple questions that decision.

"I had money to put down, but they came out with the idea of no money down. I did some research, and it looked good," Garcia said. "Maybe it wasn't the smartest decision."

Garcia and Vanderhorst, who immigrated to Colorado from the Dominican Republic in 2003, obtained what's called an "80–20" mortgage package.

One loan covered 80 percent of the purchase price, and the other covered 20 percent. The second loan carried a 9.7 percent interest rate—high, but not unusual for a second loan—and a monthly payment of $340, bringing the total to nearly $1,500.

The couple, who have three children—13, 11 and 5—used their savings to finish their basement and send money to their parents.

But Garcia, a car salesman, took a big pay cut in March when his dealership was bought out by a competitor. The family also didn't receive an expected tax refund and faced some unexpected medical bills.

Behind on their payments, they received a foreclosure notice from their bank in June.

Garcia negotiated a deal with the current mortgage holder, Countrywide Home Loans, giving him eight months to pay the $7,000 he owes, including a $2,200 foreclosure fee.

With some belt-tightening, he thinks the family can keep the house.

"When we went into foreclosure, it was like someone taking my dreams away," Garcia said. "There was no way I was going to lose my house. It's about pride."

The future is bleaker for Monique and Anthony Armijo. Their two loans came with a high interest rate and some unusual terms.

Spectrum Funding, a Utah-based lender, supplied the $176,000 first mortgage toward the $220,000 purchase of a middle-class home in Arvada. Ad Two Inc., the company selling the house, provided the $44,000 second mortgage.

The first started at 9.67 percent—more than $1,400 a month in interest alone—and can jump 3 percent after two years. The second let the Armijos pay just $100 a month for a year—but required them to pay the entire balance in January 2007. They could refinance that loan but faced a $20,000 penalty if they didn't use a particular broker.

The Armijos' sole source of income: about $30,000 a year from Anthony's carpet work. Within months, they were behind on the first mortgage.

Ad Two Inc. is an independent franchise of HomeVestors, which buys, repairs and resells houses. Terri Gallmeier, Ad Two's president, said the Armijos' real estate agent asked her to carry a second mortgage that could be refinanced a year later.

"I had nothing to do with the loan," she said, "and I wasn't privy to all the financial information" about the buyers.

The foreclosure notice that came to the Armijos' home was followed by a flood of mail from people offering everything from counseling to taking the house off their hands. Monique called one, Doug Ravdin, who explained the terms of their two home mortgage loans.

"He told me, 'You're going to be in debt for the rest of your life if you stay in that property.' He was like, 'The best thing for you guys to do is get out of the house.'"

She thanked him, hung up and wept.

"We run into this all the time," Ravdin said. The Armijos bought a fix-and-flip house and "got loaded into it horribly, I mean horribly." Housing counselors say borrowers need to be very careful when choosing a loan and to read the papers before signing.

"If it sounds too good to be true, then it probably is," said Donald May, executive director of the Adams County Housing Authority. "The buyer has to be a lot more sophisticated and educated with all the mortgages available today."

Loans' door wide open

More choice and lower lending standards have made it easier than ever to buy a home, but has the trend gone too far?

The jury is still out. The U.S. rate of homeownership—the percentage of homes occupied by the owner—was 68.9 percent last year, up from 63.9 percent two decades ago, according to the Federal Deposit Insurance Corp.

But foreclosures rose 39 percent from January to July compared with the same period of 2005, RealtyTrac reports.

Beginning in the early 1980s, regulators allowed banks to sell their loans and offer homebuyers variable interest rates, stimulating capital investment and consumer demand.

Securitization of mortgages helped lenders get the riskiest loans off their books. Investors were shielded because those mortgages were typically held in diversified loan portfolios.

High-risk loans such as option-ARMs, in which payments on principal and some interest can be deferred, were introduced by savings-and-loan associations in the 1980s to serve high-income borrowers. Only recently have they spread to less creditworthy consumers.

Since 2003, the height of the refinancing boom, competition has stiffened among lenders fighting for a declining number of loans.

Mainstream lenders and mortgage brokers say they've had to offer all of the alternative loans, at competitive terms, or risk losing business.

"If we don't do it, they will go down the street," said mortgage broker Mike Thomas of Hyperion Capital Group in Aurora.

Loans without down payments have been around for a long time, but they've taken off in the past three years.

In 2005, 43 percent of first-time homebuyers surveyed by the National Association of Realtors said they put no money down. Before last year, the group had never tracked that category.

A common choice is the 80–20 because it allows buyers to avoid the costly mortgage insurance typically required when they put down less than 20 percent.Standard & Poor's reported in July that 80–20s and other two-loan packages known as "piggybacks" are up to 50 percent more likely to go into default than comparable one-loan transactions.

In Adams, Denver and Arapahoe counties, piggybacks were used in more than 50 percent of home purchases in the second quarter of 2006, well above the national average of less than 40 percent, according to Hackettstown, N.J.-based SMR Research.

As state housing prices doubled in the 1990s, homebuyers saw less need to invest their own money, said Holbert of the Colorado Mortgage Lenders Association. Equity accrued automatically.

Now, if homeowners put no money down and prices remain stagnant, "what other option than foreclosure do they have if their income drops and they can't make their payments?" Holbert said.

"The place was a mess"

Mark Williford says his house in Northglenn was unsafe from the day he moved in. Yet he managed to borrow more than 100 percent of the sale price in 2003 from a bank that threw in $33,000 for renovations and accepted his shaky finances.

Williford's only steady source of income: permanent disability checks from a 1993 neck injury. His mortgage was co-signed by a girlfriend he had never lived with before, and their loan application counted $809 a month in tips from her casino job as household income.

"Somehow we pulled it off," said Williford, a 47-year-old disabled plumber who obtained a $161,000 loan from Wells Fargo Home Mortgage Inc. on a house Northglenn later tagged as uninhabitable.

The city responded to a 2005 engineering report that a second-floor addition rests on decorative metal columns and its windows could shatter and fall out.When Williford and his girlfriend split up months after moving in, his mortgage payments exceeded his total income. In October he lost his first home.

"I bought a condemned house, which is all I could afford," he said. "I was trying to save my house, my mortgage, my self-worth."

A mortgage expert said the bank should have known better.

"Bottom line, Wells Fargo should never have made the loan. The borrowers did not have the provable income and the property was unsafe," said Jim Spray, a consumer-oriented mortgage broker Williford called for help.

Dick Yoswa, the Wells Fargo loan officer, remembers "the place was a mess" when Williford bought it. "It was a borderline case," he said.

But Williford's disability income and his girlfriend's casino job were verifiable, a contractor estimated the house could be repaired for $33,000, and the appraiser sounded no alarms, Yoswa said.

"From the information we received from everyone, we closed the loan," he said.

Today, Williford lives in a tiny portable trailer with a refrigerator, stove, bunkbed and a flat-screen TV he squeezed in after dismantling the door. "It could be worse. I'm just grateful that I have this," he said.

Option-ARMs next wave?

Though 100 percent financing is involved in many Colorado foreclosures, the next wave of defaults may come from option-ARMs, experts say. Troubling stories about these loans are mounting.

Louis and India Harts of east Park Hill refinanced last year into a loan they thought was a 30-year fixed-rate mortgage.

But instead of a 30-year fixed, the couple in their 80s got an option-ARM with a low teaser rate of 2.6 percent that quickly shot up. They're making a minimal monthly payment of $919 on the $180,000 loan, but that doesn't even cover the interest. Since March 2005, the principal has grown to more than $183,000.

The interest rate is now 8.1 percent, and according to their loan documents, can go as high as 9.95 percent.

When the principal hits 115 percent of the original loan in a few years, the bank will force them to begin paying it off.

"I don't know how we're going to do it," said Louis, a retired worker for Public Service Co. of Colorado.

The loan has a "prepayment penalty" clause, making it difficult to sell or refinance during the first three years. When they called the lender, Countrywide Home Loans, they learned it would cost $11,000 to get out of the loan.

The Hartses blame their mortgage broker, Team Lending Concepts in Greenwood Village, for putting them into a loan they didn't understand—though they admit they signed papers spelling out the terms.

Team Lending president Jeff Lowrey said the loan was the best option for the Hartses because it guarantees a low payment for four to five years until they refinance again.

"That type of minimum-payment option definitely helps those kinds of people," Lowrey said. "We minimized their payment so they could afford things like medical expenses and gas."

Team Lending collected $3,900 in fees at closing and $4,200 more from the mortgage company for originating the loan. Lowrey said the fees are within the permissible range for such loans.

Option-ARMs and other adjustable-rate mortgages could fuel a surge in foreclosures in the next few years as adjustable rates begin moving up on billions of dollars in loans, consumer advocates and public officials warn.

"We are just starting to hear about ARMs," said Adams County trustee Jeannie Reeser. "That is what is going to drive foreclosures next year."

Staff writer Aldo Svaldi contributed to this report.

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In trouble? Here's what to do

Foreclosure can cost you your home and your credit. Here's what to do if you're in financial trouble or have received a foreclosure notice.

Act quickly

Lenders usually are willing to help you devise a plan to keep your home. They may agree to a reduced or delayed payment schedule. Call as soon as you can. The further behind you are, the less your lender can help.

Get help

Housing counseling agencies approved by the Department of Housing and Urban Development can help you assess your financial situation and help you negotiate with your lender. Call HUD at 800–569–4287 to find counseling agencies near you.

