Consumer Federation of America

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Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders

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1. Introduction

There has been a proliferation of new mortgage products in recent years. Until even a few years ago, lenders offered essentially two mortgage products: fully amortizing, fixed rate and adjustable rate mortgages. In the past few years there has been an explosion of newer mortgage products which have never been a significant part of the mortgage market. Expanded borrower choice allows households to more carefully tailor their loans to their circumstances, but the expanded choices may be confusing to some borrowers who may not understand the implications of the wide variety of mortgages. Many of these new mortgage products will also expose some borrowers to payment shocks when their payments sharply increase when the terms of the loans change abruptly. As the FDIC pointed out in a consumer brochure in the summer of 2005, "Many new loan products are being widely offered that could benefit some people but be huge mistakes for others."[1]

Lenders have long offered more flexible mortgage products, but primarily they were offered only to upscale borrowers. Wealthier, sophisticated borrowers might opt for a mortgage with low monthly payments so they could capitalize on other investment opportunities.[2] Recently, changes in the mortgage market including the increased use of automated underwriting, credit scoring and risk-based pricing including subprime loans have allowed lenders to offer a broader range of products to more borrowers with a wider range of incomes and creditworthiness. Additionally, housing price escalation has made these loans seem less risky to lenders because the underlying asset was increasing in value.

On one hand, these changes have allowed more applicants to qualify for loans to purchase the homes they want. The non-traditional mortgages may be one important way for some borrowers to become homeowners.[3] However, consumers need to understand how these mortgage products work and how the terms of these mortgages will impact their families' finances over the lifetime of the mortgage. Many, including Consumer Federation of America, are justifiably concerned that the proliferation of new mortgage products is not appropriate for many borrowers who

[1] FDIC, "A Shopper's Guide to Bank Products and Services," *FDIC Consumer News*, Summer 2005.
[2] Teems, Yvonne, "The Interest-Only Mortgage Isn't Right for All Homebuyers," *Dayton Business Journal*, July 29, 2005.
[3] Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing 2005*, 2005 at 18.

receive them and that over the long term these mortgages could threaten homeownership sustainability.

There is particular concern over the homeownership sustainability for more vulnerable consumers – first time homebuyers, unsophisticated financial consumers, and consumers traditionally underserved by the mortgage market, especially lower-income and minority consumers. These borrowers are less likely to understand their ability to negotiate mortgage terms, the complexity of the mortgage vehicles they are offered, and the long-term monthly payment variation between the different products now available on the market.

Additionally, the terms of some of these loans may mitigate some of the wealth-building effects of homeownership. Interest-only mortgages and payment option loans, which can negatively amortize, can mean that for the initial borrowing period, the wealth gain from the mortgage comes entirely from appreciating home prices and not from the repayment of the principal. If housing prices rise more slowly than they have recently or stagnate, these borrowers will have built little household wealth. If home prices fall, these borrowers could owe more in mortgage debt than their homes are worth.

Finally, the increase in the number of non-traditional mortgages could have implications for the lending industry. Although some thrifts have been offering some of these products for many years, many lenders are new to these products. Lenders who have specialized in these non-traditional mortgages could find that if a large number of borrowers face sharp payment shocks when their loans are recalculated after the initial low monthly payment rate, interest rates increase or housing prices slide, that the lenders have a larger number of non-performing loans on their books. The majority of non-traditional mortgages originated during 2004 and 2005 will season in 2006 and 2007, so consumers could start facing payment shocks soon. There are some financial analysts that are concerned that the credit scoring mechanisms that have been used to assess repayment and default risks for traditional 30-year mortgages may be ill suited to measure the risks of these emerging non-traditional mortgage products. Banking regulators have been warning the lending industry of such an eventuality more consistently than the regulators have been warning consumers about the risks of taking these more complicated financial products.

This paper examines the non-traditional mortgage market and its potential impact on borrowers and lenders. First, it describes the range of non-traditional mortgage products, their typical loan terms, market distribution and potential effects for consumers. Second, it examines the market conditions that have fostered non-traditional mortgage lending, the underwriting and credit implications of non-traditional mortgage lending for originators and the potential for payment shocks and defaults for borrowers. Third, it analyzes information gathered regarding the characteristics of non-traditional mortgage borrowers in terms of income, credit scores and loan-to-value ratios relative to all mortgage borrowers. Fourth, it lays out the key concerns over non-traditional mortgage borrowing for consumers and the housing market. Fifth, it discusses some actions that are needed to ensure that these products are not aggressively marketed to vulnerable consumers. Last, it discusses the proposed federal regulatory guidance on non-traditional mortgages.

2. The Variety of Non-Traditional Mortgage Products

Over the past few years, the number of loan products available to homebuyers has exploded, but there is little understanding by many borrowers about how to compare or even understand the differences between these loan products. The language the lending industry uses has contributed to this confusion, since the multiplying number of loan products are described by a multiplying number of labels or names. Even the broader industry description of "non-traditional" or "exotic" mortgages confers little information to average consumers at the same time that more people are paying closer attention to the real estate market since housing prices began to steeply appreciate.

Over the past fifty years, borrowers traditionally used loan products that were primarily either fixed rate or adjustable rate 30-year mortgages. Fixed rate mortgages had monthly payments which were constant for the duration of the mortgage; adjustable rate mortgages (ARMs) had monthly payments that would vary from month to month or year to year based on an interest rate index which moved with market interest rates.

Generally, what non-traditional mortgages have in common is that they feature lower initial monthly payments than do traditional fixed or adjustable rate mortgages. Interest-only, payment option, piggy-back, and low- or no-documentation loans are all non-traditional mortgages. These mortgages often combine the non-traditional features with newer adjustable rate mortgage features or with other non-traditional features. So it is not impossible to imagine a low-documentation, interest-only hybrid ARM that permits negative amortization. These layered risk combinations only serve to concentrate the risk to the borrower and the lender. John Dugan, Comptroller of the Currency, noted, "There is no doubt that when several risky features are combined in a single loan, the total risk is greater than the sum of its parts."[4]

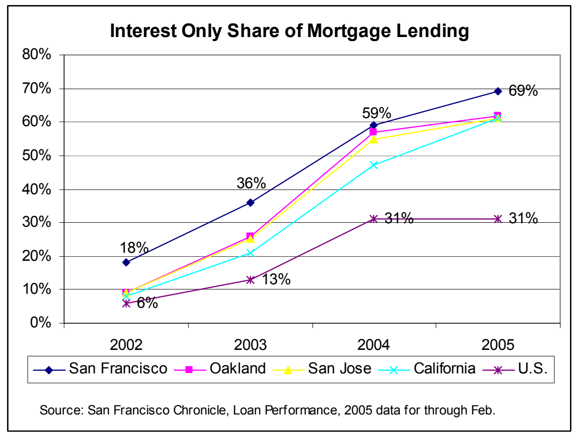
Interest-only mortgages (I/O Loans) allow borrowers to defer payment of principal and thus pay only the monthly interest on their mortgages for a set period of time (usually 1, 3, 5 or 10 years) after which the borrowers must pay down (or amortize) their mortgage at a faster rate. Payment option (or option ARMS or pick-a-payment mortgages) allow borrowers to choose their monthly payment structure – either amortizing, interest-only or minimum payment (which is often even lower than the monthly interest payment). This may be somewhat familiar to consumers because it is similar to the way credit card bills are presented – a minimum payment which makes little if any dent in the principal of the consumer loan. Hybrid ARMs start as fixed rate mortgages which convert to adjustable rate mortgages after an initial period and thus offer the prospect of higher monthly payments should interest rates rise. Piggyback (no money down, 80/20, or 80/10/10 loans) allow borrowers to purchase a home with little or nothing down and without requiring private mortgage insurance. Lenders have recently been offering mortgage products which help borrowers avoid the costs of paying PMI by making an 80 percent of the home price traditional mortgage and a 10 percent second lien for borrowers with a 10 percent down payment or in some cases with a 20 percent second lien mortgage to make the down payment to the seller. Low-documentation, no-documentation or Alt-A loans are alternative qualification standards

[4] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 6.

where borrowers pay a premium for lenders to approve mortgages for applicants who do not present detailed proof of income or assets that traditionally have been required; borrowers certify their income instead. These products are discussed at some length below.

Interest-Only Mortgages (I/O Loans)

Interest-only mortgages have recently become increasingly popular, especially in real estate markets with skyrocketing prices. However, interest-only mortgages are not new; they were common in the 1920s. At that time, most mortgages were interest-only loans for their entire terms (usually less than 10 years), so borrowers did not amortize the loan at all and had to refinance the loan at the end of the term.[5] Homeowners used their money to invest in the stock market prior to the 1929 market crash rather than paying down their debt.[6] When real estate prices collapsed during the Great Depression, interest-only foreclosures spiked and lenders stopped making interest-only loans for the next seven decades.[7]



Interest-only loans were once niche products used for cash flow management purposes by upscale borrowers. More recently, they have been promoted in many markets as a way for cash-strapped borrowers to afford homes or afford larger homes than their incomes would ordinarily permit under traditional lending guidelines. Many interest-only borrowers will have initial monthly payments about 20 percent lower than for a traditional amortizing loan.[8] According to data from Loan Performance, interest-only borrowers tend to have higher down payments than other borrowers, meaning they have a larger equity stake in the property.[9]

Interest-only loans are a growing share of the mortgage market. Loan Performance has reported that interest-only mortgages made up nearly one third of mortgage originations in 2004 and 2005.[10] Almost one fifth (18%) of loans in securitized mortgage portfolios in 2004 were interest-only loans worth $324 billion.[11] In some markets with high real estate prices, even higher shares of mortgages were interest-only loans. In California, interest-only loans grew more than sevenfold from 8% in 2002 to 61% in 2004.[12] In 2004, more than half of the borrowers in Orange County, California used interest-only mortgages, up from only 3 percent in 2001.[13] In

[5] Guttentag, Jack, "New Interest-Only Mortgage Loans Can be Quite Risky," *USA Today*, May 14, 2005.
[6] Weston, Liz Pulliam, "Could you Handle an Interest-Only Loan?" *MSN Money*, February 2004.
[7] "Interest-Only Mortgages Gain Believers, Skeptics," *Knight-Ridder*, July 10, 2002.
[8] Updegrave, Walter, "Starting with an Interest-only Loan," *CNN/Money*, June 29, 2005.
[9] Zito, Kelly, "High Interest in Interest-Only Home Loans," *San Francisco Chronicle*, May 20, 2005.
[10] Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing 2005*, 2005 at 17; Pasha, Shaheen, "Housing Bubble May Lose Some Wind," *CNN/Money*, October 21, 2005.
[11] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 56.
[12] Zito, Kelly, "High Interest in Interest-Only Home Loans," *San Francisco Chronicle*, May 20, 2005.
[13] Lansner, Jonathan, "Riskier Loans Stir Up Interest," *Orange County Register*, April 12, 2005.

