

# Profitwise

## News and Views

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## Nontraditional Mortgages: Appealing but Misunderstood



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## Chicago Fed Income Based Economic Index (Chicago Fed IBEX)

### New Index Measures Inflation for Specific Groups

The Federal Reserve Bank of Chicago is unveiling a new economic index that measures inflation for specific population groups, such as the elderly and the poor.

The Chicago Fed Income Based Economic Index-Consumer Price Index (IBEX-CPI) contains inflation data from 1983 to 2005 for more than 30 groups defined by income, education, age, poverty status, and a range of other socioeconomic and demographic characteristics. It will be updated annually and can be found at [www.chicagofed.org/CFIBEX](http://www.chicagofed.org/CFIBEX).

This information can be used by researchers and policymakers to monitor the impact of inflation on various segments of the population.

In analyzing the data from 1983 to 2005, Chicago Fed researchers examined two aspects of inflation: the average level of inflation, and how much variance there was from this average. The principal finding of this investigation is that average inflation rates were similar across a range of groups. For example, average annual inflation over this period was 3 percent for both the working poor and the overall urban population.

In contrast to other population segments, the elderly have experienced somewhat higher inflation than the overall urban population, according to the IBEX-CPI. On average, annual inflation for the elderly was 3.3 percent from 1983 to 2005, compared with 3 percent for the urban population. This difference is driven by higher expenditures among the elderly on health care, the cost of which has increased more rapidly than average prices for a number of years, the analysis showed.

The extent to which inflation moves up and down (variability) for a particular population group depends on the fraction of a group's expenditures that are devoted to items with volatile prices, like energy and food. Groups like the working poor, which spend a relatively high fraction of their total budget on food and energy, experienced more variable inflation. In particular, the working poor experienced inflation that was 13 percent more variable than that of the urban population from 1983 to 2005. In contrast, groups that devote a smaller share of their spending to food and energy, like the elderly, experienced smaller fluctuations in inflation.

The index contains inflation information for a range of groups, including:

- Those with a college education
- High school graduates
- Those who have less than a high school diploma
- The elderly
- Food stamp recipients
- Homeowners
- Renters
- People in each income quartile
- The working poor
- Households headed by single mothers
- Whites
- Hispanics
- Blacks

A technical paper describing the construction of the Chicago Fed IBEX-CPI is available at [www.chicagofed.org/publications/workingpapers/wp2005\\_20.pdf](http://www.chicagofed.org/publications/workingpapers/wp2005_20.pdf).

Visit the Web site of the Federal Reserve Bank of Chicago at:



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## Around the District



### Illinois

#### **Interfaith Housing Center receives \$374,000 to fight housing discrimination and promote education**

The Interfaith Housing Center of the Northern Suburbs, Winnetka, Illinois, has been awarded two grants, totaling \$374,000, from the U.S. Department of Housing and Urban Development's Fair Housing Initiatives Program.

Interfaith will use the grants to investigate allegations of housing discrimination, and work towards eliminating it. The grants will also be used to promote fair housing education and outreach initiatives in 16 northern Illinois communities. Interfaith will educate the public and the housing industry about their rights and responsibilities under the Fair Housing Act, and work to promote equal housing opportunities.

For more information about the award, or the work of the organization, contact the Interfaith Housing Center of the Northern Suburbs at (847) 501-5762.

### Indiana

#### **State of Indiana invests more than \$30 million in emerging technologies in 2006**

Indiana's efforts to create a robust innovation economy by investing in entrepreneurial companies with market changing technologies have begun to yield tangible results. This year, the 21st Century Research and Technology Fund has invested a total of \$30.2 million in 28 Indiana ventures that are actively developing and commercializing market changing innovations. These investments have the potential to create 2,000 new jobs in the next three years.

For more information, visit [www.iedc.in.gov](http://www.iedc.in.gov).

### Iowa

#### **Iowa CDFI is awarded \$500,000 loan from USDA Rural Development**

Grow Iowa is a certified Community Development Financial Institution serving the southwest area of Iowa. It provides capital for small business, industrial, manufacturing, or affordable housing projects, and was recently awarded a \$500,000 loan from the United States Department of

Agriculture Rural Development through its Intermediary Relending Program (IRP). Local partners and Grow Iowa provided the \$125,000 matching funds needed to create a new \$625,000 fund for business projects in southwest Iowa.

For additional information, visit [www.growiowa.org](http://www.growiowa.org), or contact Debra Houghtaling, executive director, at (641) 343-7977.

### Michigan

#### **New loan program to help college graduates and Michigan communities**

To help the state's economy, as well as college graduates, the Michigan State Housing Development Authority (MSHDA) is offering a new program comprising \$10 million in loans to entice graduates to stay in the state. This plan will offer low-interest housing loans in communities that need economic development. The loans will be available for recent graduates interested in purchasing housing in eight selected Michigan cities.

The cities selected include: Detroit, Muskegon Heights, Hamtramck, Saginaw, Pontiac, Benton Harbor, Flint and Highland Park. The low-interest housing loans are available to those who have received a doctoral, master's, bachelor's or associate's degree from an accredited institution within three years prior to the date of the loan application. Qualified individuals can now apply for the loans, which are approximately 2 percent below market rate.

For further information, visit [www.michigan.gov/mshda](http://www.michigan.gov/mshda).

