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Notes & Comments

Nontraditional Mortgage Products: Does Guidance Effectively Inform Borrowers of Risk?

I. INTRODUCTION

It has been said many times that owning a home is part of the “American Dream.” Surely then, losing one’s home to foreclosure must be part of the “American Nightmare.”¹ Unfortunately, the latter scenario is one facing many American borrowers who have elected to utilize one of the nontraditional mortgage products² now being aggressively marketed by lenders and the mortgage broker industry. For example, take Tom and Kitty Woolover, who, in 2004, purchased their first home as a young couple in the Washington, D.C. area for \$400,000.³ Upon speaking with a mortgage broker, the Woolovers decided to use a payment-option mortgage product⁴ to finance their home. This nontraditional mortgage product allows the Woolovers to make minimum monthly payments, which start at \$1,287 per month⁵

1. Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK, Sept. 11, 2006, at 70.

2. Nontraditional mortgage products, such as interest-only loans and payment-option adjustable rate mortgages (payment-option ARMs), “allow borrowers to defer payment of principal and, sometimes, interest.” Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006). These products are also sometimes referred to as “exotic” or “alternative” mortgages. *Id.* See *infra* notes 20-27 and accompanying text for a detailed description of nontraditional mortgage products.

3. This example is a hypothetical adopted from a report by the United States Government Accountability Office. *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Subcomm. on Housing and Transportation and Subcomm. of Economic Policy of the H. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 4-5 (2006) [hereinafter *Hearings*] (statement of Orice M. Williams, Dir. Fin. Market and Cmty. Inv. Team, Gov’t Accountability Office), available at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=239>.

4. See *infra* notes 23-27 and accompanying text.

5. *Hearings, supra* note 3, at 5. William’s testimony provides an overview of the methodology that was used in determining this payment amount. See *id.*

during the first year of their five-year payment-option period.⁶ With a combined, annual household income of \$150,000, the Woolovers confidently felt they could afford this amount.⁷ If the Woolovers choose to make only the minimum payment, however, throughout the entire five-year period, their monthly payment would skyrocket by 128% to \$2,931 at the end of the payment-option period.⁸ If the Woolovers are unable to refinance their home, they stand a good chance of defaulting on their mortgage payments and losing their home in a foreclosure sale.⁹

In response to concerns about protecting consumers like the Woolovers, the U.S. depository regulatory agencies (Agencies)¹⁰ issued a proposed guidance (Proposed Guidance)¹¹ in December of 2005, and a final guidance, entitled Interagency Guidance on Nontraditional Mortgage Product Risks (Final Guidance),¹² on September 29, 2006.¹³ The Final Guidance was issued after a vast amount of industry debate over its necessity,

6. The payment option period is the initial period of the loan in which the consumer can choose the amount of payment to make, which usually consists of three *payment* choices: the minimum payment, the interest-only payment, and the fully amortizing payment. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,618 app.

7. See generally *Hearings*, *supra* note 3 (illustrating this example with an assumed household income).

8. *Id.* at 5. In her statement, Ms. Williams notes that the lender most likely would have qualified the borrower in year one at the fully indexed payment amount of \$2,039 (as opposed to the minimum payment amount). The payment amount in year six of \$2,931, however, is still 44% more than the \$2,039 payment amount used to qualify the borrower in year one. *Id.* at 5 n.2. The Final Guidance attempts to remedy this by requiring inclusion of any potential negative amortization amount in the calculation of the loan terms. See *infra* notes 79-85 and accompanying text.

9. See *Hearings*, *supra* note 3, at 5.

10. The agencies include the Office of the Comptroller of the Currency, Treasury Dept. (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision, Treasury Dept. (OTS), and the National Credit Union Administration. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,609 (Oct. 4, 2006).

11. Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249 (Dec. 29, 2005).

12. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,609.

13. Press Release, Office of the Comptroller of the Currency, Federal Financial Regulatory Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks (Sept. 29, 2006), available at <http://www.occ.treas.gov/toolkit/newsrelease.aspx?JNR=1&Doc=M3ZM5FQW.xml>.

effectiveness, and scope.¹⁴ In the ten-month period between the publication of the Proposed Guidance and the Final Guidance, the Agencies received input from all interested parties on what form the Final Guidance should take to most effectively and prudently carry out the Agencies' goals.¹⁵ This Note argues that despite the Final Guidance's questionable enforceability and scope, it, along with the accompanying commentary, hearings, and legislative action resulting from its publication, accomplished what the Agencies set out to do – alert consumers and the mortgage industry *now* to the dangers of nontraditional mortgage products and encourage modification of the laws so as to account for the products' added risk.

