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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

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GAO-06-1021

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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

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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

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.

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[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.

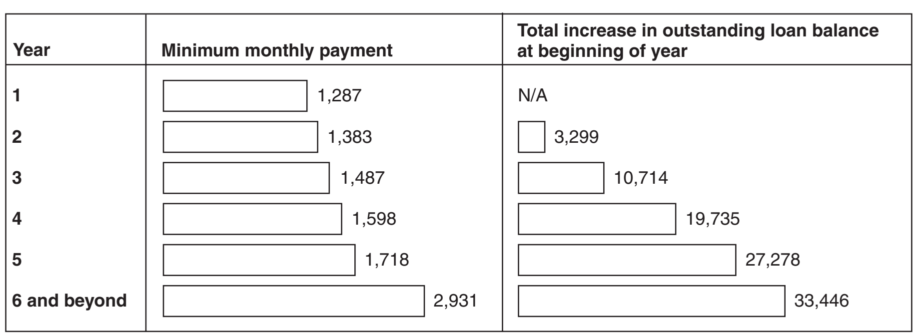
[14] *Inside Mortgage Finance*, Longer Amoritzation Products Gain Momentum In Still-Growing Nontraditional Mortgage Market (July 14, 2006), 3.

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

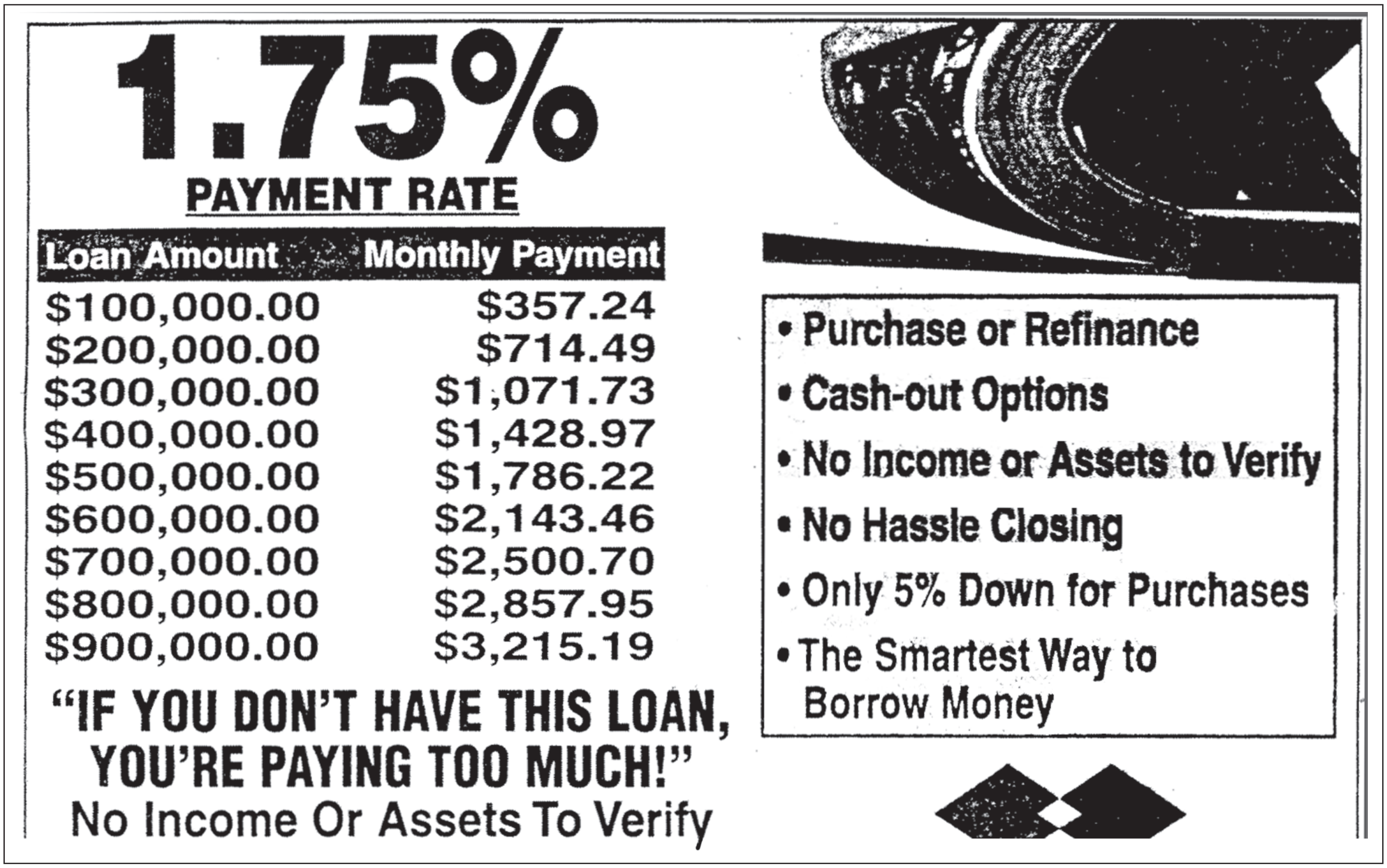
Borrowers can acquire information on mortgage options from a variety of sources, including loan officers and brokers, or as noted by mortgage industry participants, through the Internet, television, radio, and telemarketing. However, federal regulatory officials expressed concerns that some consumers 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	FINANCE CHARGE	Amount Financed	Total of Payments
The cost of your credit as a yearly rate.	The dollar amount the credit will cost you.	The amount of credit provided to you or on your behalf.	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 obttain 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.

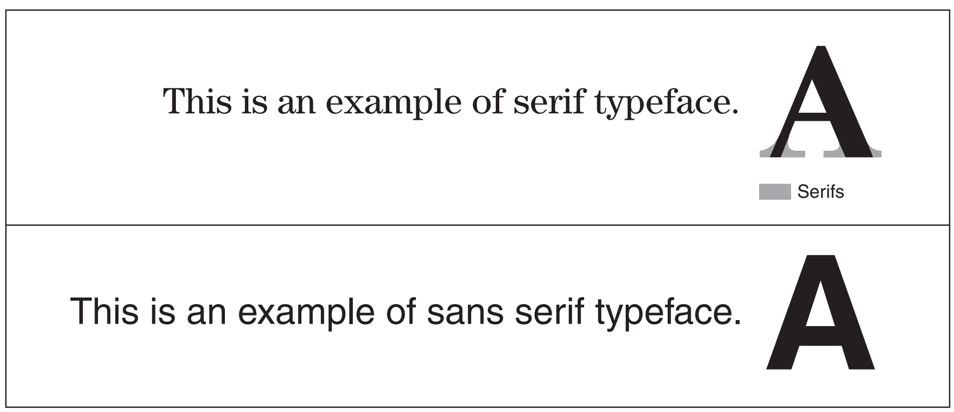
[1]These readability formulas did not evaluate the content of the disclosures or assess whether the information was conveyed clearly. For more information on this topic, see appendix I.

[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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