Washington, DC, more than a third of new mortgages in the first half of 2005 were interest-only loans, up from only 2% in 2000.[14]

Interest-only loans are being marketed to consumers as a way to leverage their purchasing power, but consumers may not understand the implications of choosing an interest-only loan. Some real estate agents are encouraging families to take out interest-only loans as a way for families with tight budgets to get over the homeownership hurdle of rising home prices. In an interview with ABC7 News in the San Francisco Bay area, Vivian Rivera from Paragon Mortgage in California recommended, "If you are just getting into a home and you really need every single edge you can get, then an interest rate only loan is the way to go."[15] In a 2004 survey, Consumer Federation of America found that young adults, Latinos, lower-income and less educated consumers are the most attracted to and least informed about interest-only mortgages.[16]

Initially, interest-only loans are not much different than fully amortizing loans during the opening years of a mortgage, because even for fully amortizing mortgages the majority of monthly payments are predominantly interest for the first few years. Consequently, households that are able to move to a new home or refinance their mortgages before the amortizing period of the mortgage kicks in can benefit. Households that relocate frequently or are planning on moving before the amortizing principal payments kick in might benefit from interest-only loans. Borrowers who are in school might benefit from low monthly payments while they are enrolled in class, but they could afford the payment increases once they were in the workforce.[17]

However, borrowers who are not in a position to refinance when the interest-only period ends will face a jump in monthly mortgage payments which can be quite steep. When the interest-only period on the mortgage ends, the increase in the monthly payments (known as payment shock) could be so large that some borrowers may not be able to afford their mortgage payments.[18] After the interest-only period ends the loan converts into a fully amortizing mortgage, but because of the years of interest-only payments, it amortizes more quickly and the payments are higher than a 30-year amortizing mortgage. Some borrowers are receiving interest-only adjustable rate mortgages, so when their loan starts to amortize, the interest rate could significantly increase at the same time, making the monthly payments much higher.[19] In the first half of 2005, nine out of ten interest-only loan originations were adjustable rate loans.[20]

Interest-only loans are also being marketed to borrowers with less than perfect credit. These subprime borrowers are more vulnerable to payment shocks than prime borrowers. The Comptroller of the Currency is concerned that the mass marketing of IOs to subprime borrowers

[14] Henderson, Nell, "Concerns Raised as Home Sales, Prices Rise Again," *Washington Post*, September 27, 2005.
[15] "Financing Options for Home Buyers," ABC7, KGO-TV, April 6, 2005.
[16] Consumer Federation of America, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.
[17] Teems, Yvonne, "The Interest-Only Mortgage Isn't Right for All Homebuyers," *Dayton Business Journal*, July 29, 2005.
[18] Weisser, Cybele, "Crazy Loans: Is This How the Boom Ends?" *Money Magazine*, September 16, 2005.
[19] Guttentag, Jack, "New Interest-Only Mortgage Loans Can be Quite Risky," *USA Today*, May 14, 2005.
[20] Mortgage Bankers Association, press release, "Mortgage Originations Rise in First Half of 2005; Demand for Interest-only, Option ARM and Alt-A Products Increases," October 25, 2005.

can create significant payment shock for many borrowers who are not prepared for the payments to spike.[21] Syndicated real estate columnist Kenneth Harney has called interest-only mortgage products "one of the most toxic to the unwary."[22]

Many borrowers are now trying to refinance their loans before their amortizing payments begin. However, with rising interest rates and many homeowners having cashed out much of their homes' equity, lenders may be reluctant to offer credit on affordable terms and it could be difficult to secure a refinance loan.[23] Moreover, refinance loans could lead to additional costs from fees that are charged by lenders. Some interest-only borrowers may be forced to sell their homes before the amortizing payments begin. Even in stagnant or flat housing markets, interest-only loans could be costly for borrowers. If a borrower sells before making any principal payments and the home has not appreciated more than the cost of the real estate sales commission or transaction costs (typically about 6% of the sales price), the homeowner could end up having to pay those costs out of pocket.[24] In the third quarter of 2005, the median sales price for existing home sales was $215,000, which would mean that sellers would need nearly $13,000 to pay for real estate commissions to sell their house.[25] These potential refinance or resale difficulties are ignored by desperate buyers and glossed over by realtors and mortgage brokers who are pushing these products.

Interest-only mortgages may be appropriate for some borrowers, but the rapid increase in the proportion of interest-only mortgages suggests that they may be being over promoted to borrowers. Because interest-only loans appear to be marketed in some cases based on a borrower's ability to make initial monthly payments, CFA is concerned that borrowers may not adequately understand the long-term implications of the cost of the loan or the potential difficulty in refinancing. Since many of these loans will convert to rapidly amortizing mortgages within a few years, some of these borrowers could face difficulty in paying their mortgages. If these borrowers fall behind on their loans when the interest-only period ends, their credit scores would be negatively impacted, it would become more difficult and costly to refinance the loan, and they could face foreclosure.

Pay Option, Option ARMs or Pick-a-Payment Mortgages

Payment option mortgages allow borrowers to choose the amount they pay each month – from a fully amortizing payment, an interest-only payment or a minimum payment that is lower even than the amount of an interest-only payment. Payment option mortgages once were offered only to wealthy borrowers who could manage the costs and risks of these loans, but recently the loans have been push-marketed as "affordability products" for households to become homeowners in

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[21] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 7.
[22] Harney, Kenneth R., "Interest-Only Loans are Potential Time Bombs," July 3, 2004.
[23] Haddad, Annette, "Risky 'Exotic' Loans Fostering Refi Cycle," *Los Angeles Times*, October 10, 2005.
[24] Teems, Yvonne, "The Interest-Only Mortgage Isn't Right for All Homebuyers," *Dayton Business Journal*, July 29, 2005.
[25] National Association of Realtors press release, "Home-Price Appreciation Stays Hot in Most Metro Areas," November 15, 2005.

rapidly appreciating real estate markets.[26] A 2005 *Wall Street Journal*/Harris Interactive poll found that overall 4 percent of households had a payment option mortgage.[27] However, option ARMs have been an increasing component of mortgage originations during the first half of 2005. In the first five months of 2004, less than one in twenty mortgages were option ARMs, but in the first five months of 2005 option ARMs made up 25% of prime and Alt-A mortgages.[28]

Option ARMs became more prevalent in 2005, but as the housing market started to cool and interest rates rose, the demand for option ARMs slowed by the end of the year. By mid-2005, the Mortgage Bankers Association estimated that option ARMs constituted about 10 percent of mortgage loans.[29] The lenders that have specialized in option ARMs saw their option ARM volume fall to about a third of mortgages in the third quarter of 2005 from about 40 percent in the previous year or previous quarter.[30]

The lowest payments actually increase the size of the borrower's mortgage obligation, as the deficit between what the borrower pays and owes is added to the mortgage debt. This is especially likely when the option ARM's teaser rates expire. Teaser rates are the lower rates lenders offer to make mortgage products more attractive to borrowers focused on initial monthly payments, and option ARMs typically offer their products at 200 basis points below the prevailing market rate.[31] When the teaser rates expire, the lender raises the interest rate, but not the minimum payment requirement, so the borrower who makes only minimum payments will be accumulating additional debt from the higher interest rates which are not covered by the minimum payments. Less financially sophisticated borrowers could enter these mortgages unwittingly. Borrowers can be lured into these mortgages with initial teaser interest rates that can be as low as one percent but last only a few months.[32] One lender that specializes in option ARMs, Golden West Financial's Herb Sandler, noted recently that some lenders are not fully explaining or disclosing the risks of option ARMs and "are clearly faking their borrowers out."[33]

Although borrowers can choose to repay their loan under a number of options, the majority of borrowers are only making the smallest possible payments. Some industry analysts estimate that 70 percent of option ARM borrowers are currently making only the minimum payments.[34] Fitch Ratings reports that a significant number of new option ARMs immediately begin to negatively amortize upon origination.[35] To date, payment option mortgages have been primarily marketed

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[26] Dugan, John C., Comptroller of the Currency, Remarks before the Consumer Federation of America, December 1, 2005 at 10.
[27] Bright, Becky, "A Third of U.S. Homebuyers Use Creative Mortgages Poll Finds," September 9, 2005.
[28] Office of Thrift Supervision, "Option ARMS: Part One," *The Quarterly Review of Interest Rate Risk*, Vol. 10, Iss. 2, Second Quarter, 2005 at 3.
[29] Ambrose, Eileen, "Option ARMs Often Are Poor Choice for Buying a Home," *Baltimore Sun*, August 1, 2005.
[30] Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal*, November 29, 2005.
[31] Office of Thrift Supervision, Examination Handbook, Section 212C.1, Negatively Amortizing Mortgages, June 2005.
[32] Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal*, November 29, 2005.
[33] Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.
[34] Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal,* November 29, 2005.
[35] Fitch Ratings, "U.S. Residential Mortgage Products: Only Time Will Tell," September 22, 2005 at 4.

to borrowers with strong credit scores. However, as the popularity of the mortgage product increases, it is likely that option only mortgages will be marketed to subprime borrowers.[36]

The unique terms of payment option mortgages are particularly dangerous for the least sophisticated borrowers and for borrowers with less than pristine credit records. Comptroller Dugan has warned lenders not to aggressively market payment option loans arguing that "Lenders should not encourage or accept applications from borrowers who clearly cannot afford the dramatically increased payments."[37] The Comptroller of the Currency reports that half of the least creditworthy option ARM borrowers have mortgage balances that exceed their original loan amount.[38] Moreover, it is no longer just affluent borrowers who are using payment option mortgages to maintain financial flexibility. Borrowers from all portions of the credit score spectrum are utilizing option payment mortgages, with riskier borrowers using these mortgages the most frequently.[39]

A borrower making only the minimum payment can see the principal grow by about 2.5% over the course of a year.[40] Although lenders have been willing to make non-traditional mortgages because of the rapid real estate price increases, average real estate price appreciation over the long-term has been modest. Between 1975 and 1995, real single family home prices increased 0.5% per year and during the real estate price boom subsequent to 1995, real home prices increased 3.6% per year.[41] This means that even if home price appreciation remains at the level of the past decade, some of the home price appreciation would be consumed by the increasing size of the loan because of negative amortization. If real estate appreciation slowed to more reasonable historic levels, minimum payment borrowers would add to their debt each year.[42]

Most option ARMs require borrowers to start paying down the mortgage if the mortgage negatively amortizes too much (typically if the principal grows to more than 110-125% of the original loan). Increasing the size of the mortgage hurts borrowers in a rising interest rate environment because their monthly payment rises even faster – the principal grows while the mortgage interest rate adjusts up at the same time.[43] If real estate prices decline, payment option borrowers will not be able to use refinancing or resale as an escape hatch to avoid payment shocks.[44] For median priced existing homes, a 10 to 25 percent increase in the mortgage balance would add $21,500 to $53,750 to the homeowner's debt. Even if home price appreciation

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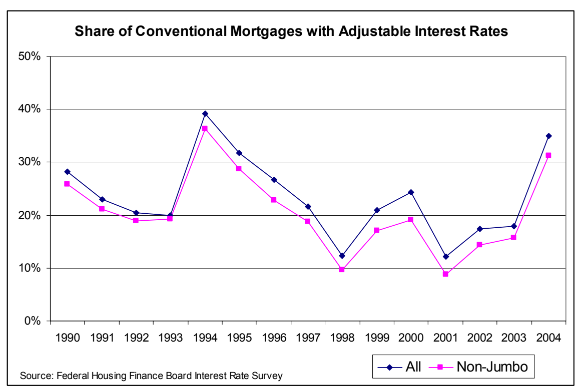
[36] Remarks by John C. Dugan, Comptroller of the Currency, Before the Consumer Federation of America, December 1, 2005, at 10.
[37] Remarks by John C. Dugan, Comptroller of the Currency, Before the Consumer Federation of America, December 1, 2005, at 12.
[38] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 7.
[39] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 7.
[40] Simon, Ruth, "A Trendy Mortgage Falls from Favor," *Wall Street Journal*, November 29, 2005.
[41] Himmelberg, Charles, Christopher Mayer and Todd Sinai, "Assessing High House Prices: Bubbles, Fundamentals, and Misperceptions," Federal Reserve Bank of New York Staff Report no. 218, September 2005 at 1.
[42] The increasing principle figure is not adjusted for inflation so it is not exactly comparable to the housing price appreciation figure.
[43] Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.
[44] Remarks by John C. Dugan, Comptroller of the Currency, Before the Consumer Federation of America, December 1, 2005, at 11.

exceeds the mortgage debt, to resell the home, the owner could be required to pay as much as six percent to real estate brokers or agents in closing costs, leaving homeowners to pay the difference.