Part II of this Note provides a basic overview of nontraditional mortgage products and examines some of the conditions in the mortgage industry and market that necessitated such a guidance.¹⁶ Part III summarizes the Final Guidance and its purpose – in particular as it relates to consumer and borrower protection.¹⁷ Part IV of this Note examines some of the controversial issues of the Final Guidance through analyzing its necessity, effectiveness, and sufficiency.¹⁸ Finally, Part V will argue that the Agencies were effectively able to meet the majority of their goals, despite the Guidance's limited enforcement power and non-applicability to entities outside its regulation.¹⁹

II. NONTRADITIONAL MORTGAGE PRODUCTS AND THEIR RISKS

The two primary types of nontraditional mortgage products are the interest-only mortgage loan and the payment-option adjustable rate mortgage (ARM).²⁰ The interest-only mortgage

14. The Agencies received approximately 100 official Comments regarding the Proposed Guidance. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,610.

15. *See* Press Release, Federal Financial Regulatory Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks, *supra* note 13.

16. *See infra* notes 20-55 and accompanying text.

17. *See infra* notes 55-85 and accompanying text.

18. *See infra* notes 86-209 and accompanying text.

19. *See infra* notes 210-37 and accompanying text.

20. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,613 (Oct. 4, 2006).

requires the borrower to pay *only* the interest due on the loan for a specified number of years (typically three or five years) during which time the interest rate may be fixed or variable.²¹ After the interest-only period, the borrower is required to pay both interest and principal, which totals a much larger amount than the interest-only payments.²² A payment-option ARM permits the borrower to choose the amount of the payment each month: the borrower may make a minimum payment based on an introductory “teaser” rate, an interest-only payment, or a fully amortizing payment based on a traditional fifteen-year or thirty-year loan.²³ Borrowers, however, face serious risks if they make only the minimum payment because often, that payment amount is not enough to cover the interest accruing on the loan, which results in negative amortization.²⁴ Thus, the borrowers may owe more when the payment-option period expires than when they signed the loan.²⁵ Additionally, the interest rate resets to the current market rate at the end of the payment-option period,²⁶ which may compound the consumer’s problem of an increased principal amount if interest rates have risen. These two occurrences – a larger amount owed and a higher interest rate – result in a significantly elevated monthly payment for the borrower.²⁷

21. *Id.* at 58,618.

22. *Id.*

23. *Id.*

24. “Negative amortization . . . is an amortization method in which the borrower pays back less than the full amount of interest owed to the lender each month. The shorted amount is then added to the total amount owed to the lender.” Negative amortization, Wikipedia, The Free Encyclopedia, http://en.wikipedia.org/wiki/Negative_amortization (last visited Dec. 21, 2006).

25. *See id.*

26. The exact terms of option loans may vary. Some option loans provide that the interest rate will reset earlier than the expiration of the payment option period if the principal amount plus interest owed reaches a certain amount; this may occur where the borrower is not paying the interest accruing each month. Also, some favorable consumer loans put a cap on how much the interest rate can increase when the loan resets, but the lender may recapture that interest in a subsequent year. *See* Brochure, Bd. of Governors of the Fed. Reserve Sys., *Interest-Only Mortgage Payment and Payment-Option ARMs – Are They for You*, at 3-4 (Oct. 2006), available at http://www.federalreserve.gov/pubs/mortgage_interestonly.

27. *See id.* The Agencies have published a brochure on interest-only and payment option loans to provide a plain-language resource for borrowers thinking about utilizing a nontraditional mortgage. It also provides a succinct explanation of the interest-only and payment-option loans. *See id.*

The situation experienced by the Woolovers, our home-buyers, is particularly alarming in light of the increased popularity of nontraditional mortgage products.²⁸ According to *The Washington Post*, whereas only 1% of new home-buyers obtained a nontraditional mortgage loan in 2000, that number had risen to approximately 33% in May 2006.²⁹ As illustrated with the Woolovers, the problem with these nontraditional products is that, even more than traditional ARMs,³⁰ they “can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers.”³¹ According to a comment submitted by the Center for Responsible Lending (CRL), “[i]n the current 2006 interest rate environment, as teaser rates expire on [one set of nontraditional loan products originated in 2004], 97.5% of [those] borrowers are likely to face an implicit payment shock of at least 25% and three of four (75%) could face a shock of 50% or more.”³²

28. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,609 (Oct. 4, 2006).