### Wisconsin

#### **Communities seeking federal tax credits to facilitate commercial development**

On November 28, the Milwaukee Journal Sentinel reported that a group of southeastern Wisconsin communities will create a consortium that will seek federal tax credits to facilitate commercial development in lower income areas of the region. The First-ring Industrial Redevelopment Enterprise, FIRE, will apply for New Markets Tax Credits in 2007. The group's focus will be on older industrial areas in need of redevelopment.

# Nontraditional Mortgages: Appealing but Misunderstood

By Shirley Chiu

Carl obtained an “option ARM”, an adjustable rate mortgage with payment options, to finance the purchase of an \$800,000 home in Silicon Valley, California. The loan terms let him choose from a variety of alternative payment structures ranging from the fully amortized principal and interest down to less than the interest due. Because he expected his salary and his home's value to increase in the future, Carl initially chose to make the lowest monthly payment his loan terms allowed, which comprised less than the interest due, and no principal. This decision resulted in an *increasing* principal balance as the unpaid interest was added to his principal. Simply put, this option let him trade lower payments near term for higher payments in the future. Unfortunately, a lost deal forced his employer, a small, upstart software firm, to close, leaving Carl unemployed and wondering how he could afford higher future payments.

With lenders competing for market share during the recent housing boom, stories such as Carl's are not uncommon. In fact, many borrowers who sought to profit from the housing boom and obtained nontraditional mortgages may not understand the associated risks and obligations. Understanding the details connected to nontraditional mortgages is critical to using them successfully.

Nontraditional mortgages such as the option ARM were typically offered in the past only to wealthy and financially sophisticated borrowers. More recently, they have been marketed to middle- and lower-income home buyers seeking to reduce their payments, or that cannot qualify for a conventional mortgage with a fully amortizing payment.

## Introduction

Nontraditional mortgages offer potential benefits for home buyers in strong, stable housing markets. Various payment options increase flexibility and enable borrowers to significantly reduce payments in the short term. In rapidly appreciating housing markets, these options also allow borrowers with certain needs, such as those who must live in areas defined by their employers (e.g., police, municipal workers, etc.), to make home purchases where real estate price increases have outpaced their capacity to buy using conventional financing. These mortgages typically feature lower initial monthly payments, or the option to make lower payments for some period, compared with traditional fixed or adjustable rate mortgages. However, these lower payments can increase significantly if the borrower initially makes only the minimum payment, which may comprise less than the interest due. Nontraditional mortgage products can be effective tools for borrowers who are financially sophisticated and understand the risks of payment shock and negative amortization.<sup>1</sup> Less financially savvy and less credit-worthy borrowers may not necessarily understand the terms and consequences of these products. In some instances, borrowers have found they owe more than their house is worth, even in appreciating markets, as a result of negative amortization.

Historically, lenders only offered nontraditional mortgage products to high-income, financially-sophisticated borrowers who were aware of and able to manage the associated risks and costs. Investors have in the past, and currently take advantage of these products to steeply leverage purchases of investment property. More recently, since roughly 2003, these products have been marketed more broadly to middle- and lower-income households. These mortgages have been especially attractive

for borrowers in states with the greatest increase in housing prices, such as California, Nevada, Washington,

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and Virginia.<sup>2</sup> Although a significant amount of attention has focused on mortgage bankers and brokers, commercial banks currently offer more of these loans than in the past to attract or retain lower- and middle-income borrowers. The effect of the broader availability of these loans

is twofold. Flexible financing may have boosted the U.S. homeownership rate during the recent sharp upturn in housing prices. However, some originators and lenders aggressively pushed these loans to less financially sophisticated borrowers, who may have been better served with more conventional loans. Such borrowers are also associated with sharply rising defaults and foreclosures.

This article will provide background and descriptions of nontraditional mortgage products, their role in the market, the impact on consumers, impact on financial institutions, and related regulatory guidance.

### **Nontraditional Mortgage Products: Where Can You Get Them and What are They?**

Nontraditional mortgage products are offered by federally and state regulated banks, mortgage banks, and mortgage brokers. According to the Consumer Federation of America, the main types of nontraditional mortgage products sold and purchased are option ARMS, interest-only mortgages, hybrid ARMS, no-money-down, and Alt-A (also called alternative-, or low-documentation) loans. Although a variety of products make up the nontraditional mortgage market, most of these products are not prevalent in the nonprime market.

Each of the above mentioned products offers lower initial payments than do fixed-rate mortgages. The ideal borrower for these products is one whose financial circumstances at origination prevent entry into an amortizing, fixed-rate loan contract, but whose predicted future financial circumstances will improve enough to support higher future payments, or refinancing to another instrument. These types of loans allow for the purchase of a more expensive home than the buyer could otherwise afford, in anticipation that home prices in the local market will escalate further, and the borrower's financial position will also improve. Therefore, it is critical that borrowers understand the temporary nature of the introductory low rate, and that higher payments are required following the expiration of the introductory period rate. Unfortunately, alternative mortgages are often marketed to borrowers whose financial circumstances only allow them to afford

the initial lower payments. (This article will focus mostly on the option ARMS and interest-only mortgages, since these are the most common, and have raised the most concern.)

