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Mortgage Lending Review

Interagency Guidance Sheds Light On Nontraditional Mortgages

By Anna DeSimone

In October, the office of the Comptroller of the Currency, the board of governors of the Federal Reserve System, the Federal Deposit Insurance Corp., the Office of Thrift Supervision and the National Credit Union Administration (collectively, the agencies) issued final interagency guidance on nontraditional mortgage product risks. The guidance was developed to clarify how institutions can offer "nontraditional" mortgage products in a safe and sound manner – and with clear explanations so borrowers can fully understand their loan terms. Additional guidance has been released for home equity lines of credit loans. Nontraditional mortgages (also referred to as alternative or exotic) allow borrowers to defer payment of principal and sometimes interest. Many programs give borrowers a wide choice of amortization options and include interest-only loans and payment option adjustable-rate mortgages, known as "option ARMs."

In addition to the guidance, the agencies released a consumer information pamphlet for lenders to provide to applicants of nontraditional mortgages. The 16-page guide provides clear understandable explanations of loan programs and how they amortize with financial illustrations, a mortgage shopping worksheet and a glossary of terms. The pamphlet "Interest-Only Mortgages Payments and Payment-Option ARMs – Are They for You?" is available on all of the agencies' Web sites (for a full color print version of the pamphlet, visit www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf).

The agencies have determined not to include required model or sample disclosures in the guidance, but have issued a notice for comment, titled "Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products" (to access the FDIC press release, which includes links to final guidance and the home equity lines of credit guidance and proposed illustrations, visit www.fdic.gov/news/news/press/2006/pr06086.html).

The agencies note that both state financial regulatory organizations – the Conference of State Bank Supervisors and the state Financial Regulators Roundtable – are committed to working with state regulatory agencies to distribute guidance similar in nature and scope to the financial service providers under their jurisdictions. In addition to regulating 6,230 state-chartered commercial and savings banks, CSBS serves as a national forum in the regulatory oversight of the mortgage industry.

Under state jurisdiction there are more than 90,000 mortgage companies, with 63,000 branches and 280,000 loan officers and other professionals. According to Wholesale Access, mortgage brokers and state-licensed loan correspondents now originate an estimated 68 percent of all residential mortgage loans in the United States. CSBS and the American Association of Residential Mortgage Regulators are developing parallel guidance which will primarily focus on mortgage underwriting and consumer protection. According to Standard & Poors, the Alt-A mortgage-backed securitizations for the first half of 2006 jumped to a record $177 billion. This figure comprises $83 billion in interest-only products, $66 billion in option ARMs and $30 billion in fixed-rate loans. Verbal verifications of income and employment are the most widely used methods of documentation in Alt-A loans. Standard & Poors' Alt-A sector reports that of the $177 billion securitized during the first and second quarters, $117 billion was approved with verbal verifications. Within this sector, 63 percent of purchase loans included simultaneous second mortgages.

Nontraditional mortgages generally have fewer written verifications and two well-known types are stated income/stated asset and stated income/verified asset. Actual requirements can vary based on loan characteristics, such as combined loan-to-value percentage; loan seasoning; property type; loan purpose; occupancy; co-borrower occupancy; and citizenship and credit scores and debt ratios are primary factors that generally affect both pricing and documentation parameters. Verbal employment verification is completed by loan processors on all stated-income loans. Lenders utilizing automated underwriting, such as Fannie Mae's Desktop Underwriter or Freddie Mac's Loan Prospector, call for verbal confirmation prior to funding and underwriters are expected to perform a "salary reasonableness test" on borrower income. In addition, Fannie Mae and Freddie Mac will advise lenders to verify the authenticity of the borrower's place of employment and obtain salary surveys on Internet sites such as Salary.com.

Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term, with initial monthly payments lower than other home financing options. While these programs provide flexibility for consumers, the agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Lenders should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. Communication with consumers, including advertisements, oral statements, promotional materials and monthly statements, should provide clear and balanced information about the relative benefits and risks of nontraditional mortgages. Clear and timely communication to consumers of the risks of payment shock or other features will provide con-

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sumers with useful information at crucial decision-making points.

Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. An institution's quality control, compliance and audit procedures should focus on mortgage lending activities posing high risk. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm policies are being followed. The agencies expect institutions to develop strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Lending personnel should be trained and monitored regarding the conveyance of information to consumers about product terms and risks and review consumer complaints to identify potential risks to their reputation.

Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans and should have strong systems and controls in place for establishing and maintaining relationships with these third parties, including procedures for performing due diligence. Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. Remedial action could include more thorough application reviews, more frequent re-underwriting or termination of the third-party relationship. Oversight of third parties should involve monitoring the quality of originations so they reflect the institution's lending standards and compliance with applicable laws and regulations. ■

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COMPARISON OF SAMPLE MORTGAGE FEATURES

(For illustrative and educational purposes only – does not represent actual terms of loans available from any particular lender.)

A Typical Mortgage Transaction

Loan Amount $180,000 – 30-Year Term

	Mortgage with a Fixed Interest Rate		**Mortgage with an Adjustable Interest Rate (ARM)**		
	Principal and Interest Fixed Rate (6.7%)	**Interest Only** Fixed Rate (6.7%) Interest Only for First 5 Years.	**5/1 ARM** Fixed Rate for First 5 Years; Adjustable Each Year After First 5 Years (Initial rate for years 1 to 5 is 6.5%; Maximum Rate is 11.5%)	**Interest Only** Interest Only and Fixed Rate for First 5 Years; Adjustable Rate Each Year After First 5 Years (Initial rate for years 1 to 5 is 6.6%; Maximum Rate is 11.6%)	**Option Payment** Adjustable Rate for Entire Term of the Mortgage (Rate in month 1 is 1.25%; Rate in month 2 through year 5 is 6.4%; Maximum Rate is 11.4%)
Minimum Monthly Payment Years 1-5, except as noted	**$1,162***	**$1,005**	**$1,138**	**$990**	**$600*** (1st year only)**
Monthly Payment Year 6 -- no change in rates	**$1,162**	**$1,238****	**$1,138**	**$1,227**	**$1,324**
Monthly Payment Year 6 -- 2% rise in rates	**$1,162**	**$1,238**	**$1,357**	**$1,462**	**$1,581**
Maximum Monthly Payment Year 8 -- 5% rise in rates	**$1,162**	**$1,238**	**$1,702**	**$1,832**	**1,985**
How Much Will You Owe after 5 Years?	**$168,862**	**$180,000**	**$168,500**	**$180,000**	**$197,945**
Have You Reduced Your Loan Balance after 5 Years of Payments?	**Yes** Your loan balance was reduced by $11,118	**No** You did not reduce your loan balance	**Yes** Your loan balance was reduced by $11,500	**No** You did not reduce your loan balance	**No** Your loan balance increased by $17,945

* This illustrates an interest rate and payments that are fixed for the life of the loan.
** This illustrates payments that are fixed after the first 5 years of the loan at a higher amount because they cover both principal and interest.
*** This illustrates minimum monthly payments that are based on an interest rate that is in effect during the first month only. The payments required during the first year will not be sufficient to cover all of the interest that's due when the rate increases in the second month of the loan. Any unpaid interest amount will be added to the loan balance. Minimum payments for years 2-5 are based on the higher interest rate in effect at the time, subject to any contract limits on payment increases. Minimum payments will be recast (recalculated) after 5 years, or when the loan balance reaches a certain limit, to cover both principal and interest at the applicable rate.

The "Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products" are provided to illustrate the type of information the Interagency Guidance clarifies.

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