29. Kirstin Downey, *Insurers Urge Action on Risky Mortgages*, WASH. POST, Aug. 19, 2006, at D1 (citing data provided by First American LoanPerformance, which tracks mortgage statistics). The concentrations of nontraditional products increases in higher priced markets. Approximately one-half of home borrowers in Washington, D.C. used such products in May 2006. *Id.* Approximately 44% of California borrowers refinanced with payment-option ARMs in the first half of 2006. Vikas Bajaj & Ron Nixon, *Variable Loans Help to Put Off Mortgage Pain*, N.Y. TIMES, July 23, 2006, Late Edition at 1.

30. Traditional ARMs work much like payment-option ARMs, with the primary difference being that during the option period, payment-option ARMs give borrowers a choice of what type of payment to make: the minimum payment, the interest-only payment, or a traditional fully amortizing payment. Like payment-option ARMs, traditional ARMs have an interest rate that fluctuates periodically (either up or down), often in relation to an identified index rate. Payment-option ARMs, however, have the additional risk of negative amortization. See generally Bd. of Governors of the Fed. Reserve Sys., *Consumer Handbook on Adjustable Rate Mortgages (ARM)* (May 2005) [hereinafter *CHARM Booklet*], available at http://www.federalreserve.gov/pubs/arms/arms_english.htm (explaining ARMs and their associated risks).

31. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,616.

32. Comment submitted by Deborah N. Goldstein & Jamie Z. Goodson, Center for Responsible Lending, to the Federal Reserve Board (Mar. 29, 2006) [hereinafter *CRL Comment*], available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink). The CRL calculated these figures based on data from the Loan Performance Subprime Asset-Backed Securities Database. It interpreted data for one type of payment-option loan, (2/28 hybrid

The Washington Post, citing information from the Federal Deposit Insurance Corporation (FDIC), reports that approximately 70% of the borrowers utilizing a payment-option ARM choose to make only the minimum payments.³³ With upwards of 30% of borrowers using such mortgages, a large proportion of homeowners can expect to experience payment shock when their interest rates adjust.³⁴ Those who cannot afford the higher payments are stuck with three options: refinance, sell, or default.³⁵ In the past, consumers have had little trouble refinancing due to a robust housing market, low interest rates, and good appreciation in housing prices.³⁶ The ability to refinance diminishes, however, when home prices stop going up and the borrower's debt, due to negative amortization, has surpassed the value of the home.³⁷ In addition, nearly 60% of interest-only and payment-option loans originated in 2005 carried a prepayment penalty,³⁸ which the borrower would be forced to pay if the loan was refinanced.³⁹

As recent trends show, the outlook is not good for those betting on a continued boom in the housing market.⁴⁰ *The New*

ARM loans), which carry a "fixed interest rate for two years and a variable rate semiannually adjusted for the remaining 28 years." *Id.* at 9. It looked at such loans that originated in the year 2004. *See id.*

33. Downey, *supra* note 29. *Business Week* reported the percentage of payment-option ARM borrowers making minimum payments at closer to 80%. Der Hovanesian, *supra* note 1 (citing data from Fitch Ratings).

34. *See supra* note 29 and accompanying text.

35. *CRL Comment, supra* note 32, at 10.

36. *See generally Hearings, supra* note 3 (explaining that higher interest rates and lack of appreciation may lead to payment shock).

37. *See Bajaj & Nixon, supra* note 29.

38. A prepayment penalty is triggered when a borrower pays all or a portion of the mortgage debt before it is due. Freddie Mac, *Borrower Information Guide Prepayment Penalty Mortgages* (Aug. 2006), available at <http://www.freddie.mac.com/singlefamily/pdf/ppm.pdf>. This penalty is only triggered in most loans during the first few years, but, with ARM loans, that is the time-frame when most borrowers will experience the payment shock which may make prepayment desirable. *See Bajaj and Nixon, supra* note 29. Generally, refinancing or even selling the loan, will constitute prepayment and may trigger the penalty. Freddie Mac, *supra* note 38.

39. *See In Focus this Quarter: The Evolution of the Credit Cycle*, FDIC OUTLOOK 1, 26 (Summer 2006) [hereinafter FDIC OUTLOOK], available at <http://www.fdic.gov/bank/analytical/regional/ro20062q/na/t2q2006.pdf> (citing data from the LoanPerformance Corporation).