Consider your options

If you simply can't afford to keep your home, your lender may give you the time to sell it, even if the sales price is below what you owe.

Beware of scams

Homeowners in foreclosure are often targets of fraud. "Equity skimming" is when a buyer offers to repay the mortgage or sell the property if you sign over the deed and move out. Phony counseling agencies also may offer help for a fee you don't need to pay.

Help on the web

For more information about foreclosure, go http://www.hud.gov/foreclosure/index.cfm

Source: U.S. Department of Housing and Urban Development

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

AND

SUBCOMMITTEE ON ECONOMIC POLICY

UNITED STATES SENATE

"Calculated Risk: Assessing Non-Traditional Mortgage Products"

September 20, 2006

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its written testimony to the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy of the Senate Committee on Banking, Housing, and Urban Affairs, concerning issues presented by nontraditional mortgage products.

CMC appreciates the interest of the Subcommittees in the innovative mortgage products that the mortgage industry has provided in response to consumer demand for more flexibility in financing their home purchases. Nontraditional mortgage products present some new risks that lenders and their regulators must carefully monitor. When prudently managed, however, these products can also reduce other types of risks to both the consumer and the lender. In considering possible restrictions on these products, it is important to note that the current homeownership rate of close to 70% could not have been achieved if lenders had not been allowed to meet consumer demand for innovative mortgage loan products that meet their financial needs.

CMC's testimony explains why we believe that nontraditional mortgage products can actually reduce risk and benefit borrowers–particularly "nontraditional" borrowers such as individuals who are starting a business–while also improving the functioning of the mortgage market. We also briefly discuss some of the issues raised by the Interagency Guidance on Nontraditional Mortgage Products proposed by the banking agencies and the National Credit Union Administration.

Finally, we have attached four documents. The first describes the mortgage process. The second describes some loan features that are often labeled predatory, including negative amortization, a common element of many of the new nontraditional mortgage products. The third describes the mortgage origination, funding and servicing process, its participants and the compensation each receives. The fourth is a copy of CMC's detailed comments to the agencies on the proposed Interagency Guidance.

Nontraditional Mortgage Products Can Reduce Risk to Consumers and Lenders

Many recent media reports on developments in the housing market seem to assume that nontraditional mortgage products are inherently riskier than the alternatives that may be available to a consumer. CMC believes that nontraditional mortgage products, when used appropriately, can reduce rather than increase the risks to the consumer as well as the lender.

A threshold question is the meaning of the term "nontraditional mortgage product." The mortgage industry has extensive experience with many products that contain elements that would appear to be labeled "nontraditional" by the proposed Interagency Guidance. For example, lenders have been offering both interest-only home equity lines of credit, and home-equity loans with a balloon feature, in volume for decades without encountering either safety-and-soundness or consumer problems. Much of the recent discussion, however, concerns first-mortgage residential loans that allow the borrower to defer repaying principal and sometimes interest in the early years of the loan, which creates the potential for significantly higher payments later in the loan term.

All loans involve a balancing of risks and rewards to the consumer as well as the lender. For example, a consumer who chooses an adjustable-rate mortgage ("ARM") is making a tradeoff between the certainty of a fixed rate and, in most cases, the lower average interest rate and total cost of loan that are available with an ARM because the lender has lower interest-rate risk. Conversely, a consumer who chooses a fixed-rate loan usually pays more interest and makes higher initial payments in exchange for the security of a guaranteed rate.

Advantages of Nontraditional Mortgage Products to Consumers

Some of us remember when an ARM was viewed as a nontraditional mortgage product that was fraught with risk to consumers. The ARM, it was said, also posed a threat to lenders because consumers would default on their loans if market interest rates increased and their payments increased accordingly. At this point, the ARM is so common that it can no longer be described as "nontraditional," and neither borrowers nor lenders have had any great difficulty in managing the risks of an ARM.

The newer nontraditional mortgage products offer consumers payment flexibility that is not present in either a fixed-rate loan or a traditional ARM. This flexibility gives the borrower more control over his or her monthly expenses, which can reduce rather than increase the risk of default. It should not be assumed that greater flexibility–*i.e.,* a lower minimum payment–implies a higher risk. On the contrary, the ability to make lower payments during the early years of the loan, a common feature of nontraditional mortgage products, allows the borrower to stay current during period of temporary financial difficulty. Lower payments also allow borrowers who have uneven incomes to manage their cash flow. A lower payment allows a self-employed entrepreneur to devote resources to building the business rather than paying down a mortgage.

Advantages of Nontraditional Mortgage Products to the Mortgage Market

Similarly, although nontraditional mortgage products may increase the risk to lenders in some ways, there are other ways that those products reduce the lender's risk. Any product creates risk-management challenges. Long-term, fixed-rate loans, the most traditional, "plain-vanilla" mortgages in the marketplace, create interest-rate risk for the lender–the risk that the lender will, in the future, have to pay more for the money that funds the mortgage (such as deposits) than it receives in interest from the borrower. This risk has been perceived by banking regulators as so severe that banks and thrifts often avoid or severely limit their holdings of fixed-rate mortgages. Nontraditional mortgage products should not be singled out as necessarily riskier than other products; they simply present different types of risks.

Regardless of the type of loan product, the goal of the loan underwriting process is not to prevent all defaults, but to evaluate the risk and make mortgage credit available at a price that reasonably reflects risk. Unfortunately, some criticisms of nontraditional mortgage products, which are reflected in the proposed Interagency Guidance, seem to reflect a belief that these products should be virtually risk-free to the lender.

Issues Raised by the Proposed Interagency Guidance

As an example of the "risk-free" approach, the proposed Guidance would require lenders to underwrite loan applications on the assumption that the monthly payment from the beginning will be at the fully-indexed interest rate and will be sufficient to fully pay off the loan by the end of the loan term. In other words, in determining whether the borrower has sufficient income to make the payments, lenders would have to compare his or her current income, not with the payment expected for the next few years, but with a higher payment that may not apply for as long as ten years. This may not be a reasonable assumption, depending on the nature of the product and the borrower's particular circumstances.

Prudent lenders, with the approval of regulators, do not make similar "worst-case" assumptions in underwriting other types of loans. For example, while lenders underwrite an ARM loan with a low short-term "teaser" rate at the fully-indexed rate that applies after the teaser period, they do not assume that the payments on every loan will increase to the maximum possible amount allowed under the loan note and remain at that level for the full term of the loan, because that is not a reasonable economic assumption. In evaluating their risks on ARMs and other loan products, lenders also recognize that most long-term loans will be paid off long before the stated term of the loan, which significantly reduces the lender's risks.

Imposing much stricter underwriting requirements on nontraditional mortgage products than on other types of loans could have unintended consequences. For example, the requirement to make worst-case assumptions would drastically reduce the maximum debt-to-income ratio for nontraditional mortgage products in comparison to the maximum ratio for other loans, placing nontraditional mortgage products at a significant competitive disadvantage. Current maximum debt-to-income ratios and other requirements, such as cash reserves, are set conservatively in relation to the borrower's current status, at a level designed to protect against the possibility of future temporary reductions in income or increases in other expenses.

The proposed Guidance also includes extensive new consumer disclosures for nontraditional mortgage products that would not be required for other loans. Like the underwriting standards, these notices require lenders to assume a frightening and unrealistic "worst-case" scenario. Moreover, the proposed new disclosures would be superimposed on the extensive existing framework of required consumer disclosures for all mortgages. These disclosures would bias consumers against these products even when they are advantageous for them. They could cause "information overload" that confuses, rather than helps consumers. While CMC agrees that consumer comprehension is essential, we believe that the approach taken in the proposal is counterproductive.

In addition, the disclosure requirements in the proposed Interagency Guidance would apply only to regulated depository institutions and credit unions and their affiliates that are subject to examination. CMC believes that any special disclosures for nontraditional mortgage products should apply to all lenders, not only regulated institutions.

Finally, the thrust of the Guidance is to impose suitability requirements on lenders offering nontraditional mortgage products analogous to requirements for broker-dealers offering investments. Lenders would be expected, for these products only, to undertake a comprehensive review of the borrower's financial situation and to refuse to make a loan to a consumer if the lender found that the loan was not in the consumer's best interest.

Although we strongly support efforts to improve consumer understanding, once the consumer understands the available options, he or she should be allowed to decide which product best meets his or her needs. Institutions should not be required to impose their opinions on consumers. We agree that lenders should not mislead consumers and should provide full disclosure of the material terms of the transaction, but it would not be feasible or good policy to impose on the lender the additional burden of investigating each consumer's specific circumstances–beyond repayment ability–and recommending what the lender thinks is the best product. In contrast to a broker-dealer, a lender is advancing funds to, rather than receiving funds from, the consumer, and has a significant incentive to avoid making a loan if the borrower's record does not demonstrate both the capacity and willingness to repay.

The CMC appreciates the opportunity to submit its views on the issues presented by innovative new mortgage products.

