Consumer Federation of America

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March 29, 2006

Public Information Room, Mail Stop 1-5
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
Attention: Docket No. 05-21

Jennifer Johnson
Secretary
Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. OP-1246

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: Docket No. 2005-56

RE: Proposed Interagency Guidance on Nontraditional Mortgage Products

Dear Sir or Madam:

Consumer Federation of America (CFA) welcomes the opportunity to submit these comments concerning the *Proposed Interagency Guidance on Nontraditional Mortgage Products.* 70 FR 77249 (December 29, 2005). CFA shares the regulators concern that the proliferation of nontraditional mortgages poses heightened risks both for lenders and mortgage borrowers alike. The proposed guidance provides a good start by sending a message to the mortgage industry that urges greater restraint in the underwriting of

nontraditional loan products and in how these products are offered to consumers. However, in view of the rapidly changing market conditions, CFA believes that federal regulators should be looking beyond the guidance and undertake a comprehensive review of existing consumer protection regulations to determine whether revisions are needed to ensure that borrowers are adequately protected in today's environment.

While we believe that the proposed guidance will be useful, CFA also recognizes that its scope has certain limitations. First, while it contains some mandatory requirements, the overall impact on the mortgage market will depend on how these standards are interpreted. Second, since the guidance applies only to regulated depository institutions and their subsidiaries and unfortunately, not to their non-bank affiliates, it is unclear what reach this guidance will have on these and other important segments of the nontraditional mortgage market. Third, since the guidance does not entail revisions to existing rules it will not expand any consumer protections, nor will consumers be able to enforce the application of these standards to individual lenders.

New Federal Guidance Can Help

The guidance appropriately focuses on non-amortizing loans, such as interest only (IO) and negative amortization option adjustable rate mortgages, along with other features that lenders increasingly are offering with these loans. These products have been the subject of significant attention and rightly so. While IO loans and option ARMs have existed in in some form for many years, today these loans are mass marketed to a much broader spectrum of borrowers. CFA is concerned that the proliferation of these products is confusing many consumers as to their payment terms and that these loans are being made to consumers for whom they are not appropriate.

Nontraditional mortgage products may benefit certain consumers who use them, including some that could not afford to purchase their home using traditional fixed rate thirty year mortgages. However, for many other consumers these loans have more risks than benefits. For those borrowers that are taking out these products to leverage their purchasing power beyond what is affordable over the long term, the terms of these loans may not only be inappropriate but they may be a financial ticking time bomb for families that cannot handle the payment shock.

CFA believes that many borrowers are not fully aware of the financial implications and risks that these products entail. It is easy to understand why. Consumers today face a dizzying array of mortgage products that are marketed and promoted under a range of product names. Although the number of loan products available to homebuyers has exploded, there appears to be little understanding by many borrowers about key features in today's mortgages and how to compare or even understand the differences between these products. A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage.[1] A recent Federal Reserve study confirms this. The Fed study also found that 35 percent of

[1] CFA, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages, press release, July 26, 2004.

ARM borrowers did not know the maximum that their interest rate can rise at one time and, 41 percent were unsure of the maximum rate they can be charged. [2]

Many new borrowers appear to be choosing loan products based on the initial payment structure with little appreciation of the long-term costs of the mortgage. 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." [3] Meanwhile, the marketplace appears to be downplaying the risk of loan which could exceed the value of property which secures them. One California mortgage broker described many prospective borrowers' attitudes as "Why knock ourselves out trying to build up equity through the mortgage payment when the market will take care of it for you?"[4]

A September 2005 Harris poll found that one in five (19%) buyers purchased homes above their anticipated price range.[5] 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. A Public Opinion Strategies focus group 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. These focus group members had all taken out nontraditional mortgages of their own, but when shown rates sheet featuring potential potential payment shock permitted for these products, participants were surprised by their magnitude. Lower income participants, in particular, found that the magnitude of the potential monthly payment increases to be "shocking" and some said that they would be unable afford such increases for their own mortgages.[6]

Yet many borrowers are turning to nontraditional mortgages to cope with rising housing costs and the initial lower monthly payment structures that leverage the borrowers' capacity to afford homeownership. However, many of these loan products have terms that reset and minimum monthly payments that may jump by as much as 100 percent upon expiration of the initial teaser rate. Consumers should not be choosing mortgages based on the outside limits of their ability to pay, nor should lenders be making loans without regard to the borrower's ability to make afford higher payments later in the life of the mortgage.

Of more immediate concern is the number of nontraditional mortgages that face resets in the next few years. Lehman Brothers, Inc. has estimated , with ARMs representing 25 percent of the roughly $8 trillion in outstanding single family mortgage debt, and most of those loans have been originated over the last two years, that about $540 billion in

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[2] Hagerty, James, "The Home-Mortgage Muddle," Wall Street Journal, March 11-12, 2006.
[3] Fratantoni, Michael, Mortgage Bankers Association, "Housing and Mortgage Markets: An Analysis, MBA Research Monograph Series No. 1, September 6, 2005 at 42.
[4] Pender, Kathleen, "High Interest in Interest-Only Home Loans," San Francisco Chronicle, May 20, 2005.
[5] 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.
[6] Public Opinion Strategies, Memorandum: Focus Groups Observations, September 29, 2005.

subprime rate resets will occur over the next two years. These loans will be followed by a huge volume of resets among prime loans. [7] Thus millions of mortgage borrowers are entering what is described as their "danger years," when delinquencies and defaults peak and owners risk losing their homes. Since in today's market risk is increasingly dispersed among a variety of market participants who may either underestimate or be willing to price for the greater risks of default and foreclosures these loans entail. However, we are disturbed that proposed guidance focus entirely on the ways in which nontraditional mortgage products potentially increase risk to lenders, while not taking into account the impact that high foreclosure levels can have for consumers and the neighborhoods in which they live. This risk appetite differential should be taken into account in framing public policy for risk nontraditional mortgage products that can lead to higher default and foreclosure levels.