40. James R. Hagerty, *Home Prices Keep Sliding*, WALL ST. J., Oct. 26, 2006, at D1.

York Times reported that “prices of traditional single-family dwellings fell in [eighty-seven] of the nation’s 379 major metropolitan areas” from the first to the second quarter of 2006.⁴¹ Furthermore, in August of 2006, the median sales price of existing homes dropped nearly 2% from a year earlier to \$225,000, which represented the first year-to-year decline in sales prices in a decade and the second largest price decline ever recorded.⁴² This drop was in stark contrast to the growth seen between 2002 and 2005, when there was a 34% increase in the median home sale price nationwide from \$158,000 to \$212,000.⁴³ The American Bankers Association (ABA) commented in late March 2006 that “there are a number of markets around the country that have shown rapid increases in housing costs, and consumers want these [nontraditional] mortgages because housing prices have become much less affordable without the use of interest-only mortgages, payment-option ARMs, or variations of such products.”⁴⁴ Therein lies the problem: as consumers struggled to “afford” housing in the midst of the housing boom of the early twenty-first century, the mortgage industry marketed these nontraditional loan products that temporarily allowed consumers to meet their mortgage payment.⁴⁵ Consumers have often purchased homes utilizing these products that they could only “afford” at the minimum payment-option ARM payment or via an interest-only payment.⁴⁶ Worse yet, the ability of the borrower to refinance these types of loans is

41. Vikas Bajaj, *Mortgages Grow Riskier, and Investors Are Attracted*, N.Y. TIMES, Sept. 6, 2006, at C1.

42. See Michael Corkery, *Existing Homes’ Median Price Falls*, WALL ST. J., Sept. 26, 2006, at A2. This type of data has been collected for nearly forty years. *Id.*

43. *Open Forum: The Need for Guidance*, NAT’L MORTGAGE NEWS, Aug. 7, 2006, at 4, available at <http://www.lexis.com>.

44. Comment submitted by Paul A. Smith, Senior Counsel, American Bankers Association, to the Board, at 3 (Mar. 29, 2006) [hereinafter *ABA Comment*] (on file with the Board), available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink).

45. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,609 (Oct. 4, 2006) (indicating an increase in the number of institutions offering nontraditional products).

46. See generally Bajaj & Nixon, *supra* note 29 (indicating that these products can be used to qualify for a larger loan amount and put off payment shock by refinancing).

dependent on the same inflated housing market that initially forced them to resort to the nontraditional products.⁴⁷

The ABA points out that the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTC) authorized federally chartered banks to offer ARMs with negative amortization features⁴⁸ to consumers in 1981.⁴⁹ The ABA suggests that the reason for that authorization, much like today, was that “consumers could no longer obtain the housing that they wanted using the fixed-rate mortgages then available at extremely high interest rates.”⁵⁰ The difference, though, was that in 1981 consumers could not afford their desired housing due to extremely *high interest rates*.⁵¹ Now, however, with interest rates near historic lows, it is the *appreciated price* of the house that the consumer is attempting to overcome.⁵² This is an important distinction because in 1981, a borrower selecting an ARM stood a good chance of seeing the interest rate go down when the rate reset.⁵³ Today, in contrast, interest rates are on the rise from historic lows.⁵⁴ Thus, it

47. *See id.*

48. *See* Adjustable-Rate Mortgages, 46 Fed. Reg. 18,932 (Mar. 27, 1981) (codified at 12 C.F.R. pt. 29); Adjustable Mortgage Loan Instruments, 46 Fed. Reg. 24,148 (Apr. 30, 1981) (codified at 12 C.F.R. pt. 545).

49. *ABA Comment, supra* note 44, at 2. Due to the success of ARMs and concerns about state-chartered entities suffering from a competitive disadvantage, Congress later enacted the Alternative Mortgage Transaction Parity Act of 1982. *See* 12 U.S.C. § 3801 (2000). This Act expressly allowed state-chartered institutions to offer ARMs and preempted any state law to the contrary. *See* 12 U.S.C. § 3803 (2000).

50. *ABA Comment, supra* note 44, at 2.