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Attachment 1

DESCRIPTION OF SUBPRIME MARKET

Although the involvement of CMC's members in subprime lending varies, all CMC members share an interest in the efficient operation of the mortgage lending market. Subprime lending plays a crucial part in that market, allowing individuals who do not qualify for "prime" loans to make use of the equity in their homes to obtain credit at reasonable rates. As Comptroller of the Currency John D. Hawke, Jr., noted in a letter to the Senate Banking Committee—

> "One problem with the fact that 'predatory lending' is not susceptible to precise definition is that many people make the mistake of equating subprime lending to predatory lending. Responsible, risk-based subprime lending, that provides access to credit for individuals with less than perfect credit histories, should not, in and of itself, be considered predatory. The OCC encourages national banks to engage in responsible subprime lending, and has issued guidance to ensure that banks engaging in this type of business do so in a safe and sound manner and consistent with applicable consumer protection law."[1]

Legitimate subprime lending offers many benefits to consumers. A subprime home loan provides financial options to borrowers who cannot obtain prime loans because of problems with their credit history or for other reasons such as a reduction in income or other change in financial circumstances. Subprime credit gives such individuals a chance to buy a home. In other instances, the availability of subprime home-equity credit gives credit-impaired borrowers financial options that would not otherwise be available, including debt consolidation or other purposes.

The Subprime Mortgage Industry

Mortgages are the largest component of the U.S. debt market with over $5 trillion in outstandings. Total first mortgage origination volume in 2000 was over $1 trillion. Subprime mortgage lending accounted for approximately 13% of the entire mortgage industry's production in 2000.

Scale, capital and risk management requirements are driving rapid consolidation in the mortgage banking and servicing sectors of the industry. However, the mortgage origination business remains relatively fragmented.

[1] Letter from John D. Hawke, Jr., Comptroller of the Currency, to the Honorable Phil Gramm, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 5, 2000.

Subprime Credit Borrowers and the Use of Subprime Credit

Subprime borrowers are like any other borrowers in the U.S. economy. In fact, a study of nearly one million subprime and manufactured housing loans originated in 1998 shows a racial and ethnic borrower profile similar to the racial and ethnic composition of the total U.S. population.[2]

As practiced by mainstream lenders, including those CMC members who participate in the subprime market, subprime lending is also not conceptually different from lending to "prime" borrowers. The process begins when the borrower identifies a need for financing, either for a home purchase or for cash for other purposes. Although a significant portion of subprime loans are made to finance the purchase of a home, the proportion is lower than for prime loans.[3]

More frequently, a subprime borrower will seek cash to consolidate existing debt—the most common use of subprime credit. Home equity financing often allows the borrower to reduce monthly payments dramatically, allowing an overextended consumer to gain control of his or her budget. In addition, subprime loans carry significantly lower interest rates than other forms of credit. Although subprime loans average about 250 basis points (2.5 percentage points) above prime loans, at around 9.5%-10% they are still much less expensive than credit cards and other sources of credit (when those alternative sources are even available to credit-impaired borrowers).

Other common uses of subprime home equity loans include—

- Financing a college education;
- Paying medical bills;
- Providing alternatives for homeowners who fall behind on their mortgage payments; and
- Home improvement and repair.

[2] An April 2000 SMR Research study of 1998 HMDA data.

[3] An April 2000 SMR Research study of 1998 HMDA data showed the following distribution of loans by loan purpose:

Purchase	Refinancing	Home Improvement	Total
Subprime loans			
197,917	661,876	94,116	953,909
20.75%	69.39%	9.87%	100.00%
Prime loans			
3,968,766	5,863,187	819,393	10,651,346
37.26%	55.05%	7.69%	100.00%

Subprime Credit Grades

In the mortgage industry, loans are graded from "A" (a prime loan) to "D" (the riskiest subprime loan). An "A" loan is a "prime" loan, or a loan of the highest credit value. Typical factors that determine a consumers' credit grade are:

- Mortgage delinquency history
- Consumer debt delinquency history
- Bankruptcy or foreclosure
- Collection or judgments
- High debt-to-income ratios
- High loan-to-value ratios
- Low credit risk scores

Although the definitions of the subprime grades are neither precise nor completely uniform throughout the industry, the following examples convey the general concept of credit grading:

- A homeowner who filed for bankruptcy two years ago due to mismanagement of credit and was sixty days late on his current mortgage may qualify for a "B-" credit grade;

- A borrower who was laid off and had to accept a lower-paying job, and, as a result, was occasionally thirty days late in making her mortgage payment may qualify for an "A-" credit grade; and

- A widow who has an excellent credit record but has had difficulty in paying outstanding medical and home repair expenses and needs cash for her son's college education may qualify for a "B" credit grade. In this example, the subprime credit grade is based on income compared to total amount of debt, rather than on credit history.

Attachment 2

SPECIFIC PRACTICES OFTEN LABELED "PREDATORY"

In this section we discuss a number of practices that have been attacked as "predatory."[4] As the Board of Governors of the Federal Reserve System has noted, there are two types of abusive practices in home equity lending—blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways. . . .* [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[5]

Fraud and Deception

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements. Examples of "predatory" practices that are prohibited under current law include the following:

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[4] This list of alleged predatory lending practices is largely drawn from Patricia Sturdevant and William J. Brennan, Jr., *The Double Dirty Dozen Predatory Mortgage Lending Practices* (National Association of Consumer Advocates, Inc. 2000).

[5] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Misleading Solicitations

Advertising and marketing material may mislead consumers about the true cost or nature of a loan. These marketing practices are already prohibited under the Federal Trade Commission Act and analogous state laws. In many instances, deceptive solicitations also violate the Truth in Lending Act.

Home Improvement Scams

A home improvement contractor may originate a mortgage loan to finance the home improvements and sell the loan to a lender, or steer the homeowner to the lender for financing. The contractor may mislead the consumer about the work to be performed, fail to complete the work as agreed, damage the property, or fail to obtain required permits.

Current law prohibits all of these practices. In addition, under the Federal Trade Commission's "Holder in Due Course Rule," similar state law provisions, and HOEPA (for HOEPA loans), the lender will generally subject to the same claims and defenses that the consumer has against the contractor (up to the amounts that the consumer has paid on the contract). Thus, if the work is not completed in a satisfactory manner, the consumer will not be responsible for full payment.

As a result of this exposure, subprime mortgage lenders use devices such as joint proceeds checks and progress payments to ensure that home improvement contractors perform the work properly. We would recommend that all lenders these practices.

Falsified or Fraudulent Applications; Forgery of Loan Documents; and Inflated Appraisals

An unscrupulous broker or lender may convince an unsophisticated borrower who cannot repay a loan to sign a blank application form. The broker or lender then inserts false information on the form, claiming income sufficient to make the payments, and sells the loan to an investor on the basis of the false information. Alternatively, the "predatory" broker or lender may simply forge the borrower's signature. Another fraudulent practice is for the broker or lender to collude with a corrupt appraiser to deliver an appraisal that exceeds the true value of the property. The investor then purchases the loan on the basis of the inflated appraisal.

All of these practices have two things in common—

- They are illegal under current law; and
- The investor is a victim along with the borrower, since the loan will eventually default and the investor will lose most or all of its investment.

Although legitimate, mainstream lenders maintain extensive procedures to avoid being caught in scams of this type, they are sometimes victimized by fraud by "predatory lenders." We recognize that more can be done—CMC's plan for addressing predatory lending includes the creation of a nationwide registry that would report on licensing status and disciplinary actions, so that brokers and companies who are caught engaging in fraud in one jurisdiction could not simply relocate to another area.

Incapacitated Homeowners

There have been allegations that predatory lenders make loans to homeowners who are mentally incapacitated. Since the homeowner does not understand the nature of the transaction, the end result is default and foreclosure.

Under long-standing contract law principles, a mortgage loan in which the borrower was incapacitated at the time of signing is unenforceable. Entering into such a transaction may also represent civil or criminal fraud.

As noted, subprime lenders are not in the business of making loans that are likely to default, and major lenders maintain procedures to avoid originating or purchasing loans in which the borrower lacks the legal capacity to enter into a contract.

Acceptable Practices That Are Subject to Abuse

The second type of alleged predatory lending consists of practices that are not illegal or unacceptable but may harm consumers when used in abusive ways.

Mortgage Broker's Fees and Kickbacks (Including Yield Spread Premiums)

A prominent target of critics of "predatory lending" has been the yield-spread premium —compensation paid to the broker through an increase in the interest rate. Yield spread premiums have been the subject of extensive class-action litigation in which plaintiffs have argued that this form of compensation is illegal under the prohibitions in RESPA against kickbacks and fee-splits.

Yield spread premiums can be helpful to consumers. Paying a yield spread premium allows a lender to reduce the cash required to close the loan by financing closing costs through a higher interest rate. A borrower who understands the cost of the loan can choose between paying more of these costs upfront or over the course of a loan.

The appropriate remedy for any abuses of yield spread premiums is not to prohibit a practice that often benefits consumers. It is to provide more effective disclosures and improve the competitive environment so that consumers can make informed choices that serve their interests. If consumers understand their closing costs, including the broker's fees they are to pay, before they commit themselves to a transaction and lenders are allowed to compete in providing ancillary settlement services, the broker's receipt of a yield spread premium is irrelevant to the consumer's shopping decision. Importantly, we note that the Mortgage Bankers Association of America and the National Association of Mortgage Brokers have encouraged the use of a form, developed jointly by those organizations, that explains the broker's role.

Prepayment Penalties

Another practice that is often criticized as "predatory" is the imposition of a prepayment penalty—a fee for paying off the loan before some specified time. In most instances, the penalty is reduced over time until it is finally phased out completely.