The complexity of payment option mortgages and the considerable risk they could pose to homeownership sustainability make these loans poor choices for many borrowers. Although the borrowers will ultimately have to repay these increased mortgage balances, if the principal has grown significantly, borrowers may be forced into default which will destroy their credit rating.[45] The Office of Thrift Supervision has warned that rising interest rate shocks could lead a substantial number of homeowners to default at the same time, which harms individual families and could pose risks to lenders.[46] These risks could be especially acute for minimum payment borrowers when they are forced to start repaying their principal after a few years of negative amortization at the same time housing prices slumped. As Julie Williams, Chief Counsel at the Office of the Comptroller of the Currency noted, "If housing prices enter a period of decline, borrowers could wind up with a depreciating asset backing a rising loan balance – a recipe for potential trouble for them and their lenders."[47]

Developments in the Adjustable Rate Mortgage (ARMs) and Hybrid ARM Market

To date, lenders have not been aggressively marketing payment option and, to a lesser extent, interest-only mortgages to the subprime market, but the borrowers with compromised credit histories and lower incomes have been increasingly utilizing adjustable rate mortgages (ARMs) as affordability tools. These mortgages also can have significant payment shocks, particularly for borrowers with limited income flexibility as the mortgages adjust. Moreover, subprime borrowers taking ARM products (over 80 percent of the subprime market) assume greater interest rate risk than prime ARM borrowers because their loans typically have higher interest rates than prime notes. The most common subprime ARMs adjust after the first two years, which could further compound financial strain on some borrowers should interest rates rise during this period.



Adjustable Rate Mortgages or ARMs are mortgages with interest rates which are pegged to a prevailing interest rate index. When interest rates rise, the interest rate on one's mortgage increases and so does the monthly payment, but when prevailing interest rates fall, so do one's mortgage payments. The adjustments to the interest rate are typically capped so that the interest rate cannot rise more than a certain amount at any given adjustment or for a total over the life of

[45] Dugan, John C., Comptroller of the Currency, Remarks before the Consumer Federation of America, December 1, 2005 at 7.

[46] Office of Thrift Supervision, "Option ARMs: Part One," *The Quarterly Review of Interest Rate Risk*, Vol. 10, Iss. 2, Second Quarter, 2005 at 4.

[47] Julie Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005.

the loan. With fixed-rate mortgages, lenders earn more from borrowers than the marketplace when the prevailing rates are lower than the fixed mortgage rate and earn less if the prevailing interest rates are higher than the mortgage rate. With ARMs, this risk is transferred to the borrowers, who will forgo the stability of monthly payments under a fixed-rate mortgage for the chance that interest rates will decline making their future payments potentially lower. ARM borrowers face the risk that future interest rates will rise and they will have to pay more each month to cover the higher interest on their mortgage.

Some ARMs adjust from the outset of the mortgage by readjusting every year or another fixed period, and others start adjusting after a fixed period, known as hybrid ARMs. The most common ARMs in the prime market are the so-called 5/1 ARMs which start adjusting after five years and adjust annually every year after. Hybrid ARMs made up nearly three quarters (72%) of all adjustable rate mortgages in the second quarter of 2004, up from a low of about a third (32%) of adjustable mortgages in the fourth quarter of 2000.[48]

Generally, borrowers are more likely to want fixed-rate mortgages when interest rates are low to lock-in the best rates possible. The share of mortgages that are ARMs has been increasing in recent years as the interest rates have risen, perhaps with the hope that in the future interest rates might return to the three decade lows of the late 1990s and early 2000s. In 2001, 12.2% of conventional mortgages had adjustable rates, but by 2004 more than a third (35.0%) of conventional mortgages had adjustable rates, nearly a three-fold increase in four years.[49]

It is unusual for borrowers to shift to ARMs when there is a widespread perception that interest rates will rise. However, despite successive increases in the Federal Funds Rate by the Federal Reserve, both fixed and adjustable mortgage rates have not risen appreciably. Since July 2004 when the Fed began raising interest rates, the conventional fixed mortgage interest rate has hovered around 6 percent. However, the adjustable rate mortgage interest rate has been creeping up from 3.56% in March 2004 to 5.30% in November 2005.[50] For example, if a borrower took out a 3-year hybrid ARM in January 2003 at the prevailing rate of 4.26% on an average sized existing home with a 10% down payment ($215,000 home with a $193,500 mortgage) the payments would have been $954 a month for the past three years but would rise to $1,074 in January (if rates remain about where they were in November at 5.30%). This is why most borrowers avoid ARMs when interest rates are rising.

CFA has found that lower-income and minority consumers were more likely than other consumers to prefer ARMs but they were less likely to understand the risks.[51] More than three fifths of young adults, African Americans, Latinos, those with incomes below $25,000, and those without a high school diploma did not know how to estimate what would happen to monthly mortgage payments if interest rates rose two percentage points. Those who were willing to estimate the increased monthly costs underestimated the increase by between 40-50 percent. A

[48] Fahey, J. Noel, Fannie Mae, “The Pluses and Minuses of Adjustable-Rate Mortgages,” *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 3.
[49] Federal Housing Finance Board, Monthly Interest Rate Survey.
[50] HSH Associates, National Monthly Mortgage Statistics, 1995 to 2005.
[51] Consumer Federation of America, “Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages,” press release, July 26, 2004.

January 2006 Federal Reserve study found that significant numbers of ARM borrowers did not understand the reset period, the rate cap or the terms of their mortgages. It found that more than a third (35%) of ARM borrowers did not know the value of the reset interest rate cap and more than two in five (44%) did not know how to calculate the lifetime interest rate cap.[52] It is likely that this lack of knowledge has helped encourage borrowers to take out loans based on their initial repayment schedule without appreciating the possible risk of rising interest rates and increased monthly costs.[53]

Borrowers who are basing their mortgage decision on the initial monthly payment level could face significant payment shock as soon as the mortgage adjusts. For a median-priced existing home with a 10% down payment at the current 5.32% interest rate for 5/1 ARMs, the monthly payment would be $1,069.71.[54] If interest rates adjusted to 7.5%, the monthly payment would rise to $1,352.98, or a nearly $300 or 26.5% increase. In the late 1980s, interest rates rose to 10.25%.[55] If interest rates adjusted to that high level, the monthly payment on a median-priced home would rise to $1,733.96 – a 62.1% increase. A March, 2006 survey by the *Los Angeles Times/Bloomberg* found that one quarter (26%) of homeowners with adjustable rate mortgages were not confident that they could continue to make their mortgage payments if rates adjusted upwards in the future.[56]

ARMs are also offered with an initial lower interest rate to encourage borrowers to choose an ARM over a fixed rate mortgage. The initial teaser rates can be significantly lower than the 30-year fixed interest rates and ARM rates because currently ARM rates are close to fixed mortgage rates. The teaser rates revert to the ARM index rate at the first adjustment period, which means the first adjustments for ARM borrowers are almost certain to be increases in the interest rate and thus increases in the monthly payments. Borrowers who do not understand that their initial rate is a concessionary rate and that their rates will jump at the first adjustment (especially borrowers with the shortest adjustment periods) will likely face sharp increases in cost at the first adjustment.[57] The readjustment dates are looming for many ARMs. More than $200 billion worth of ARMs will adjust in 2006 and more than $1 trillion will adjust in 2007.[58]

The payment shock is especially worrisome for the subprime ARM borrowers. By the first quarter of 2005, more than half of subprime borrowers had adjustable rate mortgages compared

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[52] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.
[53] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 2.
[54] National Association of Realtors, Median Sales Price of Existing Single-Family Homes for Metropolitan Areas, Third Quarter 2005; "5/1 Interest-Only ARM Rates Remain Unchanged in the United States Monday," *Bankrate*.com, November 28, 2005.
[55] Porter, Eduardo, "Good New, Bad News: Your Loan's Approved," *New York Times*, August 28, 2005.
[56] *Los Angeles Times/Bloomberg* Poll, "Undercurrent of Concern Amid General Optimism About Home Values and Personal Finances," March 7, 2006 at 26.
[57] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 10.
[58] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 54.

to about fifteen percent of prime borrowers.[59] The concentration of ARMs and hybrid ARMs among subprime borrowers has additional risk of payment shock because these borrowers already have higher interest rates, so subsequent increases will be more difficult to afford.[60]

Piggyback, No Money Down, Simultaneous Second, or 80/20, 80/10/10 Loans

Mortgage lenders traditionally required borrowers to make down payments of at least 20 percent of the real estate purchase price to qualify for a loan. Borrowers who cannot put 20 percent down on their home purchases are typically required to buy private mortgage insurance (PMI) which insures the lender against the risk of borrower default. For years, borrowers with high incomes who had their wealth tied up in investments were able to receive no down payment loans.[61] Over the past fifteen years, the proportion of loans that have been made to borrowers making small down payments has increased significantly. In 1990, less than 3 percent of borrowers made down payments smaller than 5 percent, but the share of low or no down payment mortgages has grown more than fivefold to about 16-17 percent after 2000.[62] The National Association of Realtors reported last year that 43% of first-time homebuyers purchased homes with no-money down (compared to 28% of all homebuyers).[63] About half of all mortgages currently being written are either piggyback or lower-documentation loans.[64]

Lenders have recently been offering mortgage products which help borrowers avoid the costs of paying PMI by making a first-lien mortgage covering 80 percent of the home price, financed with a fixed rate, or increasingly, an ARM. The second lien loan is used to cover an additional 10 percent or even the remaining 20 percent to cover the down payment to the lender. The second mortgage is either a closed-end loan, or more often, an open-ended Home Equity Line of Credit (HELOC) with an adjustable rate. In 2004, three fifths (41.7%) of home purchase mortgage borrowing utilized piggyback loans, and by the first half of 2005 the proportion of borrowing using piggyback mortgage loans rose to nearly half (48.2%).[65] The average piggyback loan for home purchase was $46,000, or about 20 percent of average existing home prices.[66] A 2005 *Wall Street Journal*/Harris Interactive poll found that 4 percent of households had used a piggyback mortgage.[67] These no-downpayment mortgages have higher interest rates to compensate lenders for the additional risk.[68]

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59 Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 46.
60 Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 4.
61 Gaynor, Pamela, "Homeowners May Be Mortgaging Their Future with New Loan Products," *Pittsburgh Post-Gazette*, July 31, 2005.
62 Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing 2005*, 2005 at 17.
63 Tse, Tomaeh Murakami, "Down Payment's Downward Trend," *Washington Post*, January 21, 2006.
64 Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 6.
65 SMR Research, press release, "More People Use Scant Downpayments to Buy Homes, New Study Finds," August 16, 2005.
66 Greenspan, Alan and James Kennedy, Federal Reserve Board, "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," Finance and Economics Discussion Series, 2005-41, September 2005 at 11**.**
67 Bright, Becky, "A Third of U.S. Homebuyers Use Creative Mortgages Poll Finds," September 9, 2005.
68 Esswein, Pat Mertz, "A Mortgage for Every Buyer," *Kiplinger's*, August 2005 at 86.