51. Freddie Mac: Weekly Mortgage Market Surveys, <http://www.freddiemac.com/pmms/pmms30.htm> (last visited Dec. 21, 2006). In October 1981, the 30-year mortgage rates peaked at 18.45%. *Id.*

52. Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L. REV. 305, 306. “Beginning in April 2002, the United States experienced an astonishing decline in residential mortgage interest rates. The thirty-year fixed-rate mortgage, usually considered the standard or bell-weather of the industry, had been near 7% since the beginning of 2001. But in April 2002, it began a remarkable plunge, reaching a low of 5.21% in June 2003.” *Id.* The mortgage rate remains at or near 6.18% today. Freddie Mac’s Weekly Primary Mortgage Market Survey, <http://www.freddiemac.com> (last visited Jan. 3, 2006).

53. This conclusion is drawn from the fact that in 1981, interest rates were near historic highs. *See supra* note 51 and accompanying text.

54. *See supra* note 52 and accompanying text.

is most likely that a borrower will see interest rates and payments increase as the loan's interest rate resets.⁵⁵

III. SUMMARY OF THE FINAL GUIDANCE AND ITS CONSUMER PROTECTION CONCERNS

A. *Purpose and Goals*

The Agencies issued the Final Guidance as a result of increasing concern that these nontraditional mortgage products were being marketed to a larger proportion of borrowers, many of whom did not understand the risks involved in these loans and some who would not otherwise qualify for a loan.⁵⁶ The Agencies hoped “to clarify how institutions can offer these products in a safe and sound manner, and in a way that clearly discloses the potential risks that borrowers may assume.”⁵⁷ With nontraditional mortgages, the Agencies have heightened concern because of negative amortization and the lack of principal amortization, and the Final Guidance is intended to address these concerns.⁵⁸ With those goals in mind, the Final Guidance addresses the following topics: (1) consumer protection concerns, such as assuring that borrowers understand the loans; (2) appropriate risk-management practices and standards; and (3) “prudent lending practices” in underwriting these loans.⁵⁹ It is the first of these topics, consumer protection concerns, that forms the crux of this Note.

55. With interest rates rising from historic lows, the loan payment amount would increase as it resets to the rising market rates. This is especially true of those who took out a nontraditional loan in 2003 or 2004. *See supra* note 52 and accompanying text.

56. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

57. *Id.* at 58,609.

58. *Id.* Amortization is “the paying off of debt in regular installments over a period of time.” Amortization normally results in the amount owed by a borrower decreasing. *See* Investopedia.com, <http://www.investopedia.com/terms/a/amortization.asp> (last visited Dec. 21, 2006).

59. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,613.

B. *Borrower Protection and Comprehension*

The negative amortization that often results from nontraditional loans (specifically payment-option ARMs) leads to lower home equity than in a traditional mortgage.⁶⁰ Under such circumstances, home equity may have greatly declined or been completely eliminated when the home-owner sells or refinances the home, even when the value of the property has appreciated.⁶¹ The Agencies' main consumer protection concerns are that the wave of new consumers utilizing these products do not understand the risks of these products in a *non-ideal*⁶² scenario, and that the institutions offering the products are not making adequate disclosures to consumers to enable them to better understand these potential risks.⁶³ As a result, the Final Guidance provides a number of recommended practices for addressing the risks associated with the nontraditional products that institutions and lenders offering these products should implement.⁶⁴ Those recommended practices include ensuring that all communications with borrowers – including oral conversations, advertising and promotional materials, and monthly statements – accurately reflect the loan terms and payment arrangement.⁶⁵ Institutions need to present information to borrowers in a clear and concise format, free of excessively technical language, so that the borrowers understand the terms, realize their importance, and can make an informed decision.⁶⁶

The Final Guidance suggests that “promotional materials and descriptions of these products” should include information

60. *Id.* at 58,616.

61. *Id.*

62. A *non-ideal* scenario references market conditions such as rising interest rates when those rates are adjusted and the possibility of declining homes prices. It also includes consumer behavior such as only making minimum payments on a payment option loan or selecting a product that has prepayment penalties if refinancing.

63. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,616 (Oct. 4, 2006) (indicating concern that “marketing and promotional practices that emphasize potential benefits without also effectively providing complete information about material risks” do not fully inform the consumer).

64. *See id.* at 58,617-18.

65. *Id.* at 58,617.