The first of these nontraditional products is the option ARM. Created in 1981, option ARMs were originally marketed to wealthy home buyers, especially those with large fluctuations in monthly income, who wanted the flexibility of making low payments for a period and then paying off the loan, or a large chunk of principal, all at once. These loans are also suitable for homeowners or investors who plan to own their property for a short period of time, and anticipate relatively rapid appreciation and a quick sale. Borrowers can typically choose among four payment choices each month, from a low minimum payment that amounts to less than the monthly interest due, to a fully amortized amount consisting of principal and interest. Option ARMS advertise introductory rates as low as 1 percent to entice borrowers, but the rate is adjusted monthly. In subsequent months, the rate is equal to the most recent value of the rate index<sup>3</sup> plus a margin.<sup>4</sup> Changes in the monthly payment are capped to avoid large changes in the payment. Negative amortization (see figure 1) is also limited, meaning that if the borrower reaches that

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**...an estimated 80 percent of all option ARM borrowers choose to make only the minimum payment.**

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limit (usually from making only minimum payments), the lender immediately increases the payment to the fully amortizing level, and the sum of the

amortized monthly principal and interest due becomes the required payment. The limit is designed to protect the lender more than the borrower. A negative amortization cap takes priority over a payment adjustment cap, so a borrower will face an even larger payment increase if negative amortization has exceeded the contractual limit. Nevertheless, an estimated 80 percent of all option ARM borrowers choose to make only the minimum payment.<sup>5</sup> The real danger is that borrowers who do not understand that repeated minimum payments will result in payment shocks may face default and foreclosure if they have not planned accordingly.

The interest-only mortgage allows borrowers to defer payment of principal and pay only the monthly interest on their mortgages (or even less than the full interest for negative amortization mortgages) for a set period of time, after which the borrowers must pay down their mortgages at a faster rate on a shorter amortization schedule. For instance, a 30-year mortgage that is interest-only for the first three years of the term will convert to a fully amortizing mortgage on a 27-year (versus 30-year) amortization schedule. Similar to the low introductory rate of an option ARM, the interest-only option of the mortgage disappears once the introductory period ends. Afterwards, the loan must be paid back on an accelerated schedule

consisting of much higher payments. Interest-only and negative amortization mortgages make the most sense for homeowners experiencing a temporary drop in income, after which they refinance to an amortizing mortgage.<sup>6</sup> These loans are also optimal for investors who plan to hold property for a short period of time before selling it. Recently, however, these products have been promoted by lenders as a way for cash-strapped borrowers to purchase more expensive homes than they can afford under traditional loans. Although some borrowers may not understand the implications of choosing an interest only loan, lenders reportedly continue to market these mortgages to individuals that are vulnerable to payment shocks.

The third product, the hybrid ARM, offers a fixed interest rate for a period of time, and a floating rate thereafter. The initial fixed rate of interest for a fixed period of time, such as 3, 5, 7, or 10 years, is generally below the rate for a 30-year, fixed-rate mortgage, but after the initial term, the note rate adjusts annually. Hybrid ARMs are referred to by their initial fixed period and adjustment periods. For example, a 5/1 hybrid ARM has a fixed rate for five years, and subsequent rate adjustments at one-year intervals. The popularity of hybrid ARMS has risen significantly over the last few years. Between 1998 and 2004 alone, the percentage of hybrids relative to 30-year, fixed-rate mortgages increased from less than 2 percent to 27.5 percent.<sup>7</sup>

The fourth product, the no-money-down mortgage, as its name implies, requires no down payment. The most common of these mortgages is a so-called “piggyback” loan. Normally, a home buyer who puts less than 20 percent down on a home must pay private mortgage insurance. With the piggyback loan, a home buyer can borrow money for their down payment using a home equity loan or line of credit rather than paying the 20 percent out of the borrower’s own funds. The no-down-payment nature of the mortgage makes it a popular alternative to more traditional products. This product is most suited for the home buyer with a high income, but little equity or savings, who is able to make regular mortgage payments in addition to payments for the home equity loan or line of credit. In 2004, 42 percent of first time home buyers and 13 percent of repeat purchasers used no-money-down mortgages.<sup>8</sup>

Finally, Alt-A loans, or alternative documentation loans allow borrowers to obtain a mortgage without having to submit all the documentation normally required for a traditional loan. These loans are primarily driven by a borrower’s credit score, since most Alt-A borrowers cannot document income from traditional employment.

Borrowers do not have to provide verification of income and assets. Traditionally, Alt-A borrowers meet Fannie Mae and Freddie Mac standards for credit scores, but may not meet standard guidelines for documentation requirements, property, type, debt ratio, or loan-to-value ratio. Generally, Alt-A borrowers must pay a higher interest rate for not meeting standard documentation guidelines. The landscape of Alt-A borrowers include self-employed who lack payroll stubs and W-2 forms, and divorcees or entrepreneurs who earn income, but may not be able to meet lenders’ documentation requirements.