Legitimate lenders use prepayment penalties to protect themselves against the risk that the borrower will prepay the loan before the lender has recovered its origination costs. A prepayment penalty is one way for a lender to hedge against that risk as well as other financial risks that can occur from early prepayment of the loan. The benefit of reduced prepayment risk can be passed on to the borrower in the form of lower points or a lower interest rate. If a lender is not allowed to impose a prepayment penalty, then it may not be able to offer a zero- or low-closing-cost loan or it may have to increase its rates to be profitable.

On the other hand, an unscrupulous lender can use a prepayment penalty to lock a consumer into an undesirable loan. The CMC believes that the appropriate remedy for the "predatory" abuse of prepayment penalties is to ensure that borrowers understand that a loan with a prepayment penalty is an option that allows them to reduce their interest rate or upfront costs, not a requirement to obtain the loan. In addition, under the CMC's mortgage reform proposal, no prepayment penalty would be permitted after five years from the date of the loan. However, prepayment penalties would be authorized during this five-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of six months' interest on the original principal balance.

Making Unaffordable Loans (Asset-Based Lending)

Another common allegation is that predatory lenders make loans on the basis of the value of the property, disregarding the borrower's ability to pay and in fact anticipating that the borrower will default and the lender will foreclose.

CMC members and other responsible subprime lenders are not in the business of making loans that borrowers cannot repay. Foreclosing on a house is costly, time-consuming, and almost always results in significant losses to the lender. As discussed in greater detail under Tab 3, many subprime loans are now sold into the secondary market, and the rating agencies insist that such loans meet underwriting standards.

For those reasons, the CMC supports, in principle, the existing HOEPA rule against engaging in a pattern or practice of lending without regard to repayment ability. In practice, however, it is difficult to craft specific rules to prevent such "asset-based" lending that reliably apply to all situations. Attempts to specify static rules regarding each borrower's repayment ability are likely to be counterproductive and injure the very borrowers they are intended to protect. For example, one common proposal is to establish a presumption that a borrower with a debt-to-income ratio ("DTI") above a certain cutoff, such as 50%, lacks repayment ability. This rule seems to make sense until a lender encounters a borrower who currently is meeting her obligations with a DTI of 65% and wants a loan that would reduce her DTI to 55%. Moreover, a DTI that indicates an excessive debt load in a rural area may reflect the average in areas such as New York City or San Francisco with very high housing costs.

In addition, setting a cutoff for DTI at any particular level ignores differences in borrowers' circumstances that affect the debt load they can carry. At one extreme, an individual with a very high income, $1 million/year for example, and few family obligations can easily afford to make high monthly payments and still have enough to meet other living expenses. At the other extreme, a borrower with a low level of income and many dependents may not be able to make mortgage payments that represent a high fraction of his or her income.

Another proposed remedy for asset-based lending is to institute "suitability" rules that create lender liability for making an individual loan if, in hindsight, the lender should have anticipated that the borrower would default. For a mainstream subprime lender that already makes every effort to avoid making loans that go into default, the effect of such a rule will be to increase the costs of foreclosure by requiring the lender to absorb both the losses on the loan itself and the cost of settling the claim that it made an unsuitable loan. These costs will ultimately be passed onto borrowers in the form of higher loan costs or reduced credit availability.

<u>High Points and Fees: Padding Closing Costs; Inflated Appraisal Costs; Padded Recording Fees; Bogus Broker Fees; and Unbundling (Double-Charging for the Same Service)</u>

One of the major sources of criticism of and litigation against the subprime lending industry has been fees paid to mortgage brokers and to other participants in the mortgage process such as appraisers. For example, critics allege that lenders overpay mortgage brokers in comparison to the services the brokers provide or require an expensive appraisal when a "drive-by" evaluation would suffice. Critics also note that the actual amount of these costs (as opposed to an estimate) is not disclosed in advance of settlement, when the borrower still has the opportunity to shop for a better deal or negotiate an improvement in the current one.

Although the CMC agrees that borrowers should not have to pay for services that are not needed or not provided, we believe that a focus on the specific components of the cost of the mortgage is misplaced. Ultimately, the borrower is concerned with total costs (closing costs and interest rate) and not with the relationship among the different providers of settlement servicers or the cost of each individual component of the loan.

The CMC also agrees that present disclosure requirements do not give borrowers accurate and understandable information about the costs of obtaining a loan when they are in a position to use it. In some instances, current requirements may actually have facilitated abuses—as when an unscrupulous lender allegedly misrepresented the TILA-required "amount financed" (which does not reflect loan fees deducted from the proceeds) as if it were the total amount of the loan.

But the CMC believes that it is ineffective to combat excessive loan fees through ever-increasing scrutiny of the practices of settlement service providers and the relationships among them. A more sensible approach—the one taken in the CMC's mortgage reform proposal—would be to eliminate the disincentives in current law that prevent mortgage originators from offering a single, guaranteed price for all settlement services, and then impose a requirement mortgage originators to honor that commitment. Borrowers have no way of knowing what a service such as an appraisal or flood certification "should" cost, yet current law has created an elaborate system of disclosure and monitoring of such costs that is of very little value to most consumers.

Credit Insurance

Consumer advocates often assert that credit insurance products are of little or no benefit to consumers. In fact, while credit insurance is clearly not a good choice for all consumers, lender-provided credit insurance meets a consumer demand that is not met elsewhere in the marketplace. Independent insurance agents are often not interested in providing insurance to subprime borrowers in the relatively small amounts characteristic of a second mortgage loan. In addition, the liberal eligibility standards and convenience of purchasing the insurance are attractive to some subprime customers.

An unscrupulous lender can abuse the credit insurance product by selling it to a consumer who does not want or need it, based on the misrepresentation that insurance is required to obtain a loan. But a report on subprime lending shows penetration rates for single-premium credit insurance ranging from 28.3% for first-mortgage loans to 47.9% to second mortgages.[6] These statistics do not support the common assertion that credit insurance is being foisted on unwilling consumers.

Moreover, abusive credit insurance practices are illegal under current law. TILA currently permits a creditor to exclude credit insurance from the finance charge and annual percentage rate only when the lender discloses in writing that it is voluntary and the consumer consents to the purchase by signing or initialing the disclosure form.[7] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address an unmet demand for life and disability insurance. About 25% of all U.S. households have no life insurance coverage, and about 40% of single parent households and households with annual incomes below $35,000 are completely uninsured. About 50% of all households are uninsured. The Department of Housing and Urban Development estimates that 46% of all foreclosures on conventional mortgages are caused by borrower disability and that 33% of Americans will suffer a serious disability between ages 35 and 65.

[6] *See* Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* at 12 (July 24, 2001).

[7] 12 C.F.R. § 226.4(d).

Single-premium credit insurance—in which the cost of the insurance is financed as part of the total cost of the loan—has been particularly controversial. The CMC members and other large lenders have modified their sales policies in response to concerns about the marketing of this product. Our members are offering a monthly-premium product and instituting a liberal cancellation policy.

The CMC's mortgage reform proposal, discussed above, includes a number of other protections related to credit insurance. There would be a clear and conspicuous disclosure given to the consumer that the insurance is voluntary and that it may be cancelled at any time with a refund of unearned premiums. Monthly-pay insurance could also be sold at or before closing. In both situations, there would be a notice after closing that the borrower may cancel the insurance at any time. Refunds of unearned premiums would be based on the actuarial method, not the less favorable Rule of 78's.

Loan Flipping

Loan flipping is the practice of an unscrupulous broker or lender repeatedly convincing the borrower to refinance in order to get a small amount of cash back. The broker or lender then receives additional points and fees. Consumer advocates often argue that it would be better for the consumer to take out a second, junior loan than to refinance the entire obligation. While that may be true in many instances, there are other situations in which the rate and terms on a new first mortgage are more desirable than the combination of retaining the existing first mortgage and obtaining a new second mortgage.

Loan flipping is another example of a practice that is easy to condemn in theory but difficult to prevent through a single rule that can be applied to all situations. One approach, taken in several state anti-predatory laws, is to require a demonstrated "net benefit" to the borrower before the same lender can refinance a loan. The difficulty in this approach is its subjectivity, which could leave lenders exposed to litigation if they could not demonstrate an adequate net benefit.

The CMC's mortgage reform proposal would limit the financing of closing costs and points on HOEPA loans to 3% of the loan amount for refinancings or equity loans entered into within twelve months of a prior financing. The rationale for this approach is to reduce the lender's incentive to flip HOEPA loans. Borrowers who must bring cash to closing to pay costs over the 3% are less likely to be "flipped" numerous times. At the same time, the CMC believes that 3% should be sufficient to allow for refinances to take advantage of declining interest rates.

Arbitration Clauses

Many consumer credit contracts—including many subprime mortgages—include a provision requiring that disputes be resolved through arbitration rather than through the lengthy process of litigation in the courts. Consumer advocates have asserted that binding arbitration clauses are inherently unfair, and there is no question that such a clause could be abused by erecting insuperable obstacles to a consumer's obtaining relief. But the U.S. Supreme Court has upheld the use of such clauses even when the case involves "claims arising under a statute designed to further important social policies," so long as the consumer can vindicate the rights granted under the law before the arbitrator.[8]

The Supreme Court noted in another case that arbitration benefits consumers in many ways:

> "[A]rbitration's advantages often would seem helpful to individuals, say, complaining about a product, who need a less expensive alternative to litigation. See, *e.g.,* H.R. Rep. No. 97-542, p. 13 (1982) ('The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices . . .')."[9]

In place of long, drawn-out proceedings in which the attorneys' fees often dwarf any nominal amount received by consumers, an arbitration clause offers consumers speedy access to a neutral forum that can resolve their dispute with the damages being paid to the consumer, rather than attorneys. The one group that clearly does not benefit from reasonable arbitration clauses in consumer contracts is the class-action trial bar.