66. *Id.*

about payment shock, negative amortization, and prepayment penalties.⁶⁷ For instance, a product description for a nontraditional product should include not only initial payments, but also potential, future maximum monthly payments.⁶⁸ This estimate could include the required payment amount “once amortizing payments are required and the interest rate and negative amortization caps have been reached.”⁶⁹ The Final Guidance also indicates that monthly statements to consumers utilizing a payment-option loan should clearly illustrate the effect of choosing one payment over another.⁷⁰ For instance, if in one month the borrower chooses to make the minimum payment, as opposed to the interest-only or fully amortizing payment, the monthly statement should clearly indicate that choosing that payment will increase the outstanding balance due to negative amortization.⁷¹ In addition to these disclosures, lending institutions should not make excessively optimistic predictions about the future direction of interest rates or one-sided assurances about the amount of money that can be saved by using a nontraditional mortgage.⁷² The lender must make explicit that paying only the minimum payment may not cover the interest accruing on the loan and that interest rates on the loan are subject to change in the future.⁷³

C. *Control Systems and Risk Management*

The Final Guidance also touches on control systems that should be put in place by institutions to assure compliance with these recommended practices.⁷⁴ The Guidance indicates that federal lenders are responsible for monitoring not only the marketing and disclosure practices on loans that it originates internally, but also on those loans originated by its subsidiaries and

67. *Id.*

68. *See id.*

69. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,617 (Oct. 4, 2006).

70. *See id.* at 58,618.

71. *Id.*

72. *Id.*

73. *Id.*

74. *See generally id.* at 58,615 (describing proper control systems).

third-party mortgage brokers.⁷⁵ It directs institutions to monitor their compensation programs – including third-party broker incentives – to ensure that loan originators are not encouraged to direct borrowers to inappropriate nontraditional mortgages.⁷⁶ Furthermore, the Guidance says that “[m]onitoring procedures should track the quality of loans by both origination source and key borrower characteristics,” and if problems are discovered, corrective action should be taken which may include terminating the relationship with the third-party originator.⁷⁷ The Agencies also add that the control systems should address compliance and fair disclosure concerns, as well as provide lending personnel with adequate training on educating consumers properly.⁷⁸

D. Prudent Lending – Qualifying the Borrower

One of the most controversial portions of the Final Guidance is the required qualification process for a borrower seeking a nontraditional mortgage. The Final Guidance provides that:

[A]n institution’s analysis of a borrower’s repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,⁷⁹ assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.⁸⁰

75. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,615 (Oct. 4, 2006).

76. *Id.* at 58,618.

77. *Id.* at 58,615.

78. *Id.* at 58,618.

79. “The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of the introductory interest rate The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period.” *Id.* at 58,614 n.5.

80. *Id.* at 58,614.

The Final Guidance also requires that when calculating the amount added to the initial loan amount due to negative amortization, the lender must assume that the borrower makes only the minimum payments.⁸¹ These qualification standards have two consequences. First, a lender cannot qualify a borrower who might not otherwise qualify for a loan by using an initial teaser rate or the interest-only payment.⁸² Second, requiring the lender to include an assumed amount of negative amortization in the initial principal amount extended increases the amount of debt for which the borrower must be qualified.⁸³ This prevents the lender from calculating an artificially low debt-to-income ratio.⁸⁴ The Agencies believe that only by using these qualification standards can an institution provide a “credible analysis of a borrower’s capacity to repay the full amount of credit . . . extended.”⁸⁵

IV. CONTROVERSIAL ISSUES REGARDING THE FINAL GUIDANCE

The Agencies’ Final Guidance was received with both praise and criticism. This is not surprising considering that the Agencies received ninety-one comments⁸⁶ from various sources, including trade associations, lenders, brokers, and consumer advocate groups, during the ten-month comment period between issuing of the Proposed Guidance and publication of the Final Guidance.⁸⁷

81. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,611 (Oct. 4, 2006).

82. See Comment submitted by the Nat’l. Consumer Law Ctr. to the Fed. Reserve Bd., at 4 (Mar. 29, 2006) [hereinafter *NCLC Comment*], available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink).

83. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,611.

84. The debt-to-income ratio sets a limit on how much of a borrower’s income can be devoted to a mortgage payment. Lee Ann Obringer, *How Mortgages Work*, <http://money.howstuffworks.com/mortgage3.htm> (last visited Dec. 21, 2006).

85. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,611.

86. *Id.* at 58,610. The Agencies actually received 100 comments, but only ninety-one were substantive, as nine comments were simply asking for a time extension. *Id.* at 58,610 n.5.