Borrowers who rely on 80/20 mortgages could be pinched if the value of their home is steady or declines if they want to sell, because they will have built up very little equity.[69] FDIC noted that, when mortgaging the entire value of a home, "the risk of losing your home increases substantially and there's no margin for error."[70] One advantage is that the interest rate payments on the second mortgage (though not the principal) are tax deductible, compared to PMI premiums which do not receive tax benefits.[71] Piggyback borrowers could also end up upside down in their homes if housing prices declined within a few years of purchasing their homes. Borrowers who make down payments can survive small fluctuations in the real estate market, but borrowers who owe 100 percent of the value of their homes could owe more than their homes are worth even with minor downturns in the real estate market.

Low-Documentation, No-Documentation or Alt-A Loans

Lenders are increasingly approving mortgages for applicants who do not present the detailed proof of income or assets that traditionally have been required. In 2004, more than a quarter million conventional home purchase loans were originated to borrowers whose income was not disclosed. These borrowers represent 4.3% of all originations, which is only slightly below the 5.3% of originations to borrowers with incomes below 50% of the metropolitan area median income.[72] These loans benefit applicants who have volatile incomes such as those who work on commission, the self-employed or those who earn most of their money from bonuses.[73] In theory, small business owners who have assets but less ability to project earnings are able to vouch for their own incomes or provide minimal detail as to their incomes. For example, applicants might provide gross revenue figures for their small business but not net earnings or profits. These no documentation or low documentation loans (known as no-doc or low-doc mortgages) were historically very uncommon.

Many are concerned that a large number of low-doc borrowers may pose higher credit risks to lenders, especially if interest rates rise and housing prices fall.[74] There is some anecdotal evidence that lenders and brokers may be using low- no-doc loans to qualify borrowers who could not get the loans through traditional underwriting standards.[75] One anecdote shared in a *Motley Fool* column described a mainstream, unnamed lender that allegedly instructed an applicant to "Go ahead and just leave the application mostly blank; we'll fill it in."[76] To compensate for this risk, lenders charge higher interest rates for low- or no-doc loans.[77]

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[69] Weisser, Cybele, "Crazy Loans: Is This How the Boom Ends?" *Money Magazine*, September 16, 2005.
[70] FDIC, "A Shopper's Guide to Bank Products and Services," *FDIC Consumer News*, Summer 2005.
[71] "How Some Nontraditional Mortgages Work," *Associated Press*, October 8, 2005.
[72] Federal Financial Institution Examination Committee, Home Mortgage Disclosure Act National Aggregate Table 4-2, 2004.
[73] Joint Center for Housing Studies at Harvard, *The State of the Nation's Housing 2005*, 2005 at 18.
[74] Rozens, Aleksandrs, "Lenders Push Envelope to Get More Biz," *Associated Press*, November 23, 2005.
[75] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 48.
[76] Jayson, Seth, "H is for Housing. And Hiss," *Motley Fool*, November 28, 2005.
[77] Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing 2005*, 2005 at 18.

Lenders could be exposed to some risk from these loans if they have offered too many of them to borrowers who would not otherwise be deemed creditworthy to receive mortgages. In essence, lenders making mortgages on this basis use substitute assumptions in analyzing the borrower's capacity to repay the loan, such as lower LTVs or debt-to-income ratios. The fact that some of these borrowers are receiving other non-traditional mortgage terms on their loans and this layering of risk could be pose greater risks for lenders than anticipated.

All of these non-traditional mortgage products may have their proper uses. However, at the same time, non-traditional mortgages present genuine risks to borrowers who may not have the capacity to afford the payment shocks when these loans recalibrate and monthly payments rise. Additionally, just as these types of mortgages pose greater risk for consumers, they also pose greater risks to credit quality if they are not properly underwritten.

3. The Face of the Changing Mortgage Market

The shift to non-traditional mortgages of all types has been facilitated by three broad trends in the mortgage lending and real estate market. First, rapidly escalating real estate prices have encouraged households to leverage their purchasing capacity by choosing more flexible loans with lower monthly payments. Rising housing prices have also encouraged lenders to originate mortgages to more marginal borrowers, because the risk is balanced against an asset that is rising in value. This change is a double edged sword for consumers: it helps get families into homes or into larger homes, but it subjects them to a potentially steep payment shock when their non-traditional mortgages reset. Second, lenders are offering more tempting mortgage products to compensate for the decline in refinance mortgage originations as a result of the rising interest rate environment. Third, a series of technological changes in the lending industry has allowed lenders to more efficiently estimate risk and offer a wider range and variety of mortgage products tailored to the borrower.

The primary motivation for these new mortgage products is the rapidly escalating cost of housing which makes it more difficult for prospective homeowners, especially first time homebuyers, to make down payments as well as monthly mortgage payments. Most of the non-traditional mortgages have been written in strong real estate markets where there is an expectation of continued home price appreciation.[78] Higher home prices mean that new homeowners seek more flexible mortgage products to ensure that their monthly payments are affordable, but most of these products have payment structures which increase over time so the affordable initial payments could become significantly higher. Additionally, low interest rates and more flexible terms have led more homebuyers to purchase larger and more expensive homes which have put upward pressure on home prices. This cycle creates added demand for non-traditional mortgages – as more buyers use non-traditional mortgages to purchase more expensive homes, driving up prices and forcing more buyers to utilize non-traditional mortgages.[79]

[78] Gaynor, Pamela, "Homeowners May Be Mortgaging Their Future with New Loan Products," *Pittsburgh Post-Gazette*, July 31, 2005.
[79] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 6.

A September 2005 Harris poll found that one in five (19%) buyers purchased homes above their anticipated price range.[80] First time homebuyers who do not have equity from a previous home to make a down payment are often pushed into non-traditional mortgages in order to purchase a home.[81] Alan Greenspan testified to Congress in July 2005 that "Some households may be employing these instruments to purchase homes that would otherwise be unaffordable."[82] The Harvard Joint Center for Housing Studies suggests that the recent rapid increase in the use of interest-only mortgages demonstrates that an increasing number of families have reached the outer limits of housing affordability.[83] In a speech in October 2005, Federal Reserve Board Governor Susan Bies referred to non-traditional mortgages as "affordability" mortgages.[84]

Secondly, these new loan products help to maintain what would be a flagging demand for new mortgages. The rising interest rate environment has dampened the demand for new refinance mortgages, but the newer products with low initial payments have sustained loan volume over the past two years.[85] Since total loan volume is expected to stall or decline over the next few years, lenders are offering more flexible and initially affordable mortgages in an effort to compete for a declining pool of customers.[86] Additionally, more flexible loans which are easier to qualify for larger mortgages are helping lenders to bolster demand for new purchases and maintain loan volume as the real estate market cools.[87]

Third, the lending industry is offering these products with more risk than standard fixed-rate mortgages in part because of changes in the industry. First, transaction costs for mortgages have declined rapidly over the past decade. Mortgage fees and points have fallen from 1.10% of mortgages in 1994 to 0.40% in 2004, a 63.6% decline.[88] Second, the increased use of more sophisticated credit scoring devices has allowed lenders to better assess the risks of their loans – although these new scoring methods have yet to be tested in a high interest rate and falling real estate price environment.[89] Third, the evolution of automated underwriting standards helped to rapidly and accurately price different mortgage products for different consumers.[90] Fourth, the increasingly sophisticated modeling software allows lenders to look at each borrower individually for a wide range of loan products, terms and options.[91]

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[80] Gullo, Kelly, Harris Interactive, "Nearly One in Five Recent Homebuyers Purchased a Home That Exceeded Their Price Range," Vol. 1, Iss. 3, September 16, 2005.
[81] Porter, Eduardo, "Good News, Bad News: Your Loan's Approved," *New York Times*, August 28, 2005.
[82] Testimony of Alan Greenspan, Chairman of the Federal Reserve, before the Committee on Financial Services, U.S. House of Representatives, July 20, 2005.
[83] Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2005*, 2005 at 2.
[84] Bies, Susan Schmidt, Governor, Federal Reserve Board, Remarks at the National Bankers Association Convention, Beverley Hills, California, October 12, 2005.
[85] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, Georgia, October 27, 2005 at 6.
[86] Haviv, Julie, "Housing is Hot, But Types of Loans Seen Cooling," *Reuters*, July 14, 2005.
[87] Rozens, Aleksandrs, "Lenders Push Envelope to Get More Biz," *Associated Press*, November 23, 2005.
[88] Federal Housing Finance Board, Monthly Survey of Rates and Terms on Conventional Single-Family Non-farm Mortgage Loans, Table 1.
[89] Weisser, Cybele, "Crazy Loans: Is This How the Boom Ends?" *Money Magazine*, September 16, 2005.
[90] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 73.
[91] Yipp, Pamela, "Borrowers' Buffet," *Dallas Morning News*, July 25, 2005.

Concerns About Underwriting and Credit of Non-Traditional Mortgages

Non-traditional mortgages also may present underwriting concerns and credit risks for lenders since there is little long-term experience with the current concentration of non-traditional mortgages. Although some thrifts have experience with some of the non-traditional loan products, the broader lending industry has never marketed the current volume or concentration of non-traditional mortgage products. The new mortgage products "have the potential to take risk to a higher level than bank managers may be accustomed to" because of their inexperience with the new mortgage products over time, according to FDIC Director John M. Reich.[92]

Additionally, because of the intense competition for borrowers after the steep decline in refinancing when interest rates rose, lenders have been willing to accept more risk to drive originations. The overcapacity in the lending industry has encouraged the mortgage lenders to weaken their lending standards to compete for borrowers.[93] As Comptroller of the Currency John C. Dugan noted, "We're at the top of the credit cycle and banks naturally gravitate towards more risk."[94] Accurate assessment of credit risk of financial institutions is vital, because credit risk has been the leading cause of bank failures and remains the largest risk for most financial institutions.[95]

The 2005 federal regulators survey of underwriting found that banks had broadly and extensively eased their lending standards.[96] Larger lenders are making and holding more non-traditional mortgages than smaller banks. The Federal Reserve survey of lenders found that nearly a third (32.1%) of large banks estimated that non-traditional mortgages were more than 25% of their originations over the past year, but only 11.1% of smaller lenders made that many non-traditional loans.[97] Two thirds (67.8%) of large banks reported making more non-traditional mortgages over the past year than the previous year and no banks reported making fewer non-traditional mortgages compared to the previous year.[98]

Non-traditional mortgages require much more extensive application of meticulous underwriting standards, especially assessing the borrower's long-term ability to afford monthly payments.[99] The concentration of non-traditional mortgages by some lenders and the application of layered risk (notes with more than one non-traditional mortgage characteristic) requires lenders to assess

[92] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 4.
[93] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 5.
[94] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 2.
[95] Remarks by Federal Reserve Governor Susan Schmidt Bies, At the National Bankers Association Annual Convention, Beverly Hills, October 12, 2005.
[96] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 3.
[97] Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices at Selected Large Banks in the United States," July 2005.
[98] Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices at Selected Large Banks in the United States," July 2005.
[99] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 8.

borrower risk more carefully and to monitor the loans over time to ensure that borrowers' risk profile and underwriting has not worsened. Non-traditional mortgage products combined with loosened underwriting standards pose higher risks for default.[100] Office of Thrift Supervision Director Reich noted:

> "All other things being equal, these products harbor more risk than traditional mortgages. That additional risk needs to be managed and ameliorated by the application of sound underwriting practices and strong risk management systems together with complete disclosure of not only the benefits of these products but also the risks they pose for the borrower."[101]

There are concerns that lenders are focusing on credit scores alone to assess the creditworthiness of borrowers without taking into account the borrower's ability to repay the note over the length of the mortgage.[102] This risk also needs to be understood and monitored as changes affect the mortgage and real estate market. The FDIC Risk Analysis Branch recently reported to the FDIC Board of Directors that credit losses on poorly underwritten non-traditional mortgages could "increase significantly" as interest rates rise and the housing market cools.[103] Alan Greenspan testified before Congress that "It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change."[104] As OTS Director, Reich believes that it is important for regulators and consumers to distinguish between the challenges borne by new entrants into non-traditional lending field with those of thrifts with long term experience in providing these types of loans. "Thrifts have offered adjustable rate mortgages (ARMs) for more than thirty years," said Reich, "And thrifts have offered – and successfully managed – ARMs with negative amortization features for twenty years."[105]

The payment shocks associated with non-traditional mortgages could have credit risks for lenders. For example, lenders typically book even minimum loan payments as income even if the payments do not cover the amount due. When these negatively amortizing loans come due, with significant payment shocks to the borrowers, lenders may have to write loans down or off if borrowers cannot surmount the payment shock.[106] These payment shocks could happen within the next few years on the rising number of non-traditional mortgages that have been originated in the past few years. The FDIC estimates that the majority of the non-traditional loans

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[100] Remarks by Federal Reserve Governor Susan Schmidt Bies, At the National Bankers Association Annual Convention, Beverly Hills, October 12, 2005.
[101] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 5.
[102] Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 6.
[103] FDIC Division of Insurance and Research, Risk Analysis Branch, "Economic Conditions and Emerging Risks in Banking: A Report to the FDIC Board of Directors," November 1, 2005.
[104] Testimony of Chairman Alan Greenspan, Federal Reserve Board's Semiannual Monetary Policy Report to the Congress, Before the Committee on Financial Services, U.S. House of Representatives, July 20, 2005.
[105] Speech by John M. Reich, Director, Office of Thrift Supervision, Before the Community Bankers Association of New York State, Naples, Florida, November 18, 2005 at 5.
[106] Remarks by John C. Dugan, Comptroller of the Currency, Before the Consumer Federation of America, December 1, 2005, at 2.

underwritten in 2004 and 2005 will season in 2006 and 2007 when the borrowers will face higher payments.[107]

The flexible approach that is used to facilitate non-traditional mortgage customized underwriting for each borrower may have limitations. Traditional credit scoring may not be entirely suited to measuring a borrower's ability to repay the new, non-traditional mortgages. For example, some of the non-traditional mortgages allow borrowers to forgo paying down the balance of the mortgage for an initial period. These borrowers would be reported as current to the credit bureaus, even though they would be considered delinquent and a credit risk if they failed to pay down any of the principal on a traditional mortgage.[108] Because these loans are considered current, they are not deemed to be risks, but a silent risk for lenders is building nonetheless as borrowers may become decreasingly able to repay their notes, especially when their loan payments are readjusted.[109]

Some believe that the risk posed by non-traditional mortgages is mitigated by mortgage securitization, but most lenders that originate non-traditional mortgages do not sell them on the secondary market. Fannie Mae and Freddie Mac have not been securitizing non-traditional mortgages, in part because the risk that these loans may end up in foreclosure conflicts with their mission to promote homeownership.[110] Ratings firm Standard & Poor's reported that fewer than 3 percent of Freddie Mac's retained mortgage portfolio was interest-only or payment option mortgages.[111] Less than 2 percent (1.8%) of the dollar value of mortgage-backed securities Freddie Mac issued in the first three quarters of 2005 were interest-only or payment option mortgages.[112] Surveys have shown that banks are significantly less likely to securitize non-traditional mortgages than traditional mortgages and instead keep these loans in their portfolios.[113] Bear Stearns estimates that interest-only and option ARM loans constitute a little less than 10% of the total securitization market. As a result, depository lenders that carry these loans on their books will face the entirety of the risk of delinquency and default. However, although non-traditional mortgages that are securitized protect banks that sell these mortgages from their portfolios, the secondary market absorbs part of the risk that the lenders sell. Recently, Standard & Poor's reported that the private residential mortgage backed securities will have the market's second-best year, but "increasing risks presented by the recent popularity of affordability products could contribute to deteriorating credit quality in the coming year."[114]

Although non-traditional mortgages may pose no risk for some borrowers who have the financial wherewithal and sophistication, some of the borrowers may have difficulty handling the payment shocks inherent in many of these mortgages. In that event, the credit risk shifts from the

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[107] Federal Deposit Insurance Corporation, "Economic Conditions and Emerging Risks in Banking: A Report to the FDIC Board of Directors," November 1, 2005

[108] Fitch Ratings, "U.S. Residential Mortgage Products: Only Time Will Tell," September 22, 2005 at 5.

[109] Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 5.

[110] Sichelman, Lew, "GSEs Wary of 'Exotic' Mortgages," *Realty Times*, August 24, 2005.

[111] Standard & Poor's, RatingsDirect, Research: Freddie Mac, November 30, 2005 at 4.

[112] Freddie Mac, *Mortgage Funding: Gold Perspective*, Winter 2005, at 4.

[113] Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 4.

[114] "Daily Mortgage Briefing," *National Mortgage News*, January 20, 2006.

borrower to the lender that originated the loan or whoever owns the mortgage securities. There is genuine concern by all federal banking regulators that lenders may be overly-sanguine in marketing the appropriateness of the mortgage for every consumer, carefully considering underwriting standards, and monitoring the mortgages as they begin to mature and readjust their payment schedules. The credit and underwriting risk posed to lenders by non-traditional mortgages may be significant, but it certainly would increase if the housing market stalled or declined and if interest rates continue to rise.

Potential Payment Shocks for Consumers from Non-Traditional Mortgages

Many borrowers are choosing these mortgages as the result of the rising housing costs and these non-traditional mortgages have lower initial monthly payment structures which leverage borrowers' capacity to afford homeownership. However, because many of these loans have terms which recast after a period to higher monthly payment structures, consumers could be vulnerable to payment shocks which could make their homes suddenly unaffordable and could compromise the financial stability of their households. Consumers should not be choosing mortgages based on the outside limits of their ability to afford the initial payments because most of these new mortgages will restructure their payments after an initial period and they are likely to become more expensive. Not only are stretched consumers seeking these loans, some lenders are qualifying borrowers based on their ability to make the initial monthly payments without regard to their inability to make rising payments later in the life of the mortgage.[115] A recent Mortgage Bankers Association research brief noted that "There is an overriding belief that borrowers are overly focused on finding the mortgage that has an initial payment that will get them into a property, while ignoring potential payment shocks down the road."[116]

Borrowers who utilize these mortgages to stretch their payment dollars ultimately have three options when their payment abruptly rises: cover the monthly increases which can be significant; refinance their loan into a fixed rate that still may have higher payments than their initial non-traditional mortgage payments, or sell their homes. None of these options are very attractive and all involve some costs to consumers. If interest rates continue to rise, refinancing may not even be possible for all homeowners, especially if the real estate market stalls or contracts. If little or no principal has been paid on the mortgages before the homeowners sell them and their homes have not appreciated more than 6%, some borrowers may have to pay additional amounts to real estate brokers. Additionally, many loans have penalties for borrowers who sell or refinance too quickly to ensure that the lender is able to recover costs and potentially earn a profit on the loan. A Bear Stearns analysis found that many serial refinancers only move into loans with riskier terms – from hybrid ARMS (with initial fixed rates) to interest-only loans to pick-a-payment option ARMs.[117]

[115] Eisinger, Jesse, "Investors Fret Mortgage Balloons Will Burst," *Wall Street Journal*, July 27, 2005.
[116] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis," MBA Research Monograph Series No. 1, September 6, 2005 at 42.
[117] Haviv, Julie, "Housing is Hot, But Types of Loans Seen Cooling," *Reuters*, July 14, 2005.

For a $200,000 loan, the monthly payment increase for different loan products can vary significantly when the loan is recast at higher interest rates. Monthly payments on a payment option ARM with a 5.00% interest rate would more than double if the interest rate were reset at 6.50% and would be one and a half times higher if the note were reset at 8.00%, an interest rate that was seen as recently as 2000. Monthly payments on a 5/1 interest-only ARM would rise by half at 6.5% and rise by three quarters if the note were reset at 8.00%. Monthly payments for a 5/1 ARM without non-traditional features would nonetheless increase by 16% if the loan were reset at 6.5% and rise by one third if the note recast at 8%.

Monthly Loan Payments for Different Types of $200,000 Mortgages

Interest Rate	30-Year Fixed	5/1 ARM	5/1 Interest-only ARM	Option Arm
5.00%	$ 1,104	$ 1,074	$ 875	$ 643
6.50%	$ 1,104	$ 1,244	$ 1,350	$ 1,472
Monthly Increase	$ -	$ 170	$ 475	$ 829
	0.0%	15.8%	54.3%	128.9%
8.00%	$ 1,104	$ 1,422	$ 1,544	$ 1,652
Monthly Increase	$ -	$ 348	$ 669	$ 1,009
	0.0%	32.4%	76.5%	156.9%

5/1 ARMs are at 5.25% for first 5 years then reset to scenario rate, Option ARM has a 1-month teaser rate of 1.0%, then resets to scenario rate. Payment option rate capped at 7.5% and negative amortization limit of 110%.

Financial analyst Fitch Ratings has written that sophisticated borrowers with strong financial positions can benefit from non-traditional mortgages, but that borrowers who are choosing these mortgage products to maximize affordability could end up losing their homes because of payment shocks and erosion in their home's equity.[118] Additionally, consumers could face additional problems to their credit ratings if the payment shocks cause them to miss or make late mortgage payments. Mortgage delinquency or foreclosure has very negative implications on a household's credit rating which could prevent or make refinancing or a subsequent home purchase prohibitively expensive.

Prospects for Increased Non-Traditional Mortgage Defaults and Foreclosures

There are two basic risks to these more flexible mortgage arrangements, especially those that are designed to minimize monthly payments at the beginning of the loan. First, most of these products have low initial payments which can jolt upwards over the term of the loan – often rising more than consumers expect or understand. If borrowers are unprepared to handle higher monthly payments, they may not be able to keep up the payments on their mortgages and may face the risk of foreclosure. As former-FDIC Chairman Donald Powell noted in a speech to community bankers in October 2005, "Homeowners taking on these types of mortgage products need to understand how their obligation may grow when their introductory rates expire."[119] The risk is especially high for lower-income borrowers, as Federal Reserve Board Governor Susan Bies noted "These borrowers are more likely to experience an unmanageable payment shock at some point during the life of the loan, which means they may be more likely to default on the loan."[120]

[118] Fitch Ratings, "U.S. Mortgage Products: Only Time Will Tell," September 22, 2005 at 3.
[119] "Risky Mortgages May Harm Borrowers, Banks," *Associated Press*, October 18, 2005.
[120] "Fed's Bies Warns on Mortgage, Real Estate Lending," *Reuters*, February 2, 2006.