### **The Current Homeownership Market and the Risks of Nontraditional Mortgages to Consumers**

Homeownership in the U.S. has increased dramatically since the late 1990s. Between 1990 and 2006, the homeownership rate in the United States increased from 64 percent to 68.7 percent.<sup>9</sup> According to the Federal Reserve’s Flow of Funds data, the value of residential real estate assets held by households increased from \$10.3 trillion in 1999 to \$20.4 trillion in 2006. The data also indicate that about 34 percent own their homes outright, 50 percent have fixed-rate mortgages, and about 16 percent have adjustable rate mortgages. In the first half of 2006 alone, lenders originated an estimated \$432 billion in interest-only loans and payment-option ARMS. Interest-only and payment-option ARMS represent about 29 percent of all mortgages originated during that period.<sup>10</sup> Remarks by Federal Reserve Chairman Ben Bernanke indicated that between 30 and 40 percent of new mortgages in 2005 were nontraditional.<sup>11</sup> About 25 percent of all mortgages carry adjustable rates, and more than half of such loans are made to subprime borrowers.<sup>12</sup>

Because nontraditional mortgage products are now offered to a wider audience, regulatory agencies are concerned about the frequency of negative amortization and payment shocks to borrowers, which have historically raised the probability of default and foreclosure. Regulators are concerned that nontraditional products are increasingly combined with “risk-layering” practices, such as underwriting based on less stringent verification of income or assets. Consequently there is dialogue over whether some of the available credit options are appropriate for specific borrowers, whether they are properly underwritten, and whether borrowers are informed of the risks of nontraditional products.

Negative amortization is the most common concern. The lack of principal amortization associated with certain nontraditional mortgage products and the accrual of additional principal resulting from negative amortization create an increased risk of default that is greater than

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the risks posed by many other traditional adjustable rate products. Negative amortization occurs when the monthly payment does not cover the interest, and there is a resulting increase in the loan balance. Frequently, borrowers find themselves owing more than the original

price of their house. In 2004 and 2005 alone, more than 20 percent of option ARM loans left borrowers with homes worth less than the mortgaged amount on the property.<sup>13</sup>

### Figure 1: Negative Amortization

Assume the borrower obtained a 30-year, fixed-rate loan of \$100,000 at 6%. His monthly payment is \$600. Suppose in the first month, the interest due to the lender is \$500. That leaves \$100 for amortization. The balance at the end of month one would be \$99,900.

The \$600 payment is a “fully amortizing” payment. If he continues to pay that amount every month during the period remaining to term and the interest rate does not change, the loan will be paid off at term. A \$500 payment would just cover the interest – there would be no amortization.

However, if he only paid \$400, it would fall short of the interest due by \$100, and the loan balance would rise to \$100,100. In effect, the \$100 is added to the amount he already owes. This rise in the loan balance is called negative amortization.

Source: Jack Guttentag, *Should You Fear Negative Amortization?*, Yahoo! Finance, 2002.

The second primary concern, payment shock, is faced by the borrower of a nontraditional product after the initial introductory low rate period, when rates adjust and the borrower’s monthly payments increase. Often, these borrowers are also less credit worthy and less financially able to make the increased payments following the shock.

Finally, defaulting on a mortgage greatly increases the borrower’s susceptibility to foreclosure, which occurs when a borrower falls too far behind on mortgage payments and the lender moves to take possession of the property. According to the Wall Street Journal, borrowers of one of the key nontraditional mortgage products, the Option

### Figure 2: Payment Shock

Assume a home purchase price of \$300,000, a 10% down payment, with a 5.75% interest-only adjustable-rate mortgage. The mortgage requires interest-only payments for five years. After that time, the interest adjusts every year based on rates in effect at that point.

If interest rate benchmark remains stable over initial five years:

- Initial monthly payment = **\$1,294**
- Monthly payment after five years with principal amortization = **\$1,699**

If interest rate benchmark increases 3% after five years:

- Initial monthly payment = **\$1,294**
- Monthly payment after five years with principal amortization = **\$2,220**

Source: Shopping for a Mortgage? Do Your Homework First, National Association of Realtors, available at [www.realtor.org/HousOpp.nsf/files/specialtymortgage\\_text.pdf/\\$FILE/specialtymortgage\\_text.pdf](http://www.realtor.org/HousOpp.nsf/files/specialtymortgage_text.pdf/$FILE/specialtymortgage_text.pdf).

ARM, were facing foreclosure an average of 10 months after the loan is made – much earlier than the average with other types of loans. After the recent economic downturn, the foreclosure rate was 9 percent for subprime, adjustable rate mortgages.<sup>14</sup> On a much larger scale, however, this represents only 1.2 percent of total homeowners.<sup>15</sup>

Empirical evidence supports the concern that the wider audience of borrowers using nontraditional mortgage products may not fully understand their risks. A study by Bucks and Pence at the Federal Reserve Board found

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that a sizable number of borrowers do not understand the terms of their adjustable rate mortgages. The authors concluded that certain groups of borrowers appear to underestimate the amount by which their

interest rates change, and don’t fully understand the terms of their contracts. More specifically, their study found that 27 percent of borrowers with college education compared to 42 percent of borrowers without a college education did not know their per-period cap. The study found similar

results by race. Twenty-six percent of white borrowers are unaware of the per-period cap, compared to 59 percent of minority borrowers. Additionally, the study found that 40 percent of borrowers with income less than \$50,000 did not know their per-period caps on interest rate changes compared to only 13 percent of borrowers with income exceeding \$150,000.<sup>16</sup> These results are consistent with earlier studies, which suggested that disclosures benefit middle- and high-income borrowers more than low-income borrowers. In the same study, Bucks and Pence predict that 79 percent of borrowers who will experience changes in payments equal to less than 5 percent of their gross income, actually anticipate changes of that size. This is opposed to the 15 percent of borrowers who will experience increases between 5 and 10 percent of income that anticipate a commensurate increase.