87. See *id.*

A. *Necessity of the Final Guidance*

1. Are Nontraditional Mortgages Really so Risky?

The ABA, the largest banking trade association in the country, believes that the Final Guidance overstates the risks of nontraditional mortgage products.⁸⁸ As stated earlier,⁸⁹ the ABA argues that the Agencies have not shown that “the risks in [nontraditional] mortgage products have materially changed since they were created over two decades ago” at the express authorization of the Agencies.⁹⁰ The ABA fails to acknowledge, however, that the prevalence of these mortgages among the average consumer is much greater now than when these products were created, dramatically increasing the population exposed to the risks.⁹¹ Furthermore, current interest rates⁹² are not at the historic highs of the early 1980s, but rather are slowly rising from historic lows.⁹³ Consumers now face a greater risk of interest rate and payment increases than in the early 1980s.⁹⁴ The National Consumer Law Center (NCLC), a consumer advocate group, notes that, “[u]nless . . . lenders underwrite the *maximum* payment, and disclose that information to consumers, neither consumers nor the market are taking the risk of interest rate increases into account, creating a significant danger of economic instability.”⁹⁵ The ABA, however, correctly points out that consumers want nontraditional mortgages because “housing prices

88. *ABA Comment, supra* note 44, at 2.

89. *See supra* notes 48-55 and accompanying text.

90. *ABA Comment, supra* note 44, at 3.

91. *Hearings, supra* note 3, at 4. Whereas, in 2002, interest-only and payment-option ARMs represented as little as 3% of total nonprime mortgage originations that were securitized, by late 2005, that percentage of mortgage origination was hovering around 50%. *See* FDIC OUTLOOK, *supra* note 39, at 24. Among all borrowers, nontraditional mortgage products represented 33% of all mortgage loans originated in May 2006. Downey, *supra* note 29 (citing data provided by First American LoanPerformance, which tracks mortgage statistics).

92. 6.18% for a 30-yr mortgage as of December 28, 2006. Weekly Primary Mortgage Market Survey, www.freddiemac.com (last visited Jan. 3, 2006).

93. *See supra* note 52 and accompanying text.

94. *Id.*

95. *NCLC Comment, supra* note 82, at 6.

have become much less affordable without [their] use.”⁹⁶ Perhaps, however, the solution lies in recommending to consumers that they consider lower-priced homes that they can afford with a traditional mortgage rather than a higher-priced home that is only temporarily affordable with a nontraditional mortgage.⁹⁷ The ABA, however, appropriately observes that “[t]he goal of underwriting is not to prevent all defaults, but to evaluate the risk and make mortgage credit available at a price that reasonably reflects risk.”⁹⁸ At some point, consumers must take responsibility for the financial decisions that they make.

The National Association of Mortgage Brokers (NAMB) agrees with the ABA and argues that the Final Guidance is “overly strict” and “prescriptive.”⁹⁹ The NAMB believes that the Final Guidance “could result in purposeful elimination of viable loan products that have served in the past, and continue to serve today, a real customer need.”¹⁰⁰ Some recent data from the third quarter of 2006 showing a reduction in the number of nontraditional loans originated provides some support for the NAMB’s contention.¹⁰¹ This data, however, which is from the three-month period immediately prior to publication of the Final Guidance, may also reflect some other market conditions, like the

96. *ABA Comment, supra* note 44, at 3.

97. *Cf. Der Hovanesian, supra* note 1 (indicating that lenders marketed nontraditional products as “affordability tools” allowing borrowers to afford higher priced homes).

98. *ABA Comment, supra* note 44, at 5.

99. Comment submitted by James L. Nabors, II, Former President, Nat’l Ass’n of Mortgage Brokers, to the Fed. Reserve Bd., at 9 (Mar. 31, 2006) [hereinafter *NAMB Comment*], available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink).

100. *Id.* at 10. Nontraditional mortgages do serve certain borrowers very well. For instance, such mortgages may be very useful to wealthy borrowers who have an irregular income stream or borrowers who expect to have a large income increase in the future. *See Der Hovanesian, supra* note 1; *Hearings, supra* note 3, at 4. The use of nontraditional mortgages for these purposes, however, is not what the Agencies were concerned about.

101. *Wall St. Round-up; Fewer ARM Bond Issues Likely*, L.A. TIMES, Oct. 24, 2006, at C4. “Washington Mutual Inc., the largest U.S. savings and loan, and Countrywide Financial Corp., the largest U.S. mortgage lender, originated fewer payment-option ARM loans in the third quarter” of 2006, with Washington Mutual’s origination of the loans down 25% from a year earlier and Countrywide’s down 49% respectively. *Id.*

softening of the housing market.¹⁰² The NAMB, nevertheless, believes forcing lenders to qualify borrowers under the “worst case scenario” is unfair where the “likelihood of such scenarios is minimal or nonexistent.”¹⁰³ The NAMB argues that “[a]ccountability and enforcement [would] be much more effective mechanisms in controlling the risk associated with nontraditional loan products than consumer choice.”¹⁰⁴ Such enforcement, however, depends on the uninformed borrower bringing to light such lender or originator abuses, which is unlikely considering the complexity of laws governing lender and broker disclosure requirements.