Balloon payments and Negative Amortization

Consumer advocates often characterize two loan structures—*balloon payments* and *negative amortization*—as types of predatory lending. In a balloon payment loan, the monthly payments do not fully amortize the amount of the loan, resulting in a large final payment. In negative amortization, the monthly payments are insufficient to pay the interest that accrues on the loan, and the difference is added to the principal. Balloon payments are restricted and negative amortization is prohibited under HOEPA.

We recognize that both of these structures can be used in an abusive manner. If the broker or lender misleads the borrower about the nature of a balloon loan or the final payment is due in an unreasonably short time, the homeowner may not be able to afford the balloon payment and may either lose the home or be forced to refinance on unfavorable terms. A borrower who does not understand the nature of negative amortization may face similar negative consequences.

At the same time, both of these loan structures can be helpful to some consumers. Balloon payments can benefit borrowers by allowing them to obtain lower-cost credit than they would otherwise qualify for. A balloon note can be particularly helpful to a borrower who expects to move to a new location within the period of the balloon mortgage. Such a mortgage would be less expensive than a fixed-rate, long-term mortgage loan for the consumer.

[8] *Green Tree Fin. Corp. v. Randolph,* 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

[9] *Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

Negative amortization, by definition, reduces the monthly payment and may make a loan more affordable to a borrower with significant equity but insufficient income to qualify for a standard loan. Congress has recognized the benefits of one form of negative-amortization loan—the reverse annuity mortgage—by exempting such loans from the general prohibition against negative amortization in HOEPA.

Thus, further blanket restrictions on these loan structures, while protecting some consumers, could prevent others from obtaining loans that fit their financial circumstances.

Attachment 3

MORTGAGE LENDING AND SERVICING PROCESS

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, the borrower is referred by a real estate broker or home improvement contractor. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).
- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.
- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.
- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

Compensation to Brokers and Correspondent Lenders

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[10] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid by the lender

[10] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[11] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[12] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will

[11] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[12] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

Compensation to Investors (Portfolio Lenders or Secondary Market Investors)

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

CONSUMER MORTGAGE COALITION

March 27, 2006

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Re: Docket No. 05-21, 70 Fed. Reg. 77249 (Dec. 29, 2005)

Dear Sir or Madam:

The Consumer Mortgage Coalition (the "CMC"), a trade association of national residential mortgage lenders, servicers, and service-providers, appreciates the opportunity to submit these comments on the Interagency Guidance on Nontraditional Mortgage Products proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (the "Agencies"). The proposed Guidance would address underwriting standards, portfolio and risk-management practices, and consumer protection standards related to "nontraditional mortgage products," including interest-only and payment-option loans.

The CMC supports many aspects of the Guidance. We support the decision to provide this guidance on an interagency basis, although we believe that any new disclosure or other consumer-protection requirements should apply to all lenders, including those that are not affiliated with regulated entities, in order to be effective and as a matter of competitive equity. We support the issuance of these requirements as guidance rather than regulations and the decision to seek public comments, both of which should be helpful in ensuring that the Guidance meets its goals while minimizing the burden on industry and consumers.

As to the substance of the proposed Guidance, the CMC agrees with the Agencies that a loan with an aggressive short-term "teaser" rate should be underwritten at the fully-indexed rate, which reflects current industry practice, but are concerned that this concept should not be extended to require all loans to be underwritten at the long-term rate or assuming fully-amortized payments, regardless of the period to which the initial rate applies. We agree that the added risk that may be created by nontraditional features should be balanced by features that mitigate risk such as better debt-to-income and loan-to-value ratios. Such weighing of factors is already the practice of responsible lenders. We agree that "layering" of risks demands more conservative underwriting, although we note that not all loans with more than one risk factor truly involve "layered" risk.

At the same time, however, we are concerned that some aspects of the Guidance would have a negative effect on both regulated institutions and consumers. Among other things:

- The thrust of the Guidance is to impose suitability requirements analogous to requirements for broker-dealers for nontraditional mortgage products, in which lenders would be expected, for these products only, to undertake a comprehensive review of the borrower's financial situation and to refuse to make a loan to a consumer if the lender found that the loan was not in the consumer's best interest. Although we strongly support efforts to improve consumer understanding, once the consumer understands the available options, the consumer should be allowed to decide which product best meets his or her needs. The guidance should not require institutions to impose their opinions on consumers.

- Although we agree that consumer comprehension is essential, we do not believe that safety-and-soundness guidance for regulated institutions is the appropriate location for detailed disclosure requirements. If additional disclosures are to be required, they should apply to all lenders, not only institutions and their affiliates that are subject to examination by the Agencies, and they should protect all consumers. Moreover, the new proposed disclosures would be superimposed on the extensive existing framework of required consumer disclosures for mortgage products. These extensive disclosures, which would not be required for other products, would bias consumers against these products, even when they are advantageous for them. The disclosures could cause "information overload" that confuses rather than helps consumers.

- The Guidance departs from previous interagency guidance in the level of detail of the proposed requirements and the lack of consideration of best practices in portfolio management. We believe that the Guidance should be just that – suggestions that can be tailored to each lender's, and each borrower's, situation, rather than a series of rigid rules.

Background: Nontraditional Mortgage Products Can Reduce Risk to Consumers and Lenders

Although the proposed Guidance recognizes that nontraditional mortgage products can be beneficial to many consumers, the Agencies appear to assume that nontraditional mortgage products are inherently riskier than the alternatives that may be available to a consumer. We believe that nontraditional mortgage products, if properly managed, can reduce rather than increase the risks to the consumer.

All loans involve a balancing of risks and rewards to the consumer. For example, a consumer who chooses an adjustable-rate mortgage ("ARM") is making a tradeoff between the certainty of a fixed rate and, in most cases, the lower average rate and total cost of loan available with an ARM. Conversely, a consumer who chooses a fixed-rate loan usually makes higher initial payments in exchange for the security of a guaranteed rate.

As the preamble to the proposed Guidance states, nontraditional mortgage products offer payment flexibility. This flexibility gives the borrower more control over his or her monthly expenses, which can reduce rather than increase the risk of default. It should not be assumed that greater flexibility — *i.e.,* a lower minimum payment — implies a higher risk. On the contrary, the lower payment allows the borrower to stay current during period of temporary financial difficulty. It also allows borrowers who have uneven incomes to manage their cash flow.

Similarly, although nontraditional mortgage products may increase the risk to lenders in some ways, there are other ways that they can reduce it. Any product creates risk-management challenges. The interest-rate risk from long-term, fixed-rate mortgages has been perceived by the regulators as so severe that banks and thrifts have generally avoided holding them in portfolio for many years. Nontraditional mortgage products should not be singled out as necessarily riskier than other products; they simply present different types of risks.

The goal of the underwriting process is not to prevent all defaults, but to evaluate the risk and make mortgage credit available at a price that reasonably reflects risk. Features of the Guidance such as the requirement to underwrite at the fully-indexed, fully-amortized payment, regardless of whether that is reasonable given the particular product and the borrower's particular circumstances, could discourage lenders from using automated underwriting systems and other methodologies that reduce overall risk and benefit consumers while making the mortgage-lending process more efficient.

Discussion

Scope of the Guidance

A threshold question is the intended scope of the Guidance. There is no explicit definition of a "nontraditional mortgage product" in the proposal, although it does refer to "residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest." *See* 70 Fed. Reg. 77249, 77251-52.

The mortgage industry has extensive experience with many products that contain elements that would appear to be labeled "non-traditional" by this guidance. In fact, for example, lenders have been offering both interest-only HELOCs and equity loans with a balloon feature in volume for decades without encountering either the safety-and-soundness or the consumer problems noted in the proposed Guidance. In addition, the risk of "nontraditional" features of those products is already covered in the existing interagency Credit Risk Management Guidance for Home Equity Lending. Based on the discussion in the proposal of products such as interest-only loans and "option-payment" ARMs, it appears that the Agencies' intent is for the Guidance to apply to first-mortgage closed-end residential loans that permit a significant deferral of repayment of interest or principal in the early years of the loan, followed by potentially substantially higher payments. As in previous issuances such as the 1999 and 2001 guidance on subprime lending programs, the final Guidance should clearly identify the situations that it covers.

Consumer Protection Issues

The proposed Guidance includes very broad new requirements for disclosures to consumers who are shopping for a nontraditional mortgage product, as well as on monthly statements. Although CMC supports the concept of disclosures for *all* loans — not just nontraditional mortgage products — at an early stage of the mortgage process, we believe that it is inappropriate to include specific disclosure requirements in the Guidance. The Guidance should be just that – a series of suggested best practices that individual lenders can adapt to their particular circumstances, not a set of detailed, mandatory disclosures. The Guidance should discuss a range of solutions to the issues presented and not mandate one particular approach.

In addition, although the Guidance would not itself create a private right of action, there is a risk that state courts would look to it in interpreting state unfair and deceptive acts or practices ("UDAP") statutes that allow consumers to bring suit against state-chartered institutions. This is an additional reason that the Guidance should not include specific consumer-protection requirements.