### Impact on Other Sectors of the Industry

Banks, in addition to consumers are also impacted by the less strict standards implemented by lenders when they offer nontraditional mortgages to borrowers. Banks speculate that credit quality of subprime and nontraditional mortgages on their books are deteriorating. Additionally, investors of loans purchased by investment banks from the mortgage originators are also at risk. Investment banks play a large role in purchasing mortgages on the secondary market. They purchase mortgages from mortgage originators, securitize them, and then sell the securities to institutional investors. Because of the slowing mortgage market, investment banks have been more carefully inspecting the loans upon purchase. Mortgage originators who sell mortgages with inaccurate paperwork or poor performance, such as early payment default, are subject to recourse from the buyer. In response to the alleged poor performance of certain loans, lenders contend that customers miss first payments for reasons other than credit worthiness, and investment banks are merely taking advantage of a loophole in the contract to push the mortgages back. The lenders most vulnerable to these returned mortgages are banks that “sold huge numbers of option adjustable-rate mortgages.”<sup>17</sup>

For the majority of banks, nontraditional mortgage products represent only a fraction of their total holdings. In a recent Federal Reserve survey, 48 banks responded to a question about nontraditional mortgages. Of these 48 banks, less than half reported that nontraditional mortgage products represented less than 5 percent of their holdings.<sup>18</sup> In the same survey, about 20 percent of respondents reported their share of nontraditional products to fall between 5 and 15 percent. More importantly, nearly 30 percent of the banks surveyed admitted that they expect the quality of nontraditional residential mortgages on their books to deteriorate over the next 12 months.<sup>19</sup> Even so, the damage to banks

resulting from the holding of nontraditional mortgage products will likely be limited. Banks use insurance and other financial instruments to protect their portfolios. Furthermore, they also secure loans with real assets, such as homes.

### National Response

Amid industry concerns, federal regulatory agencies in December 2005 proposed guidelines to address the major issues facing the nontraditional mortgage industry. These guidelines stress the need for timely, informative, and clear disclosure of loan terms to the consumer, and financial institutions to adhere to tighter underwriting standards and risk management programs for alternative mortgage products.

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) (“the Agencies”) collaboratively drafted a set of rules<sup>20</sup> (“the Guidance”) for institutions that offer, purchase, service, or securitize nontraditional mortgage products. The Agencies sought to clarify how institutions can offer these products in a safe and sound manner, while clearly disclosing the potential risks that borrowers may assume. The proposal is not limited to those areas directly involved in making or purchasing nontraditional loans, but also areas such as loan servicing and securitization. The Guidance calls for review and revision by institutions on three general areas: 1) the maintenance of safe and sound loan terms and underwriting process; 2) the institution of appropriate portfolio and risk management practices; and 3) ensuring that an institution’s practices address consumer protection concerns. The Agencies invited public comments from industry participants.

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to repay from sources other than the pledged collateral are typically deemed unsafe and unsound. While the Guidance does not prohibit risk layering practices, it states that institutions should avoid the use of loan terms and underwriting

practices that could lead to the borrower having to rely on the sale or refinancing of his property once amortization begins.



Guidelines concerning portfolio and risk management practices are premised on the speculation that “changing economic conditions and a housing price decline will put more stress on portfolios of these [nontraditional] loans and more stress on borrowers.”<sup>21</sup> The Guidance requires strong, highly segmented risk management practices in areas such as policies, concentrations, controls, third-party originations, secondary market activity, management information, and reposting, and stress testing. The Guidance indicates that concentration limits should be set for loans of the nontraditional type. Additionally, the Agencies assert that institutions should segment their nontraditional mortgage loan portfolios into pools with similar risk characteristics. Such characteristics include borrower attributes and the differing elements of the loans themselves.

Finally, in light of consumer protection issues, the Guidance requires institutions to alert consumers to the risks of nontraditional mortgage products, specifically the potential for payment shock and negative amortization. According to April Breslaw, Compliance Section Chief of the FDIC’s Division of Supervision and Consumer Protection, under the Guidance, “consumers should receive information at decision points, at the point when they’re shopping for loans, and at the point later on where they’re making decisions each month about how much to pay.”<sup>22</sup> Such communication to consumers should be made in a clear manner and format understandable to the consumer. For example, product descriptions should include corresponding examples showing the effect of payment leading to negative amortization on the consumer’s loan balance and home equity, in conjunction with sample payment schedules. The Agencies are looking to persuade institutions to encourage consumers to make responsible payment choices.

### **Comments in Response to the Guidance**

The provisions in the Interagency Guidance are heavily debated by institutions that have commented on the Guidance. Most nonprofits and consumer advocacy groups agreed with the provisions set forth in the Guidance. These groups observed that abusive practices surrounding these products are increasing. For example, brokers and lenders often aggressively push nontraditional mortgage products onto borrowers who do not understand or cannot afford a nontraditional mortgage.

On the other hand, lenders and lender trade organizations felt the Guidance was overly prescriptive. One of their main criticisms concerned the Guidance’s recommendations regarding oversight of third-party originators. Lenders

contended that monitoring transactions of thousands of brokers was impractical and infeasible. They believed this was especially true provided that a bank buys loans from third-party originators in bulk or in a portfolio in wholesale transactions.

Lenders also expressed opposition to the Guidance recommendation that nontraditional mortgages be underwritten with the assumption that the borrower makes only the minimum payment and that the balance would naturally increase due to negative amortization. Lenders contend that the policies are overly conservative and would discourage homeownership and liquidity.