Secondly, low initial payments could backfire on homeowners if home prices fall. Over the past few years, non-traditional mortgage products have been promoted as low-risk because the rising housing market was effectively building equity for the new homeowner even if the borrowers did not pay down the principal of the mortgage. One California mortgage broker described many prospective borrowers' attitudes as "Why knock ourselves out trying to build up equity through the mortgage payments when the market will take care of it for you?"[121] However, recent borrowers have not been growing the equity in their new homes because of the range of non-traditional mortgages products with non- or negatively amortizing terms. First American found that nearly a third (29 percent) of loans that closed in 2005 had zero or negative equity by the start of 2006.[122]

If real estate prices decline slightly (as some project in several especially hot real estate markets), homeowners who have been only paying the interest or a tiny amount of their principal could end up owing more on their mortgage than their home is worth.[123] In the summer of 2005, Alan Greenspan warned that borrowers with non-traditional mortgages would be extremely vulnerable if housing prices slump; that "could be disastrous" for some families.[124] There are some early signs that this may already be happening. RealtyTrack, an online foreclosed property marketplace, reported in February that the national foreclosure rate was 45 percent higher in January 2006 than the previous January and that foreclosure rates in Florida, Nevada and Colorado (which all have had high levels of non-traditional mortgages) were up sharply from the previous month.[125] In certain California markets with high concentrations of non-traditional mortgages, foreclosure rates in the fourth quarter of 2005 were much higher than in the previous year. In San Diego and Orange County, foreclosures grew by more than a third (34.5 and 34.2 percent respectively) between the fourth quarter of 2004 and the fourth quarter of 2005, and foreclosures in San Francisco grew by 45.2 percent over the same period.[126]

Recent Focus Group Findings on Non-Traditional Mortgages

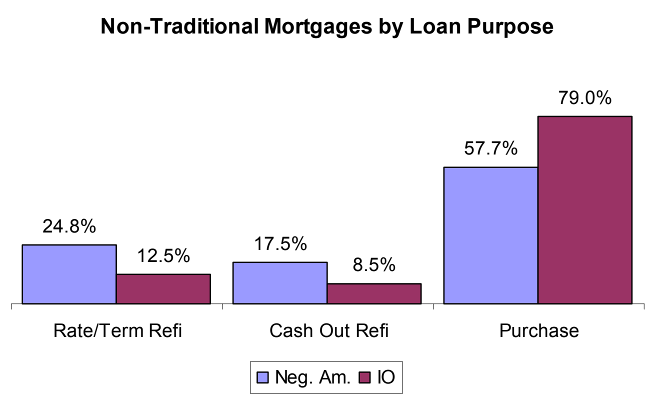
In the fall of 2005, Public Opinion Strategies performed focus group research on consumer attitudes on non-traditional mortgages that found that households were forced to take on non-traditional housing costs because of high housing costs but were surprised at the magnitude of the payment shock when these non-traditional loans reset. The focus group examined consumers earning below and above $75,000 year; the lower-income segment were more resigned to taking out non-traditional loans and more surprised by the payment shock. It found that lower-income participants did not believe traditional, fixed rate mortgages were even an option for them and that they were essentially forced to use non-traditional mortgages because of the high cost of housing.[127] The upper-income group viewed non-traditional mortgages as one in a range of mortgage product choices and these consumers understood the terms of the different types of

[121] Pender, Kathleen, "High Interest in Interest-Only Home Loans," *San Francisco Chronicle*, May 20, 2005.
[122] Harney, Kenneth R, "Equity Stake in Your Home: What Percentage?" *Realty Times*, February 27, 2006.
[123] Zito, Kelly, "Home Value Declines Seen as More Likely," *San Francisco Chronicle*, July 29, 2005.
[124] Aversa, Jeannine, "Fed Chief Warns About Mortgages," *Associated Press*, July 24, 2005.
[125] RealtyTrac press release, "National Foreclosures Increase 27 Percent in January According to RealtyTrac U.S. Foreclosure Market Report," February 21, 2006.
[126] DataQuick News, "California Foreclosure Activity Up," February 2, 2006.
[127] Public Opinion Strategies, Memorandum: Focus Group Observations, September 29, 2005 at 1.

mortgages available on the market today.[128] It also found that when consumers are shown the rate sheet with the various mortgage options they are surprised by the magnitude of the payment shock. Although upper-income focus group participants are less surprised, lower-income participants described the payment shock on the rate sheet as "shocking" and they were largely unaware of the size of the payment shock.[129] These lower-income consumers also were less informed about the payment shock and debt risks of non-traditional mortgages, with some noting the "wish they had known more."[130] All of the lower-income segment in one of the studied cities said that the higher payments after the mortgage recast would create a financial hardship for their families, and three quarters of them were concerned about their ability to make the monthly mortgage payments when the payments increased after the loan recast.[131]

4. The Characteristics of Non-Traditional Mortgage Borrowers

Recent media and industry reports suggest that a large number and share of mortgages are non-traditional mortgages, but there has been little information about the makeup of the borrowers. Although the lending industry and consultants have suggested that these borrowers have better credit scores and are wealthier, there has been little analysis of the borrowers who take out non-traditional mortgages. Consumer Federation of America analyzed certain borrower and loan characteristics for a database of more than 100,000 mortgages originated between January and October 2005. This data included whether the loans were interest-only or payment option as well as certain debt and creditworthiness information that is not contained in the Home Mortgage Disclosure Act dataset. CFA's examination of these mortgages found that more than one tenth of mortgages were either interest-only (8.1%) or payment option loans (2.3%).



Generally, but not universally, these borrowers did have higher incomes than borrowers overall, but their credit scores were not necessarily higher than borrowers overall. Many borrowers around the median income and with moderate credit scores are receiving interest-only and payment option mortgages. Moreover, African American and Latino borrowers are more likely to receive interest-only and payment option mortgages than non-minority borrowers at all levels of income, debt loads and credit scores.

The majority of these two types of non-traditional mortgages are used to purchase homes. Nearly four out of five (79.0%) interest-only mortgages and nearly three fifths (57.5%) of payment option loans were used to finance the purchase of a home. About one in five interest-only loans were refinance loans, while one eighth (12.5%) of interest-only loans were to improve the rates or terms of the mortgage and 8.5% of interest-only loans were cash out refinance loans.

[128] *Ibid* at 2.
[129] *Ibid* at 3.
[130] *Ibid* at 3.
[131] *Ibid* at 4.

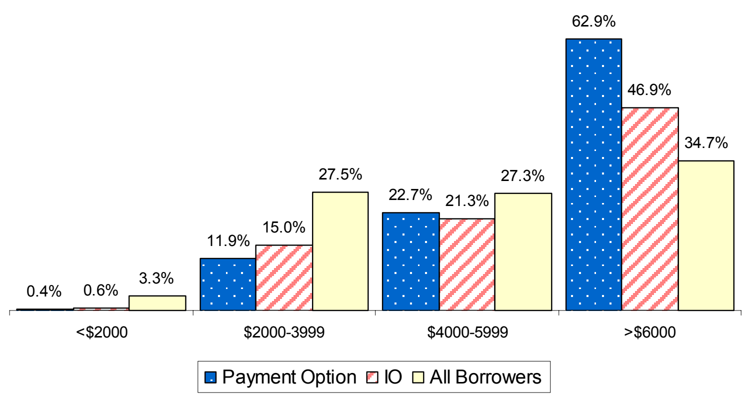
Payment option mortgages were used more frequently for refinance loans. Nearly one quarter (24.8%) of payment option mortgages were rate or term refinance loans and nearly a fifth (17.5%) were cash out refinance mortgages.

The high proportion of purchase mortgages in the non-traditional mortgage portfolio tends to support the contention that the increased use of these mortgage products is related to the rapidly escalating cost of housing.

The Distribution of Incomes of Non-Traditional Mortgage Borrowers

The interest-only and payment option borrowers are primarily upscale borrowers and they are more likely to be wealthier than overall mortgage borrowers. More than half (50.4%) of these non-traditional mortgage borrowers earned more than $6,000 each month. This represents annual earnings of more than $72,000, which is 62.2% higher than the national median income of $44,389 in 2004.[132] More than three fifths (62.9%) of payment option borrowers and nearly half (46.9%) of interest-only borrowers had monthly incomes above $6,000. In contrast, those earning around the median income and below were the least likely to receive non-traditional mortgages. About one in eight (12.3%) payment option borrowers and about one in six (15.6%) interest-only borrowers had monthly incomes below $4,000 (which at most is $48,000 annually, which is at most 8.1% above the national median income). About one fifth of interest-only and payment option borrowers (21.3% and 22.7% respectively) had monthly incomes between $4,000 and $6,000, or annual earnings between $48,000 and $72,000.

Distribution of Borrower Income by Mortgage Type



The incomes for borrowers of these non-traditional mortgage products are generally higher than those of mortgage products overall. There were 45.2% more non-traditional mortgage borrowers with monthly incomes above $6,000 than all mortgage borrowers. About half the non-traditional mortgage borrowers had monthly incomes above $6,000 compared to about a third (34.7%) of all borrowers. More borrowers in the middle income range received traditional mortgages than non-traditional mortgages. About half (54.8%) of all borrowers had monthly incomes between $2,000 and $6,000 compared to about one third (36.0%) of non-traditional borrowers. Lower-income borrowers are more likely to receive traditional mortgages than non-traditional mortgages. However, more than ten percent (11.9%) of borrowers earning between $24,000 and $48,000 annually received payment option mortgages and one in seven (15.0%) of these borrowers received interest-only mortgages.

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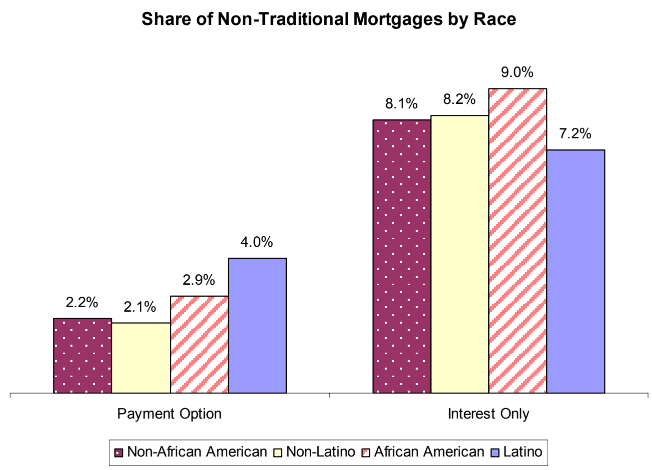
[132] Census Bureau, "Income, Poverty, and Health Insurance Coverage in the United States: 2004," P60-229, August 2005 at 3.

Some non-traditional mortgage borrowers, especially interest-only borrowers, did not record their incomes, and these borrowers may be low-documentation or no-documentation borrowers. Interest-only borrowers were more than twice as likely to have invalid incomes (unknown or unreported incomes) as all borrowers. About one in fifteen (7.2%) of all borrowers had invalid incomes compared to about a sixth (16.1%) of interest-only borrowers. Only 2.1% of payment option borrowers had invalid incomes.