Over the past few years, nontraditional mortgages products have been promoted as low-risk because the home price appreciation in many areas was effectively building equity for the new homeowners even if they were not paying down the principal on their mortgages. However, recent borrowers have not been growing the equity in their new homes as negative amortization loans became more prevalent. 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.[8] If real estate prices were to decline even slight, homeowners who have been paying only the interest or small amounts of principal could end up owing more on their mortgage than their home is worth.

Specific comments on the proposed interagency guidance

Bolstering Underwriting Guidelines

Lenders are advised to take into account the borrower's debt "repayment capacity" over the life of the mortgage. Thus lenders will be directed to qualify nontraditional mortgage borrowers under fully indexed rates and to take into account for the neg-am potential of these loans. Evaluating a borrower's ability to pay at the fully indexed rate (i.e., what the payments will be if the teaser rate was not in effect) is perhaps the most important feature of this guidance. The guidance also provides that borrowers would have to qualify at the maximum possible negative amortization – typically 10%-25% higher than the loan amount.

Both standards would represent an important upgrade over the way some in the industry are underwriting these products. However, CFA recommends that the underwriting standards go farther still and consider the borrower's ability to pay at the maximum payment after all applicable triggers for the loan product are considered. This information should be routinely provided to borrowers before the loan is made.

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[7] Smith, Steve, "Mortgage Risk in Today's Market," Mortgage Banking, October, 2005.
[8] Harney, Kenneth R., "Equity Stakes In Your Home: What Percentage?" Realty Times, February 27, 2005.

Discouraging the Use of "Stated Income" Standards

Traditionally "Stated Income", "Low Documentation" and "No Documentation" Loans have been used to enable self-employed borrowers from having to provide the usual documentation required for borrowers. Lenders are increasing approving mortgages for applicants who do not present proof of income or assets traditionally required. In 2004, loans with these features represented 4.3% of all originations.

There are concerns that many stated income borrowers may pose higher credit risks, especially if interest rates rise and housing prices fall. There is some anecdotal evidence that lenders and brokers may be using these low-doc or no-doc features to qualify borrowers who could not be approved using traditional underwriting standards.

The regulators should consider directing lenders to document the borrower's basis for selecting a stated income loan, particularly for those borrowers who have a W-2 statement and can have their income verified rather easily. CFA is concerned that some lenders may be steering less sophisticated borrowers into nontraditional mortgages without proper consideration of their ability to repay. To guard against this, we recommend that lenders with abnormally high levels of these loans should be subject to special agency exam.

Recommended Disclosures to Borrowers Are Inadequate

The guidance advises lender to inform consumers of potential increase in monthly payments, state maximum monthly payments and describe the timing of payment changes down the road. It also indicates that prepayment penalty provisions should be clearly disclosed. Requiring lenders to follow these standards would be an improvement for many over existing practices, but they are insufficient. Disclosures should be required which show the maximum monthly payment that the borrower could be required to pay for the specific loan product and the soonest possible dates that such payments may be required. Further, rewriting the mortgage loan disclosure rules is necessary so that all mortgages lenders are required to adhere to these standards.

Supplementing Consumer Loan Disclosures. Even if more comprehensive disclosures were to be required for nontraditional mortgages, this information still may not be sufficient given the complexity and wide array of products that are available. The guidance implicitly recognizes these limitations and directs lenders to develop appropriate underwriting standards that neither encourage nor accept applications from borrowers for whom these products are ill suited.

Applying the Guidance to Third Party Originations

Lenders increasingly are using third party channels, such as mortgage brokers or correspondents to originate nontraditional mortgage loans. There is evidence to suggest that these channels have contributed to qualifying borrowers that do not have full knowledge of the extra risks these products may entail and others for whom they are not

appropriate. The guidance directs lenders to develop and implement strong control systems and oversight of these channels to ensure that they apply the standards specified in the guidance. CFA supports this requirement and believe would help improve the quality of the loans being made.

In sum, CFA believes that more can be done to ensure that consumers are fully aware of the financial risks posed by complex and potentially risky nontraditional mortgages identified in the guidance. At a minimum, consumers should be provided with clear and timely information about how their loan works and the impact of its features on households finances over the life of the loan. However, we are concerned that simply providing expanded information will not be sufficient. The plain fact is that deferred payment mortgage products may not be appropriate for everyone and that many borrowers will not be in a position to handle unexpected and higher monthly payments. In this sense, poorly underwritten and inappropriate loans pose a significant threat to homeownership sustainability. This should be taken into account in adopting final regulatory policy in this area.

Thank you for consideration of our comments.

Sincerely,

Allen Fishbein
Director
Housing and Credit Policy