Furthermore, lenders urged regulatory agencies to limit their scope of the Guidance. For example, many encouraged the Agencies to exclude from the final Guidance certain loans, such as home equity loans and loans without negative amortization features, where consumers are a lot less likely to face payment shock. More specifically there was a common request among lenders to exclude fixed-rate, interest-only loans with long initial periods like 10 years. Lenders note that statistics suggest that such borrowers on average pay off their loans in seven years, and therefore significantly less likely to face payment shock.

Finally, lenders suggested that the new consumer protection related disclosures should be implemented through changes to the Federal Reserve Board’s Regulation Z, rather than through the Guidance. Regulation Z implements the Truth in Lending Act, the federal law whose purpose is to assure the meaningful disclosure of credit terms so that consumers can compare available terms and avoid make an informed decision regarding credit.<sup>23</sup> Regulation Z applies to all lenders, and not just those lenders who are subject to oversight by the federal banking agencies. Requiring the Guidance’s proposed disclosures through Regulation Z would level the playing field for institutions that offer nontraditional mortgage products. Disclosure requirements would no longer be limited to national banks, but state banks as well. Leveling the playing field is important for two key reasons. First, increasing disclosure and heightened underwriting standards through the Guidance will put federally insured depository institutions, banks, at a competitive disadvantage compared with non depository financial institutions. Second, differing (degrees of) regulation for different types of lenders offering the same products may also put consumers at risk, if the disclosures required of banks are not required of other types of lenders.

## The Final Guidance

Following the comment period, the Agencies issued a final Interagency Guidance on nontraditional mortgage products (“the final Guidance”),<sup>24</sup> superseding their initial Guidance. In the final Guidance, the Agencies addressed the main concerns raised by way of comments.<sup>25</sup> For the most part, the text remained the same in the final Guidance, with some further clarification of the guidelines.

Most notably, the Agencies are currently seeking public comment on potential model disclosures, as part of the guidelines to assist lenders in following recommended practices for adequate communications with consumers. In the original Guidance, the Agencies provided a set of recommended practices rather than model disclosures. As a result, some commentators, including trade associations, asked the Agencies to provide a sample disclosure that meet guidelines concerning consumer protection. Therefore, the Agencies have developed proposed illustrations of model disclosure for public comment.<sup>26</sup> Institutions that seek to follow the recommendations set forth in the Guidance can choose to use the proposed illustrations, and provide information based on the illustrations at their own discretion. If the institution chooses not to use the proposed illustrations, the final Guidance recommends that distributed promotional material detail the costs, terms, features, and risks of nontraditional mortgage products.

In addition to the final Guidance, the Agencies recently announced the publication of a resource for consumers. The publication contains explanations of nontraditional mortgage products and the risks that should be considered before obtaining one. According to a recent press release by the Agencies, the publication “stresses the importance of understanding key mortgage loan terms, warns of the risks consumers may face, and urges borrowers to be realistic about whether they can handle future payment increases.”<sup>27</sup>

## Other Steps Taken by Regulatory Agencies

The development of the proposed Guidance is not the first time regulatory agencies have addressed the effects of nontraditional mortgages on consumers. In the summer of 2006, the Federal Reserve Board sponsored four public hearings under the Homeownership and Equity Protection Act (HOEPA) at four regional Reserve Banks. HOEPA amended the Truth in Lending Act by imposing additional disclosure requirements on certain high-cost, home-secured loans. One of the three key focuses of the 2006 public hearings was nontraditional mortgage products including interest-only mortgage loans, adjustable-rate mortgages, and reverse mortgages. These hearings drew participation from consumers, consumer advocacy organizations, and lenders. Consumer advocates once again voiced their concern that mortgage brokers and

lenders were “push-marketing” nontraditional mortgages to low-income consumers without regard for whether the products were appropriate given the consumers’ circumstances. They also favored adoption of laws that would hold brokers and lenders liable for making unaffordable mortgage loans. In light of the proposed Guidance, lenders at the hearings, especially those in areas of high housing costs, noted the possibility that potential home buyers will be unable to purchase homes under the types of stricter parameters of the Interagency Guidance.

Following the proposed Guidance and comments from lenders regarding incorporating the consumer protection aspects into Regulation Z, Sandra Braunstein, director of Consumer and Community Affairs at the Federal Reserve Board, announced in her testimony before the Senate that the Federal Reserve staff is currently developing plans and recommendations to revise mortgage disclosure requirements in Regulation Z.<sup>28</sup> In a testimony before the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy, Braunstein discussed the considerations taken by the Federal Reserve Board in reviewing TILA, in light of concerns surrounding nontraditional mortgages. She stated that the Federal Reserve will be focusing its efforts on making Truth in Lending Disclosures more prominent and easier for consumers to use. She further added that in revising Regulation Z, the Board would use consumer testing and work with design consultants to try to improve the format and language of ARM disclosures. Additionally, Braunstein noted that the Board sought to gather information by conducting outreach to the industry, consumer interest groups, consumers, regulators, and other interested parties.