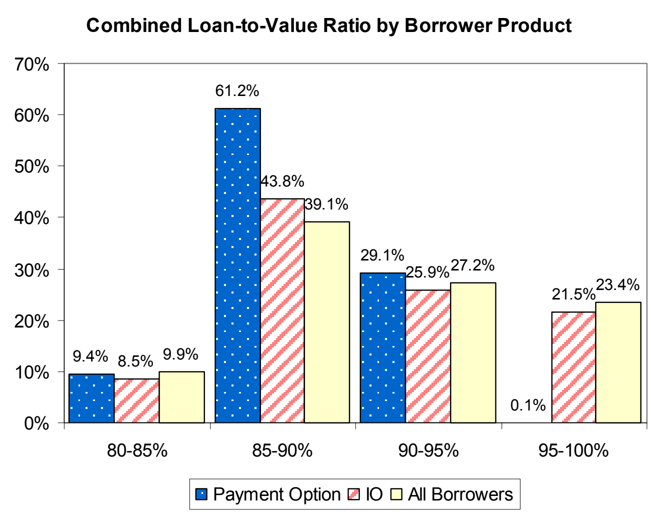
Distribution of Non-Traditional Mortgage Borrower Racial Characteristics

African American and Latino borrowers are more likely to receive payment option mortgages than non-African American or non-Latino borrowers and African Americans are more likely to receive interest-only mortgages than non-African American borrowers. Overall, Latinos are nearly twice as likely as non-Latinos to receive payment option mortgages. One in fifty (2.1%) non-Latino borrowers received payment option mortgages compared to the 4.0% of Latinos that received payment option mortgages. African Americans were 30.4% more likely than non-African Americans to receive payment option mortgages. 2.2% of non-African Americans received payment option mortgages compared to 2.9% of African Americans. African Americans were more likely than non-African Americans to receive interest-only loans and Latinos were less likely than non-Latinos to receive interest-only mortgages. Nearly one in ten (9.0%) of African Americans received interest-only mortgages, 11.7% higher than the 8.1% of non-African Americans that received interest-only mortgages. 7.2% of Latinos received interest-only mortgages compared to 8.1% of non-Latinos.



Distribution of Loan-to-Value Ratios

Generally, borrowers with non-traditional mortgages have lower debt loads than borrowers overall. Combined loan-to-value (CLTV) ratios measure the overall mortgage debt (including junior liens from piggyback mortgages) against the value of the property. More than half of non-traditional borrowers had loan-to-value ratios below 90 percent compared to more than half of all borrowers who had loan to value ratios above 90 percent. More than 70 percent (70.6%) of payment option

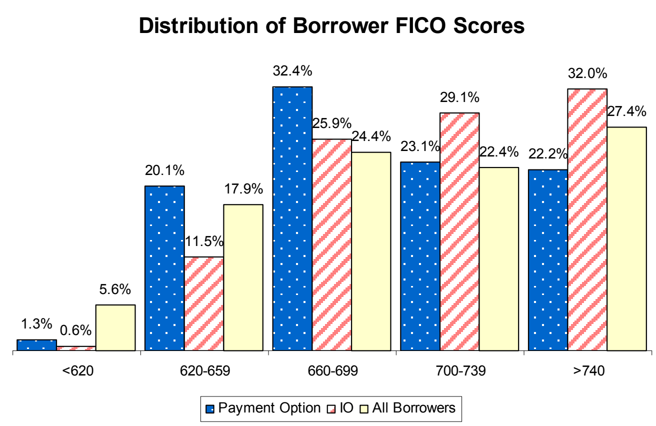


borrowers had loan-to-value ratios below 90 percent, compared to 52.3% of interest-only borrowers and 49.0% of all borrowers. Only two payment option borrowers (0.1%) had loan-to-value ratios over 95 percent. Interest-only borrowers are more likely to have higher loan-to-value ratios than payment option borrowers. More than one in five (21.5%) interest-only borrowers and nearly one in four (23.4%) of all borrowers had loan-to-value ratios over 95 percent. (Very few borrowers sampled had loan to value ratios above 100 percent (0.0% of borrowers overall and 0.1% of non-traditional borrowers) or below 80 percent (0.1% of all and non-traditional borrowers.)

Distribution of Creditworthiness

Lenders offer mortgage products and the pricing of these products based on credit-risk factors including credit scores, loan-to-value ratios, and consumer debt loads. Credit scores are an estimation of the borrower's risk assigned by the lending industry using proprietary criteria – such as repayment history, debt loads, the length of a borrower's credit history and other factors. The most common credit score is known as a FICO score, named for the Fair Isaac Company which compiles it.

Generally, payment option borrowers have lower credit scores than borrowers overall and interest-only borrowers have higher credit scores than borrowers overall. More than half (53.8%) of payment option borrowers had FICO credit scores below 700 compared to 48.2% of all borrowers and 38.6% of interest-only borrowers. In contrast, more than three fifths (61.1%) of interest-only borrowers had credit scores above 700, compared to just under half (49.8%) of all borrowers and 45.3% of payment option borrowers. This suggests that interest-only borrowers are better credit risks and payment option borrowers are worse credit risks than borrowers overall.



However, it is possible that credit scores may not adequately measure the risks of these newly prevalent loan products. Credit scores may be a good measurement of the likelihood of credit card debt repayment, but they *may* not adequately measure the likelihood of repayment for loan products where the debt payment abruptly increases, as both interest-only and payment option mortgages do. As the credit rating company Fitch Ratings noted, "Traditional FICO scores may not be as predictive of a borrower's ability to repay a loan as it was in the past, particularly with Option ARMS."[133]

CFA's analysis of this database represents a snapshot of some portion of non-traditional mortgage borrowers not necessarily representative of the overall non-traditional mortgage market. However, the data presented herein offer one of the first opportunities to examine characteristics of non-traditional mortgage borrowers. Although these borrowers broadly have

[133] Fitch Ratings, "U.S. Mortgage Products: Only Time Will Tell," September 22, 2005 at 3.

higher incomes and credit scores than borrowers overall, many of the borrowers had median incomes and middle credit scores. Borrowers with median household incomes of about $44,000 could face considerable financial hardships if the payment shock on their mortgage increases their monthly housing payment by a quarter or a half.

5. Key Concerns Over Non-Traditional Mortgages

Then-Federal Reserve Chairman Alan Greenspan this past summer received much publicity for trumpeting the potential dangers resulting from the increased reliance on non-traditional forms of mortgage financing:

> Apparent froth in housing markets appears to have interacted with evolving practices in mortgage markets. The increase in the prevalence of interest-only loans and the introduction of more exotic forms of adjustable-rate mortgages are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But some households may be employing these instruments to purchase homes that would otherwise be unaffordable, and consequently their use could be adding to pressures in the housing market. Moreover, these contracts may leave some mortgagors vulnerable to adverse events. It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change.[134]

Other federal regulators, some industry analysts and consumer advocates also have questioned whether:

- Borrowers are using these mortgages for increasing their purchasing power, without adequately understanding their potential downside?
- Lenders are making loans to consumers for which they are not appropriate?
- The proliferation of these mortgage products is contributing to affordability problems and a housing bubble?
- These mortgage products pose a growing threat to credit quality, thus raising concerns about their sustainability for consumers?

Many non-traditional mortgage borrowers may not fully understand the long-term monthly payment burden and may face significant payment shocks when their loans are recast to higher payment schedules. Adjustable rate mortgages can be tempting to borrowers because of their lower interest rates and especially their lower initial rates or short-term teaser rates. Borrowers receive these low opening rates to encourage them to take on the additional interest rate risk that can make the loans become more expensive over the term of the mortgage. Consumers may not fully appreciate that the initial rate will snap sharply upwards when the loan first adjusts, may not understand that the teaser rates – especially for the super-low rates some option ARMs have offered for a few months – are not the starting ARM rate, and some borrowers may not realize

[134] Greenspan, Alan, Federal Reserve's Semiannual Monetary Policy Report to Congress. Testimony Before the Committee on Financial Services, U.S. House of Representatives, July 20, 2005.

the extent to which their monthly mortgage payments could continue to rise over the course of the mortgage.

In 2004, the Federal Trade Commission filed an injunction against a mortgage broker and lender in Nevada for advertising negatively amortizing option ARM payments as "low fixed payments" without clearly stating that the interest rates were not fixed and that the lowest payments were not "savings" to the borrower since they increased the borrower's debt.[135] In 2005, a borrower filed suit against Chevy Chase Bank after the initial teaser rate elapsed and the interest rate more than doubled from 1.95% to 4.375% two months after the loan was closed because the family believed the teaser rate was for the entirety of the period before the loan adjusted its interest rate.[136]

The higher risk to borrowers and the complexity of the loan terms and repayment schedules of most non-traditional mortgages make it all the more imperative that borrowers receive the information they require from loan providers so that they can make adequately informed choices. The Comptroller of the Currency has stated that "Disclosures should clearly and reasonably describe the significant potential consequences of the particular product, which in this case would mean the potential payment shock."[137] Chief Counsel of the Comptroller, Julie Williams, noted that there are questions and concerns "about the marketing and disclosure practices spawned by the new practices and whether consumers fully understand the products they are selecting."[138] The agency has also warned lenders about the prospects of increased litigation risk.

There seems to be general agreement that ensuring that consumers are adequately informed about the risks as well as the benefits of non-traditional markets is essential. Indeed, a recent Radian Guaranty survey found that while homeowners stressed the importance of understanding how much home they can afford when looking for financing, less than one-half (48%) believe they were knowledgeable about the mortgage options available to them.[139]

A past CFA survey found that when consumers were asked to calculate the change in payments resulting from different interest rate increases, a third of consumers could not estimate the increase, while the remainder as a group underestimated payment impact by about 30 percent. Moreover, the survey found that more lower income, younger, and minority respondents could not estimate the payment increases or underestimated them than of all consumers surveyed.[140]

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[135] *See* Federal Trade Commission v. Chase Financial Funding et al, Case No. SACV04-549 GLT, U.S. District Court, Central District of California, May 11, 2004.
[136] Simon, Ruth, "A Trendy Mortgage Falls from Favor," November 29, 2005.
[137] Remarks by John C. Dugan, Comptroller of the Currency, Before the OCC Credit Risk Conference, Atlanta, October 27, 2005 at 9.
[138] Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, Remarks Before the Canisius College School of Business, Buffalo, September 14, 2005 at 3.
[139] Radian, "U.S. Homeowners Can (and Should) Learn More About Their Mortgages," press release, November 21, 2005.
[140] Consumer Federation of America, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.