Coverage of Only a Portion of Entire Industry

Because these disclosures would only apply to regulated lenders, they would leave consumers exposed to misleading claims by the minority of lightly regulated lenders that have been the main source of abuse, while putting regulated lenders at a competitive disadvantage compared to other lenders. The proposed Guidance does not ensure consistent disclosure across the industry.

In order to compete in the marketplace and serve their customers, banks need to be able to offer innovative products. If the government decides, as a matter of policy, that certain products are unsuitable, that decision should apply to all lenders and protect all consumers. This implies that any changes to existing disclosures should be made through amendments to Regulation Z, or, if that is not possible, amendments to the Truth in Lending Act ("TILA") or rulemaking by the Federal Trade Commission ("FTC") and the Agencies.

Overlaps or Contradicts TILA Requirements

The shopping disclosures would overlap, and in some respects conflict, with the extensive disclosures of ARMs already required under TILA. *See* Regulation Z, 12 C.F.R. § 226.19(b). For example, the Guidance suggests that:

> [P]roduct descriptions could specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.

70 Fed. Reg. at 77256. The TILA program disclosures, by contrast, give lenders the option, which most lenders choose, of providing a historical example rather than a "worst-case" one. *See* 12 C.F.R. § 226.19(b)(2)(viii)(A). We believe that the historical example is more useful to consumers than the worst-case scenario, which could cause consumers to avoid nontraditional mortgage products that could be beneficial to them, or to switch from a regulated lender to an unregulated one that was not subject to the Guidance.

In addition, the proposed advertising requirements would overlap with TILA's advertising rules. Regulation Z, which implements TILA, already prohibits practices such as advertising rates that are not available and showing only an initial (often first month's) low interest rate without showing the annual percentage rate over the life of the loan. *See* 12 C.F.R. § 226.24(a) and (b). In addition to the potential for duplication of or conflict with existing rules, some of the new requirements could trigger requirements to disclose additional information in the advertisement under TILA and Regulation Z. TILA's existing rules already appear to have the effect of suppressing competition and limiting the information available to consumers, by making it so difficult to show all the required data that creditors avoid displaying any numerical information in their advertising, depriving consumers of important information about their mortgage loan alternatives.

Finally, as noted in the proposed Guidance, existing agency regulations or interpretations already prohibit UDAPs or misleading advertising. *See* 70 Fed. Reg. at 77255 n.14. To the extent that a practice is not addressed under the existing Regulation Z rules, it will often be covered by the broad prohibitions against UDAPs contained in existing agency issuances.

Unworkable "Suitability" Standard

References to "responsible choices," consumers "prudently consider[ing] the costs, terms, features, and risks of" nontraditional mortgage products mortgages in shopping for a loan, and the like, suggest that the Agencies believe that lenders should take responsibility for steering consumers in the direction of what the lender believes is the most responsible or prudent choice for the consumer. In other words, the Guidance appears to suggest a suitability standard similar to what broker-dealers must abide by under the securities laws.

Although we agree that lenders should not mislead consumers and should provide full disclosure of the material terms of the transaction, we do not believe it would be feasible or good policy to impose on the lender the additional burden of investigating each consumer's specific circumstances – beyond repayment ability – and recommending what the lender thinks is the best product. In contrast to a broker-dealer, a lender is advancing funds to, rather than receiving funds from, the consumer, and has a significant incentive to avoid making a loan if the borrower's record does not demonstrate both the capacity and willingness to repay. In addition, a lender is prohibited under various federal laws from asking certain information that could be important in determining the most suitable product, such as information about childbearing plans, and is limited in obtaining information about the consumer's medical condition. *See* Regulation B, 12 C.F.R. § 202.5(d)(3); Fair Credit Reporting Act, 15 U.S.C. § 1681b(g)(3). After the lender provides the consumer with a range of reasonable product offerings, it should be ultimately up to the consumer to select the option that best meets his or her needs.

Information Overload

The many additional disclosures proposed in the Guidance are likely to exacerbate the existing problem of "information overload" in mortgage disclosures. As then-Acting Comptroller of the Currency Julie Williams noted in January 2005:

> I worry . . . that [the] approach [of mandating disclosures] is on the verge of breaking down, and if it's not re-focused, more prescriptive legislation and regulation could result. And it's reached that point not because consumers are getting too little information, but because they are getting *too much* information that's not what they're really after; and because the volume of information presented may not be *informing* consumers, but rather *obscuring* . . . what's most helpful to their understanding of financial choices.

Remarks by Julie L. Williams, Acting Comptroller of the Currency, before Women in Housing and Finance and The Exchequer Club, Washington, D.C., Jan. 12, 2005, at 2 (emphasis in original). Ms. Williams went on to characterize, as a "*critical element*" of the issuance of any regulation mandating disclosures, the need to "test . . . *how consumers interpret* particular disclosures and how to make disclosures *usable* to them." *Id.* at 5 (emphasis in original). As suggested by Ms. Williams, before any new disclosures are considered, they should be thoroughly tested in studies supervised by marketing professionals. The current TILA ARM disclosures are the result of a long process, in which Congress first mandated extensive worst-case disclosures and then cut back on those requirements in the face of evidence that, in addition to being burdensome to the industry, they were too complicated to be of much value to consumers. The Agencies should not repeat the error of overwhelming consumers with information rather than providing simple and comprehensible disclosures. Moreover, singling out nontraditional mortgage products for special disclosures is likely to convey the impression that these are especially risky and undesirable, compared to other products that may, in fact, not serve consumer's needs as well.

Unduly Burdensome Monthly Statement Requirements

The proposed Guidance would require extensive disclosures on the monthly statement for payment-option ARMs. Currently, federal law does not mandate disclosures related to the terms of the loan on monthly statements for closed-end loans.

Like many of the other provisions of the Guidance, this is a burden that would be imposed on the subset of mortgage lenders that are regulated by the agencies. Because of space limitations and the need to comply with a variety of state-law requirements, redesigning a monthly statement to comply with these new rules would present formidable systems problems for many loan servicers. While CMC members and other mortgage servicers have devoted a great deal of energy to making their monthly statements as clear and understandable as possible, regulated institutions and their affiliates should not be subject to a new set of requirements that does not apply to their competitors.

Self-Testing Programs

The proposed Guidance suggests that lenders use mystery shopping and call monitoring to ensure that line employees are "communicating appropriate information." 70 Fed. Reg. at 77257. While lenders should consider these approaches as part of an overall compliance program, singling out nontraditional mortgage products for this special treatment is unwarranted for at least two reasons.

First, lenders should have as much flexibility as possible in designing their compliance programs. For example, call monitoring may be appropriate in a call center but not in a retail branch that is open to the public, in which consumers as well as employees could perceive it as an invasion of privacy. Second, requiring use of these methods for nontraditional mortgage products but not for other products with similar risk profiles would tend to discourage lenders from offering the nontraditional product, reducing its availability.

Brokers and Correspondents

The Guidance would require lenders to monitor the marketing activities of brokers and correspondents. Although the CMC agrees that a lender should not encourage or acquiesce in deceptive or abusive practices by brokers and correspondents, it is not realistic to expect wholesale lenders to be able to monitor marketing practices of their retail counterparties. The wholesale players in the mortgage market generally have little or no information, other than copies of the disclosures, that would allow them to understand how retail brokers and correspondents marketed a loan that the lender purchased. Moreover, the monitoring requirement is not, on its face, limited to the originator or first purchaser but could apply to subsequent purchasers and investors, including securitizers, who are not equipped for this complex task.

Congress recognized this difficulty and generally limited the responsibility of assignees under TILA to violations apparent on the face of the documents. *See* 15 U.S.C. § 1641(a). Moreover, Regulation Z's advertising requirements apply to the "advertisement" rather than to the creditor on the note, and the FTC has generally proceeded against the entity that placed an advertisement that allegedly violated these requirements rather than against the creditor, which is often unaware that an advertisement was even placed. *See* 12 C.F.R. § 226.24. In appearing to mandate a direct role for lenders in ensuring that brokers and correspondents comply with the law, the Guidance would deviate from this pattern.

Suggested Alternative Approach

As an alternative to including detailed consumer-protection requirements in the Guidance, CMC recommends the following:

- To the extent that additional consumer disclosures are deemed necessary, they should be required of all lenders, through amendments to Regulation Z or through coordinated action also involving the FTC and Department of Housing and Urban Development.

- As part of the process of revising Regulation Z, the Agencies should consider revising the "CHARM" booklet to address the benefits and risks of nontraditional mortgage products. They could also create an online calculator allowing consumers to compare the costs of different mortgage programs, including nontraditional mortgage products, under different interest-rate and prepayment scenarios.

<u>Safety and Soundness Issues</u>

Underwriting to the Fully-Indexed, Fully-Amortized Payment

The proposed Guidance is extremely prescriptive on safety-and-soundness issues compared to other Guidance. The most significant example of such "rule-like" provisions is the proposed requirement to underwrite to the fully-indexed rate and fully-amortized payment.

The CMC would not oppose a requirement that loans with an aggressive short-term "teaser rate" should be underwritten based on the rate in effect when the discounted rate expires, which is standard industry practice. But the Guidance would apparently require basing criteria such as the debt-to-income ratio on the fully-indexed rate and fully-amortized payment even when those terms do not apply until far into the future.