## Conclusion

Even though a number of federally regulated financial institutions fund and/or originate loans through mortgage brokers, the proposed Guidance, which only affects federally regulated depository financial institutions *themselves*, may not broadly address disclosure and suitability issues concerning nontraditional mortgages. Federal regulatory agencies do not perform routine examinations of independent mortgage lenders and affiliated nonbank subsidiaries of financial and bank holding companies engaged in mortgage lending. There is some disagreement over the authority of federal and state banking regulators to regulate and supervise the operations of subsidiaries of federally chartered depository institutions. Regulation over these subsidiaries is important because several state attorneys general have agreed that predatory lending abuses are largely confined to the subprime lending market and to nondepository institutions, not banks or direct subsidiaries.<sup>29</sup>

Although the Guidance is specific to federal regulated financial depository institutions, states are also considering the possibility of expanding the Guidance to state regulated nondepository institutions that offer nontraditional mortgage products as well. Currently, 24 states, including Illinois, have enacted predatory lending laws. However, these laws do not directly address the recent issues surrounding nontraditional mortgage products. Therefore the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are considering drafting guidance for state regulators of residential mortgage brokers and lenders for use by their respective licensees. Practices concerning nontraditional mortgages are prevalent in all types of lenders, and should be closely monitored to prevent the unchecked offering of nontraditional mortgages to consumers not aware of all payment scenarios associated with their loans, or who are financially under-qualified to successfully utilize these types of loans.

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## Notes

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- 1 Negative mortgage amortization occurs when the monthly payment does not cover the interest, and there is a resulting increase in the loan balance. See page 5 of this article for full explanation and example.
- 2 Sandra L. Thompson, FDIC, before subcommittee on economic policy and subcommittee on housing and transportation of the committee on banking, housing, and urban affairs (referring to Office of Federal Housing Oversight, Loan Performance Corporation), available at [www.fdic.gov/news/news/speeches/chairman/spsep2006.html](http://www.fdic.gov/news/news/speeches/chairman/spsep2006.html).
- 3 Most option ARMs use one of four indexes: the Monthly Treasury Average (MTA), Cost of Funds Index (COFI), Certificate of Deposit Index (CODI), and Cost of Savings Index (COSI). These are chosen for their relative stability. See [www.mortgage-x.com/general/indexes/cosi.asp](http://www.mortgage-x.com/general/indexes/cosi.asp) for more detail on each index.
- 4 The number of percentage points that the lender adds to the index rate in order to calculate the ARM interest rate at each adjustment. The margin is set in the mortgage contract and remains fixed for the term of the loan.
- 5 Mara Der Hovanesian, "Nightmare mortgages", *Businessweek*, Sept. 1, 2006 (reporting number from Fitch Ratings), available at [www.businessweek.com/magazine/content/06\\_37/b4000001.htm](http://www.businessweek.com/magazine/content/06_37/b4000001.htm).
- 6 Under a conventional amortizing mortgage, a borrower makes a level payment for a specified interval; with a fixed rate loan, the interval is the term of the loan; with a variable rate loan, intervals are proscribed in the loan provisions, and the interest rate may make the actual payment size larger or smaller from one period to the next, depending on market interest rates. In either case, the payment comprises some proportion of principal and interest, and the proportion of the payment that represents principal gradually increases over the loan term, so that at the conclusion of the loan term, the balance due is zero.
- 7 Fabozzi, Frank J. (ed), *Handbook of Mortgage-Backed Securities, 6th Edition*, p 259-260.
- 8 Peter G. Miller, "Should you prepay your mortgage?", *Realty Times*, Mar. 22, 2005 (refer to figures from the 2004 National Association Of Realtors Profile Of Home Buyers And Sellers, 47), available at [www.realtytimes.com/rtcpages/20050322\\_prepaymortgage.htm](http://www.realtytimes.com/rtcpages/20050322_prepaymortgage.htm).
- 9 U.S. Census Bureau, "Housing vacancies and homeownership," Table 5. Homeownership Rates for the U.S.: 1965-2005 (calculated using Census Current Population Survey and Housing Vacancy Survey for relevant years), available at [www.census.gov/hhes/www/housing/hvs/qtr206/q206tab5.html](http://www.census.gov/hhes/www/housing/hvs/qtr206/q206tab5.html).
- 10 Testimony of Sandra L. Thompson, FDIC (see Note 2).
- 11 "Bernanke: 'Pretty Clear' Housing Market Cooling, But Should Land Softly," *Reuters*, May 18, 2006, available at [www.foxnews.com/story/0,2933,196052,00.html](http://www.foxnews.com/story/0,2933,196052,00.html).
- 12 Gerri Willis, "Guard against higher rates: adjustable-rate mortgages are getting more expensive – here's what you should do to protect yourself," *CNN Money*, Jun. 22, 2006, available at [www.money.cnn.com/2006/06/22/real\\_estate/tips/willis/index.htm](http://www.money.cnn.com/2006/06/22/real_estate/tips/willis/index.htm); Noelle Knox and Barbara Hansen, "More fall behind on mortgages," *USA Today*, Sep. 14, 2006, available at [www.usatoday.com/money/perfi/housing/2006-09-14-delinquency-usat\\_x.htm](http://www.usatoday.com/money/perfi/housing/2006-09-14-delinquency-usat_x.htm).
- 13 Mara Der Hovanesian, "Nightmare mortgages," *Businessweek*, Sep. 1, 2006 (reporting number from Fitch Ratings), available at [www.businessweek.com/magazine/content/06\\_37/b4000001.htm](http://www.businessweek.com/magazine/content/06_37/b4000001.htm).
- 14 Doug Duncan, senior vice president of Research and Business Development and chief economist, Mortgage Bankers Association. (at Federal Reserve Board's "Building sustainable homeownership: responsible lending and informed consumer choice" at Federal Reserve Bank of Atlanta, July 11, 2006), transcript available at [www.federalreserve.gov/events/publichearings/hoepa/2006/20060711/001to025.htm](http://www.federalreserve.gov/events/publichearings/hoepa/2006/20060711/001to025.htm).
- 15 Duncan (see Note 14).
- 16 Brian Bucks and Karen Pence, "Do homeowners know their house values and mortgage terms?" Federal Reserve Board of Governors, Jan. 2006, available at [www.federalreserve.gov/Pubs/FEDS/2006/200603/200603pap.pdf](http://www.federalreserve.gov/Pubs/FEDS/2006/200603/200603pap.pdf).
- 17 Jesse Elsinger, "Long & short: mortgage market begins to see cracks as subprime-loan problems emerge," *The Wall Street Journal*, Aug. 30, 2006, at C1.
- 18 *The July 2006 Senior Loan Officer Opinion Survey on Bank Lending Practices*, The Federal Reserve Board, July 2006, available at [www.federalreserve.gov/boarddocs/snloansurvey](http://www.federalreserve.gov/boarddocs/snloansurvey).
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- 20 "Interagency guidance on nontraditional mortgage products," Office of the Comptroller of the Currency, Treasury (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision, Treasury (OTS), and National Credit Union Administration (NCUA), Dec. 19, 2005, available at [www.federalreserve.gov/BOARDDOCS/PRESS/BCREG/2005/20051220/attachment.pdf#search=%22interagency%20guidance%20nontraditional%20mortgage%20products%22](http://www.federalreserve.gov/BOARDDOCS/PRESS/BCREG/2005/20051220/attachment.pdf#search=%22interagency%20guidance%20nontraditional%20mortgage%20products%22).
- 21 Michael Bylsma, director, division of Community and Consumer Law, the Office of the Comptroller of the Currency, at Federal Trade Commission Public Workshop, "Protecting Consumers in the New Mortgage Marketplace," May 24, 2006, transcript available at [www.ftc.gov/bcp/workshops/mortgage/transcript.pdf](http://www.ftc.gov/bcp/workshops/mortgage/transcript.pdf).
- 22 Federal Trade Commission Public Workshop, "Protecting Consumers in the New Mortgage Marketplace," May 24, 2006, available at [www.ftc.gov/bcp/workshops/mortgage/transcript.pdf](http://www.ftc.gov/bcp/workshops/mortgage/transcript.pdf).
- 23 Truth in Lending Act, 12 C.F.R. §§ 226.1-226.33 (2006), available at [www.fdic.gov/regulations/laws/rules/6500-1400.html](http://www.fdic.gov/regulations/laws/rules/6500-1400.html).
- 24 "Interagency guidance on nontraditional mortgage product risks," Office of the Comptroller of the Currency, Treasury (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision, Treasury (OTS), and National Credit Union Administration (NCUA) (Sept. 25, 2006), available at [www.ncua.gov/RegulationsOpinionsLaws/RecentFinalRegs/FINAL-FR-NTM-Guidance-092806.pdf](http://www.ncua.gov/RegulationsOpinionsLaws/RecentFinalRegs/FINAL-FR-NTM-Guidance-092806.pdf).
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- 29 U.S. Government Accounting Office, "Consumer protection: federal and state agencies face challenges in combating predatory lending," report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate (citing to Brief on Amicus Curiae State Attorneys General, National Home Equity Mortgage Ass'n v. OTS, Civil Action No. 02-2506 (GK) (D D.C.) (March 21, 2003) at 10-11, available at [www.gao.gov/new.items/d04280.pdf](http://www.gao.gov/new.items/d04280.pdf).