Non-Traditional Mortgages Contribute to Affordability Problems and the Housing Bubble

The presence of non-traditional mortgage products has facilitated an escalating cycle of rising home prices. Although non-traditional mortgages are marketed in part as an affordability tool for borrowers to become homeowners despite record-high housing prices, the ability of borrowers to leverage their purchasing dollars with non-traditional mortgages contributes to the rising housing costs. Buyers with non-traditional mortgages can either purchase larger homes than they might be able to afford with a fixed rate mortgage or bid up the home prices. As these buyers put upward pressure on the price of their home purchases, other home sellers increase their asking price and even more borrowers need non-traditional mortgages in order to afford their home purchases. *USA Today* editorialized at the end of 2005 that "When exotic loans become routine, the economics of housing becomes anything but. These loans add something new and troubling. One might call it a bubble."[141]

Essentially, wider access to credit, including non-traditional mortgages creates an arms race between the credit and real estate industry. Rising prices stimulate the demand for more credit mortgages which increase demand for higher-priced homes. As San Francisco Federal Reserve Senior Economist noted:

> Rapidly rising stock and house prices, fueled by an accommodative environment of low interest rates and a proliferation of "exotic" mortgage products (loans with little or no down payment, minimal documentation of income, and payments for interest-only or less) have sustained a boom in household spending and provided collateral for record-setting levels of household debt relative to income.[142]

It is unquestionable that the housing and real estate market has been extremely strong over the past decade. Between 1997 and 2005, home sale prices nationally rose by 55 percent after adjusting for inflation and these increases have added $6.5 trillion in household wealth.[143] In 2005, the number of home sales hit a fifth consecutive record year and home price appreciation was steady across the country, with many metropolitan areas having annual price increases above 10 percent.[144] Silver Spring, Maryland-based mortgage trainer Christopher Cruise noted that "These types of products have been enablers when it comes to allowing home prices to rise."[145]

Some warn that the stratospheric growth in the housing market could slow if there is less access to non-traditional mortgages. The converse of non-traditional mortgage availability's contribution to the housing bubble is that if access to this credit is tightened, the rise in housing prices may slow or even reverse.[146] Regardless of the cause, the homeowners who will be most

[141] Editorial, "As Risky Home Loans Rise, House-Price 'Bubble' Inflates," *USA Today*, December 28, 2005.
[142] Lansing, Kevin J., "Spendthrift Nation," *FRBSF Economic Letter*, Federal Reserve Board of San Francisco, No. 2005-30, November 10, 2005.
[143] Baker, Dean and David Rosnick, "Will a Bursting Bubble Trouble Bernanke? The Evidence for a Housing Bubble," Center for Economic and Policy Research, November 2005 at 3.
[144] National Association of Realtors Research Division, "The 2005 National Association of Realtors Profile of Real Estate Markets: The United States of America," December 2005 at 2.
[145] Downey, Kirsten, "Regulators to Issue Mortgage Warning," *Washington Post*, April 7, 2006.
[146] Pasha, Shaheen, "Risky Home Loan Standards Tightening," *CNN/Money*, January 6, 2006.

severely hurt by any downturn in the housing market are the non-traditional borrowers who have purchased the most recently with the least equity in their homes.

6. What Actions are Needed to Protect Borrowers and Lenders

With the continuing proliferation of non-traditional mortgage products over the past two years, it should not come as any surprise that federal regulators would be weighing new oversight policies. There also has been the suggestion that action is needed to plug any "regulatory gap" in consumer protections for these products. Very possibly Congress also may venture into this topic and consider whether new legislation is needed.

New Federal Guidance on Non-Traditional Mortgage Products

After months of anticipation, federal banking agencies this past December issued proposed new regulatory guidance for lenders on non-traditional mortgage products.[147] In issuing the guidance, the regulators said in a joint statement:

> (We are) concerned that these products and practices are being offered to a wider spectrum of borrowers, including subprime borrowers and others who may not otherwise qualify for more traditional mortgage loans or who may not fully understand the associated risks.

The guidance directed banks to tighten their lending practices for non-traditional mortgage products and focused in particular on interest-only mortgages and payment option ARMs. The directive also noted that lenders are increasingly combining these types of products with other high risk practices, such as simultaneous second-lien mortgages and the use of reduced documentation in qualifying home loan borrowers.

The guidance addresses three areas: loan terms and underwriting standards, portfolio and risk management practices, and consumer protection.

Loan Terms and Underwriting Standards: The guidance advises lenders that they should take into account the borrower's debt "repayment capacity" over the life of the mortgage. Interest-only mortgage loan borrowers must qualify at the fully amortizing payment corresponding to the fully indexed rate at reset: In other words, the borrower's monthly payment after the introductory teaser rate has expired. Teaser rates with potential for extraordinary payment shock should be avoided altogether. Qualifications for payment option mortgages must consider potential negative amortization assuming minimum monthly payments. Risk layering should be compensated by mitigating factors such as high FICO scores, low debt-to-income and reduced loan-to-value and used cautiously for subprime borrowers.

Portfolio and Risk Management Practices: The guidance also sets out a range of safety and soundness practices that lenders offering non-traditional mortgage products should be using. These include the setting of acceptable risk levels that include concentration limits for payment

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[147] *See*, Interagency Guidance on Nontraditional Mortgage Products, 70 Federal Register, 77249, December 29, 2005.

option loans, geographic areas, low FICO scores, high consolidated loan to value ratios, and high debt to income ratios. It also stresses that lenders making these loans should have in place stronger controls and enhanced information and reporting and should closely monitor the third-party origination channels (i.e., mortgage brokers and correspondent lenders) that emphasize the marketing and disclosure practices that are used.

Consumer Protection: The guidance states that federal regulators "are concerned that consumers may enter into these transactions (non-traditional mortgages) without fully understanding the product terms."[148] They appear to frown on lending practices that promote non-traditional products advertised and marketed based on their initial monthly payment affordability, and that consumers have been encouraged to choose these loans based on the lower monthly payments these loans permit compared with traditional mortgage products. The guidelines emphasize that lenders should communicate with consumers in a manner that enables them to make informed decisions about these products. Such information should include clear descriptions about the pitfalls of non-traditional products when consumers are shopping for mortgages and before they submit loan applications.

The guidance proposes a series of "recommended practices" for how this communication should occur. For example, promotional materials should be balanced and fully explain all the risks, including the payment shock that could occur when the product re-prices as well as the dangers of negative amortization, provide alerts about prepayment penalties and the amount of any such penalty, and also inform about pricing premiums attached to reduced documentation loans. Monthly payment statements on payment option ARMs should provide explanations of the impact that making a minimum payment will have on loan balances due to negative amortization.

Potential Effects of the New Guidance:

The guidance's issuance should not have come as a shock for lenders. For months prior to issuance, regulators had sounded warnings about the need for lenders to tighten up on their underwriting standards for these loans. The 41 page guidance was published in the Federal Register in late December and issued for a sixty day public comment period. This period was extended for an additional 30 days in response to requests from lenders (March 29, 2006).

The impact and reach of the guidance is a subject of considerable discussion. Its issuance seemed to have had an immediate effect on some lender practices.[149] A number of large lenders have stressed that they already employ the types of standards encouraged by the guidance. Yet, since the guidelines neither propose new rules nor apply many specific standards, their impact more likely will be determined by how they are interpreted. Some analysts recall that lenders all but

[148] Interagency Guidance on Nontraditional Mortgage Products, 70 Federal Register, 77249, December 29, 2005 at 77255.
[149] "WAMU Again Tightens its Option ARM Standards, Negative Amortization Loans 'in all Channels' Affected by the Change," *American Banker*, January 27, 2005.

ignored another guidance issued earlier in 2005 about equity loans and actually increased the level of lending on those loans.[150]

Moreover, since the guidance applies only to regulated depository institutions (banks and thrifts) and their subsidiaries, and not to their non-bank lending affiliates, the reach it will have on these and other important segments of the non-traditional mortgage market is uncertain.

New Loan Disclosure Requirements?

Another limitation is that, notwithstanding the fact that the guidance discusses the need for improved disclosures to consumers, the guidance does not expand any consumer protections, nor will consumers be able to enforce the application of these standards to individual lenders. What the guidance does instead is to advise lenders to inform consumers of the potential for payment shocks, to state maximum monthly payments and describe the timing of payment changes down the road.

Even if more comprehensive disclosures were to be required, this additional information still may be insufficient given the complexity and wide array of products commonly featured today. While loan disclosures provide standardized information they also can serve to shield lenders from accountability for not fully informing borrowers about key loan features.

The Truth in Lending Act (TILA) and its implementing rules, Regulation Z, govern the types of disclosures lenders must provide to consumers for closed-end mortgages in advertisements, with an application, before loan consummation, and when interest rates change. Certain special disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a non-refundable fee, whichever is earlier.

Regulation Z mandates that loan disclosures for variable rate loans occur at three stages. First, when the consumers initially seek out a lender regarding an ARM they must be provided with the "Consumer Handbook on Adjustable Rate Mortgages," which was developed by the federal regulatory agencies. The brochure provides useful but general information about ARMs and how they work. Unfortunately, the checklist featured in the brochure provides for comparisons of only two adjustable rate products, which is no longer adequate considering the wide array of products available in today's marketplace.

The second disclosure is required to be provided to borrowers with the loan application form. Lenders are required to list various items for each variable rate program in which the consumer has expressed an interest. No precise format is provided under current federal rules and therefore, the quality of the information provided by lenders can and does vary considerably. Moreover, while this disclosure may provide information about an ARM similar to the one the borrower is considering, it need not provide details about the very same loan being offered. The third type of disclosure seeks to quantify the risks inherent in an ARM, either by providing historical or worst case examples of how payments can increase. However, lenders again need not provide this information for the specific loan the borrower is set to receive. Jack Guttentag,

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150 Perkins, Broderick, "Feds Release Promised Proposed Risky-Loan Guidelines," *Realty Times*, December 26, 2005.

the noted mortgage lending expert, describes the current state of ARM disclosures this way: "The sad conclusion is that the mandated disclosures try to do too much and end up accomplishing little or nothing."[151]

Supplementing Consumer Loan Disclosures

Even if more comprehensive disclosures were required to be made to consumers regarding non-traditional mortgages, this still may not be sufficient given the complexity and wide array of products available today. The experience with the disclosures in place suggest that virtually any form of information provided may not be adequate to provide less financially sophisticated borrowers with the information they need to make wise choices. Further, even those that think they understand the risks may not understand the potential long-term consequences of certain non-traditional products being mass marketed. Some borrowers elect to take out riskier mortgages to qualify for home purchase, believing that they can always sell their property or refinance the mortgage should payment shock occur. However, should the real estate market soften and prices decline, these borrowers could find themselves in "upside down" loans, with balances exceeding the value of their homes. Thus, for these circumstances, selling or refinancing would not be a viable strategy for avoiding significantly higher payments.

Key features in the guidance, such as the borrower repayment analysis, would seem to recognize that even increased information and disclosures to borrowers are insufficient. Through the adoption of new understanding standards, the regulators seem to be putting lenders on notice about their responsibility to develop appropriate loan standards that neither encourage nor accept applications from borrowers who clearly cannot afford dramatically increased payments. Thus, the guidance may also have the effect of further fueling a discussion on the need for suitability rules that protect borrowers from receiving inappropriate loan products from lenders. Suitability standards have been used by the securities and insurance industries, and it is not unimaginable that these types of requirements could be adapted to the mortgage lending field.

Consumer advocates are concerned about the consequences of mass marketing non-traditional products for vulnerable borrowers, particularly those that rely on higher-cost subprime financing to purchase homes and refinance their properties. Evidence suggests that this borrower group is particularly susceptible to victimization from abusive and predatory lending practices. A majority of subprime ARMs are due to reset in the next two years and rising interest rates could make these loans unaffordable to refinance for some portion of these borrowers. Federal law and many state laws provide some protections for some of these borrowers, but it may not be enough to protect them from being preyed upon by predatory lenders. Consequently, public policy discussions on these topics must include consideration of the types of protections that would be most useful for borrowers with less than prime credit.

In sum, CFA believes that more can be done to ensure that consumers are fully aware of the financial risks of complex and potential risky mortgage products they choose. At a minimum, consumers need to fully and adequately understand how non-traditional mortgages work and be provided with timely, clearly worded and balanced information about how the terms of the specific mortgages they choose and impact these terms impact on their household finances over

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the lifetime of the mortgage. However, this may not be enough. The plain fact is that deferred payment mortgage products simply may not be appropriate for all borrowers who receive them and therefore, a threat to homeownership sustainability.

CFA believes that that the mortgage industry, consumer and housing organizations, and government all have a common stake in helping consumers to make wise choices in the financing products they choose. The actions taken by these parties in the months ahead will determine much about whether non-traditional mortgage products are viewed by the public as merely exotic and not toxic.