Such a requirement could have unintended consequences. For example, the effective maximum debt-to-income ratio for some nontraditional mortgage products would be drastically reduced in comparison to the ratio for other types of ARMs. This effect would be compounded because points paid to buy down the ARM interest rate generally apply only to the initial rate, resulting in an even greater increase in the payment after the initial period. Assuming that traditional products such as 3/1 or 5/1 ARMs are not covered by the guidance, requiring this type of "worst-case" underwriting would put nontraditional mortgage products at a significant competitive disadvantage. Current maximum debt-to-income ratios and other requirements, such as cash reserves, are set conservatively in relation to the borrower's current status, at a level designed to protect against the possibility of future temporary reductions in income or increases in other expenses.

Loan-Level Stress Test

The proposal to require underwriting to the fully-indexed rate and fully-amortized payment would, in effect, require that lenders apply a "stress test" to each individual loan, rather than to their entire portfolio. This "loan-level" stress test is unprecedented and, if taken literally, would drastically reduce the availability of nontraditional mortgage products. If the same approach were applied to traditional lending, it would also significantly reduce the amount of credit available. For example, no lender would make a 30-year fixed-rate loan to a 45-year-old couple if it had to establish that the borrowers would still be both alive and able to make the full payment at age 75. Lenders can prudently make long-term fixed loans, as they can prudently offer nontraditional mortgage products, because they have sophisticated models that allow them to manage their financial risk on a portfolio basis. Using these models, they can take into account the probability that the vast majority of loans will be paid off before the end of the term – thirty-year mortgages have an average duration of seven to ten years, despite the nominal loan term of thirty years. As the Agencies are aware, in nontraditional loans as in other mortgage loans, borrowers have the option of paying off the loan at any time, and they do so for a variety of reasons, including sale of the residence, cashing-out equity, or moving from a variable to a fixed rate.

In addition, mandating underwriting based on the fully-indexed rate and fully-amortized payment would effectively require more conservative underwriting for less risky loans. Lenders generally regard an interest-only feature as reducing the credit risk, much as the length of time that the interest rate is fixed in a hybrid ARM decreases the risk, because it lessens the impact of monthly mortgage payments on the borrower's cash flow if his or her income is reduced or other expenses increase. Under the proposal, however, a 10/1 hybrid ARM in which the loan does not begin amortizing until after the ten-year fixed period would require more conservative underwriting than a less risky 3/1 ARM with amortization beginning after three years.

Valid stress-testing, which lenders should and do conduct for their entire portfolio, makes reasonable worst-case assumptions for default and runoff rates. The Guidance should clarify that the need to consider the borrower's ability to absorb higher payments does not require unrealistic assumptions about the whole portfolio, and, in particular, lenders can consider reasonable, although still worst-case, default rates and assume that many loans will be paid off before amortization begins.

Lower-Documentation Loans and Risk-Layering

Although we agree with the general concept that there should be balancing factors when a lender accepts a lesser level of documentation, we are concerned that some of the examples could be misunderstood by examiners. For example, the preamble to the proposed Guidance refers to "over-reliance on credit scores as a substitute for income verification in the underwriting process" as risk increases. 70 Fed. Reg. at 77252. This could be interpreted as an absolute ban on placing significant emphasis on credit scores in higher-risk loans, regardless of other features of the loan or the borrower. Examiners should be directed to evaluate the whole range of a lender's criteria in determining whether a specific program feature such as a relaxed documentation requirement is justified under the circumstances.

We support the indication in the "risk-layering" section that "[m]itigating factors might include higher credit scores, lower LTV and DTI ratios, credit enhancements, and mortgage insurance," but are concerned that it could be read to bar lenders from making, for example, nontraditional low-documentation loans above a certain loan-to-value ratio, regardless of the specific circumstances.

Implicit Recourse

The proposed Guidance includes a reference to the requirement in the Agencies' risk-based capital guidelines that certain repurchases of defaulted mortgages be treated as "implicit recourse," requiring "that risk-based capital be maintained against the entire portfolio or securitization." *See* 70 Fed. Reg. at 77254. As drafted, the language could be read as providing for stricter capital treatment of "implicit recourse" with respect to pools and securitizations backed by nontraditional mortgage products than for other loans. We do not believe that this is the Agencies' intent. The agencies could clarify this point by redrafting that language as follows:

> While sale of loans to third parties can transfer a portion of the portfolio's credit risk, an institution continues to be exposed to reputation risk that arises when the credit losses on sold loans or securitization transactions exceed expected losses. In order to protect its reputation in the market, an institution may determine that it is necessary to repurchase defaulted mortgages. It should be noted that<u>, as provided in the Agencies' risk-based capital guidelines, "[r]ecourse may . . . exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold." Institutions should consult those guidelines for a detailed explanation of the capital treatment of "implicit recourse" when they provide support to collateralization pools.</u> ~~the repurchase of mortgage loans beyond the selling institution's contractual obligations is, in the Agencies' view, implicit recourse. Under the Agencies'~~

> ~~risk-based capital standards, repurchasing mortgage loans from a sold portfolio or from a securitization in this manner would require that risk-based capital be maintained against the entire portfolio or securitization.~~

Answers to Specific Questions

Although we have addressed our primary concerns with the proposed Guidance in the discussion above, we are also answering the specific questions raised in the request for comments.

(1) Should lenders analyze each borrower's capacity to repay the loan under comprehensive debt service qualification standards that assume the borrower makes only minimum payments? What are current underwriting practices and how would they change if such prescriptive guidance is adopted?

As noted above, an appropriate stress test would not assume that every single borrower would make only minimum payments over the life of the loan, but would make appropriate assumptions about the worst-case proportion of borrowers who would actually experience payment shock. For example, a lender should be able to make reasonable, although conservative, assumptions about how many borrowers with a payment-option loan: (1) will not have opted to amortize their loan; (2) will still be borrowers when the higher, amortized payments apply and (3) will not then be able to afford those payments. Payment shock will not be an issue if the borrower pays off the loan during the initial period, which is often the case, and lenders should be allowed to recognize runoff rates.

(2) What specific circumstances would support the use of the reduced documentation feature commonly referred to as "stated income" as being appropriate in underwriting nontraditional mortgage loans? What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? Please include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.

This question appears to assume (as does the proposed Guidance) that combining a nontraditional mortgage product with other "nontraditional" features such as "stated income" automatically involves "layering" of risk rather than an assessment of separate risks. In fact, the use of "stated income" in combination with a nontraditional mortgage product such as an interest-only or payment option ARM is a good example of why this might not be true. "Stated income" is often used to spare self-employed borrowers from onerous documentation requirements, in situations whether other factors, such as credit score and initial equity, indicate low risk. A lower payment during the early years of the loan, a common feature of nontraditional mortgage products, allows a self-employed borrower to devote resources to building the business rather than to paying down a mortgage and makes it easier to cope with an uneven cash flow. Thus, in this example, a nontraditional mortgage may be less risky for a "stated income" borrower than a traditional ARM or a fixed-rate loan.

The recent *Ameriquest* settlement specifically authorizes stated-income loans to any borrower, including non-prime borrowers, subject to specific disclosures and other protections. Although we oppose any blanket limitation on stated-income loans, the agencies could consider noting that lenders should understand the borrower's reasons for selecting a stated-income or other low-documentation loan. For example, a borrower with a W-2 and easily verified income who is still motivated to pay a higher rate for a stated-income loan may raise suspicions that he or she does not really earn the claimed salary.

(3) Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?

Requiring lenders to consider repayment ability far into the future for nontraditional mortgage products would be a departure from current practice for other loans, and is unnecessary for proper risk management. As noted above, if the same approach were applied to the traditional 30-year, fixed-rate loan, many current borrowers could not qualify, despite the continued very low default rate on such loans.

* * *

We appreciate the opportunity to present our views. Please do not hesitate to call (202) 544-3550 with any questions.

Sincerely,

Anne C. Canfield
Executive Director

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HEARING BEFORE THE

SENATE BANKING, HOUSING AND URBAN AFFAIRS'

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

AND THE

SUBCOMMITTEE ON ECONOMIC POLICY

ENTITLED

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®, SEPTEMBER 20, 2006

The National Association of REALTORS® (NAR), is pleased to submit our views to the Senate Banking, Housing and Urban Affairs' Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy for the hearing entitled, "Calculated Risk: Assessing Non-Traditional Mortgage Products."