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# Save the Date

## **An Informed Discussion of Nontraditional Mortgage Product Risks**

**Chicago, IL  
January 31, 2007**

The Federal Reserve Bank of Chicago, Consumer and Community Affairs Division, will host a conference titled, "An Informed Discussion of Nontraditional Mortgage Product Risks" on January 31, 2007. The conference will be held at the Reserve Bank, located at 230 South LaSalle Street, Chicago.

The conference will provide a forum exploring nontraditional mortgage product risks. The conference agenda will include a broad overview of the issues, a dialogue on regulatory considerations, and a more focused discussion of the central issues as seen from key perspectives.

Conference attendance will be limited to allow for active participation by all attendees. As a result, conference reservations will be accepted on a first-received basis. We hope that you will be able to join us at the conference. For registration and information visit [www.chicagofed.org/community\\_development/index.cfm](http://www.chicagofed.org/community_development/index.cfm), or call (312) 322-8232.

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## **18th Annual Rural Community Economic Development Conference**

**Peoria, IL  
March 7-8, 2007**

The Illinois Institute for Rural Affairs, in conjunction with Rural Partners, the Governor's Rural Affairs Council, the Federal Reserve Bank of Chicago and others, is hosting the 18th Annual Rural Community Economic Development Conference on March 7-8, 2007, at the Holiday Inn City Centre in Peoria, Illinois. The program will focus on entrepreneurial approaches to local economic development, the entrepreneurial environment, downtown revitalization, new techniques to attract businesses, second wave entrepreneurship strategies, fund-raising for development activities, and other important issues facing rural areas. More information on the conference agenda and online registration will be available in January on the IIRA web page ([www.IIRA.org](http://www.IIRA.org)).



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