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association representing more than 1.3 million members and five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

NAR Supports High Standards and Consumer Education

NAR is very concerned that some borrowers are using non-traditional mortgages without fully understanding the risks associated with such products and applauds the subcommittees for examining this important consumer issue. Last year, NAR, in partnership with the Center for Responsible Lending, issued two consumer education brochures, "Specialty Mortgages: What Are the Risks and Advantages?" and "Traditional Mortgages: Understanding Your Options," both of which are attached to this statement. The brochures emphasize how important it is for consumers to make sure they fully understand how traditional and non-traditional mortgages work before deciding which is the right choice. More recently, NAR commented in support of the federal banking agencies' and the National Credit Union Administration's (NCUA) proposed Guidance on Non-traditional Mortgage Products (Guidance) which establishes high standards to protect consumers from unknowingly agreeing to inappropriately expensive products.[1]

Common Types of Non-Traditional Mortgages

In many housing markets, home prices have risen to very high levels, making it harder to afford a home – especially for first-time homebuyers. The traditional fixed-rate mortgage and standard adjustable rate-mortgage may not be the best options for everyone. A growing number of

[1] 70 Federal Register 77249 (December 29, 2005).

homebuyers are deciding to use one of the several new types of non-traditional mortgages that let them "stretch" their income so they can qualify for a larger loan. Some common types of non-traditional mortgages include, but most certainly are not limited to:

- **Interest-Only Mortgages:** When a consumer's monthly mortgage payment only covers the interest owed on the loan for the first 5 to 10 years of the loan, and nothing is paid to reduce the total amount borrowed. After the interest-only period, the consumer starts paying higher monthly payments that cover both the interest and principle that must be repaid over the remaining term of the loan.
- **Option Payment ARM Mortgages:** When a consumer is given the option to make different types of monthly payments with this mortgage. For example, a consumer may make—
  - A minimum payment that is less than the amount needed to cover the interest and increases the total amount of the loan;
  - An interest-only payment; or
  - Payments calculated to pay off the loan over either 30 years or 15 years.
- **40, 50 and even 60-Year Mortgages:** When a consumer chooses to pay off their loan over 40, 50 or 60 years, instead of the usual 30 years. While this reduces the consumer's monthly payment and helps them qualify to buy a home, the downside is that the balance of the loan is paid off much more slowly, the consumer pays much more interest and it takes longer for the consumer to build equity in the home.

When a Non-Traditional Mortgage May be Appropriate?

NAR recognizes the important contribution non-traditional mortgages have made to achieving record homeownership and we support responsible lenders making such loans when it is appropriate for consumers in special circumstances. For example, a non-traditional mortgage may be appropriate—

- When a borrower can expect a significant future increase in income, such as (a) at the conclusion of additional education or training, (b) when children start school, (c) when a small business becomes more established, or (d) when periodic car payments, tuition, or other financial responsibilities will no longer be a family obligation;
- If the borrower proposes to renovate the home to increase its value and upon completion of the work to refinance the loan or sell the property;
- If the borrower intends to own the home for a short time;
- If the borrower has assets sufficient to permit the family to supplement its income from savings in order to meet the higher payments for a reasonable period even if the mortgage market at the time the higher payments kick in would make refinancing difficult or infeasible; and
- Even if the borrower's debt-to-income ratio exceeds standards used by automated underwriting systems or other underwriting criteria of the lender, if the borrower has a history of paying rent or mortgage payments that exceed usual ratios.

NAR underscores that, even for borrowers in such circumstances where the lender determines they qualify for a non-traditional mortgage, consumers should very carefully consider both the risks and advantages of both traditional and non-traditional mortgages before making a decision.

What are the Major Risks of Non-Traditional Mortgages?

Payment Shock. One major risk is that the consumer's monthly payment may increase by a large amount, resulting in "payment shock." Even a change of 1 or 2 percent in interest rates can result in a very big jump in the consumer's monthly mortgage payment. For example, if the interest rate on a consumer's mortgage changes from 4 to 6 percent, their monthly payment could increase by as much as 50 percent. So if your payment is currently $1,000 it could jump to $1,500. If a consumer's income has not increased enough, he or she may not be able to afford the new larger monthly mortgage payment. And if that happens, the consumer could lose the home.

Example: How Payment Shock Can Occur

Assume that a consumer buys a home for $300,000, puts 10 percent down, and chooses a 5.75 percent **interest-only adjustable rate mortgage**. The mortgage requires interest-only payments for 5 years. After that, the interest adjusts every year based on rates in effect at that point.

- Initial monthly payment: $1,294.
- Monthly payment after 5 years with no increase in mortgage interest rates (amount increases because payments begin to include principal in addition to interest): $1,699.
- Monthly payment after 5 years with a 3 percent increase in interest rate to 8.75 percent: $2,220.

Higher Debt Over Time. Another risk that comes with non-traditional mortgages involves the consumer's "equity" – the amount a house is worth after subtracting the amount still owed to the lender. Consumers who choose some types of non-traditional mortgages will build equity in their home much more slowly than with traditional loans. In fact, with some non-traditional mortgages, the amount a consumer owes on their home could increase rather than decrease over time.

Consumer Protection Issues

NAR believes that lenders should be required to explain to consumers considering a non-traditional mortgage how they work and the unique risks associated with the loan. We strongly support the federal banking agencies and the NCUA's proposed Guidance, which in addition to establishing underwriting standards for non-traditional loans, would require lenders to:

- Explain the risks as well as the benefits in a clear and timely way;
- Alert borrowers about payment shock, negative amortization, prepayment penalties, and any pricing differences for "low doc" loans; and
- Issue monthly statements that explain the impact of various choices, when the borrower has an option about how much to pay.

Payment Shock. In our comment letter on the proposed Guidance, NAR advocated that the section on the subject of Payment Shock,[2] be strengthened to make it clear that lenders should disclose to consumers, *up front*, an example of the impact of typical non-traditional mortgages. For example, consumers should see how the payment would change for a typical mortgage amount (such as $100,000 or $200,000) if they pay only interest or, for payment option ARMs, pay less than needed to amortize the loan for the first years of the mortgage. In particular, NAR recommended that the example in the promotional materials section of the draft Guidance should state that product descriptions "should" – not "could" as proposed – specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical, worst-case example.

To promote compliance and clear and concise disclosures, NAR encourages Congress to recommend that the banking agencies and the NCUA develop model disclosure forms. Model forms would be particularly helpful for consumers who are shopping for loans and comparing the extremely complex terms for non-traditional mortgages. Even though variation among these products would require tailoring the model to the particular product, having a uniform base document would make a significant contribution to promoting consumer understanding.

Prepayment Penalties. While not unique to non-traditional mortgages, the issue of prepayment penalties is frequently raised in discussions on this subject matter, including the federal banking agencies' and NCUA's Guidance. Specifically, the proposed Guidance states that lenders should inform consumers if a prepayment penalty is a feature of the mortgage and the amount of the penalty. Lenders typically justify prepayment penalties as a trade-off for a lower rate. NAR has advocated to the federal banking agencies that the Guidance state that lenders should specify the benefit the borrower is receiving in exchange for accepting a prepayment penalty to give the applicant enough information to decide whether to select a mortgage with a prepayment penalty.

Bait and Switch. Families seeking non-traditional mortgages may face an especially high risk of "bait and switch" tactics that some lenders use to, in practical effect, force a family to take a higher cost mortgage loan at closing. One way to help deter this unscrupulous behavior by some

[2] See page 77256, center column.

lenders would be to establish policies that give borrowers the option and sufficient time to obtain a new loan, without penalty, if the lender changes the terms of the loan within a reasonable number of days before closing, with a refund of any fees or other charges already collected by the lender. We ask Congress to urge the federal banking agencies and the NCUA to include this concept in their proposed Guidance, which would be a significant step and signal to lenders and their affiliates that bait and switch tactics are unacceptable.

Steering. Another way to strengthen consumer protections would be to adopt policies to minimize steering of applicants that would qualify for a traditional prime mortgage to a non-traditional mortgage or even to a subprime mortgage instead. One approach would be to require lenders to initially process every application as an application for a conventional prime mortgage. Since underwriting is now computerized, this should add very little cost or time to the process. Borrowers approved for a conventional prime mortgages would still have the option of electing a non-traditional prime mortgage. Those who do not qualify for a conventional prime mortgage could then consider other options.

Negative Amortization Mortgages: The last issue we would like to address is negative amortization, which is a frequent feature of option payment ARM mortgages but can also be found in the traditional mortgage market. Negative amortization occurs when a consumer's monthly payment is less than the amount of interest owed on the loan. The unpaid interest is added to the loan's principal amount, causing the total amount owed to increase each month instead of getting smaller. NAR recognizes that loans giving consumers the ability to pay less than the fully amortizing monthly mortgage payment can help increase the affordability of homeownership. However, we also maintain that, more often than not, the risk associated with such loans that do not fully amortize at the end of the term or that must provide for a large increase in monthly payments outweighs the reward. For example, if the interest rate on an option ARM loan is steadily increasing, the negative amortization is increasing the total principal amount of the loan, and the house appreciation is slowing or is even declining, the homeowner's equity will most likely *decrease rather than increase.*

NAR maintains that Congress should prohibit lenders from making high-cost Home Ownership and Equity Protection Act (HOEPA) loans that negatively amortize. For loans that fall outside the scope of HOEPA, NAR encourages Congress to ask the federal banking regulators to consider whether the downside (negative amortization) of the option payment ARM mortgages is in fact helpful to the consumer in the long run. Regardless, lenders should be required to explain in detail to consumers agreeing to an option payment ARM that if the monthly mortgage payment is not made for the fully amortizing amount, the consumer's monthly payment and the total amount owed on the loan will increase.

Conclusion

When shopping for a mortgage, consumers have more choices than ever before. Non-traditional mortgages can help make homeownership more affordable for homebuyers in special circumstances. NAR hopes that any action the federal banking agencies, the NCUA and Congress may take in the area of non-traditional mortgages does not have the unintended consequences of driving this type of lending to extinction as it provides for an important source of home financing in unique situations. Nevertheless, NAR is encouraged by the federal banking agencies' and NCUA's effort to establish standards for how lenders (insured banks, thrifts, and credit unions) should underwrite, manage, and inform consumers about non-traditional mortgages, including interest-only and payment option adjustable rate mortgages. NAR stands ready to work with Congress on this important issue and is happy to make available to your constituents our consumer education brochures on non-traditional and traditional mortgages. The non-traditional mortgage brochure is also available in Spanish. Thank you.