2. Should Existing Lending Laws be Enough?

Several organizations, including the ABA, argue that the Final Guidance is unnecessary due to existing lending laws and disclosure requirements and may actually increase confusion among borrowers.¹⁰⁵ Mortgage products are already subject to numerous disclosure requirements under the Truth-in-Lending Act¹⁰⁶ (TILA), and its implementing regulation, Regulation Z,¹⁰⁷ and under section 5 of the Federal Trade Commission Act (FTC Act).¹⁰⁸ Neil J. Morse, a mortgage industry consultant, agrees with the ABA and points out that “[m]ortgage companies labor under a jungle of laws, including . . . [TILA], [the Real Estate Settlement Procedures Act of 1974]¹⁰⁹ (RESPA), the Equal Credit Opportunity Act¹¹⁰ (ECOA), the Home Ownership and Equity

102. *See supra* notes 40-43 and accompanying text. This is somewhat of a chicken-or-the-egg scenario. It is not clear whether the slowing of the housing market has led to a reduction of loan originations, or, alternatively, whether the decreased willingness of borrowers to take out nontraditional mortgages has led to the borrowers' inability to afford higher priced homes, thereby slowing the housing market. It is most likely a combination of the two, as opposed to either one or the other.

103. *NAMB Comment, supra* note 99, at 10.

104. *Id.*

105. *ABA Comment, supra* note 44, at 2.

106. 15 U.S.C. § 1601 (2000).

107. 12 C.F.R. § 226.1 (2006).

108. 15 U.S.C. § 45(a) (2000).

109. 12 U.S.C. § 2601 (2000).

110. 15 U.S.C. § 1691 (2000).

Protection Act¹¹¹ (HOEPA), the Home Mortgage Disclosure Act¹¹² (HMDA), and [the] Fair Credit Reporting Act¹¹³ (FCRA).”¹¹⁴ Morse adds, “[i]n sum, regulatory compliance has gone from being a sleepy afterthought to a heavy burden; a potentially make-or-break proposition for lenders (and others in the mortgage food chain)”¹¹⁵ Prior to publication of the Final Guidance, the North Carolina Bankers Association, another bank trade organization that submitted an official comment, complained:

Any plan to add yet another series of disclosures should also include a corresponding plan to review existing disclosure requirements to determine which ones are not worthwhile and can be eliminated or consolidated. Consumers, and bankers for that matter, are suffering from information overload and measures need to be taken to pare back the volume.¹¹⁶

The ABA hoped that any new disclosures would be provided in the form of a generic disclosure or included in an already existing handbook, such as the Consumer Handbook on Adjustable Rate Mortgages (CHARM booklet),¹¹⁷ rather than an individual disclosure tailored to each borrower’s loan.¹¹⁸ The NAMB also was more in favor of updating existing disclosure

111. 15 U.S.C. § 1639 (2000).

112. 12 U.S.C. § 2801 (2000).

113. 15 U.S.C. § 1681 (2000).

114. Neil J. Morse, *The Compliance Battle*, 63 MORTGAGE BANKING 28, Sept. 2003.

115. *Id.*

116. Comment submitted by Nathan R. Batts, Associate Counsel, North Carolina Bankers Association, to the Fed. Reserve Bd, at 2 (Feb. 21, 2006), available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink).

117. The booklet, developed previously by the Agencies approximately twenty years ago, explains the features and risks of ARMs but does not specifically address payment-option ARMs or interest-only mortgages. See *CHARM Booklet*, *supra* note 30.

118. *ABA Comment*, *supra* note 44, at 12; see also *NAMB Comment*, *supra* note 99, at 7 (arguing that the Agencies’ recommended information pertaining to the risk and benefits of nontraditional mortgages simply be added to the CHARM booklet).

requirements and better enforcing them than adding some of the oversight that the Final Guidance requires.¹¹⁹ The NAMB suggested updating the CHARM booklet because it already is a requirement of both state- and federally-regulated lenders.¹²⁰ The NAMB also rightfully points out that “[a] disclosure by itself is insufficient to accomplish the stated objective of ensuring that a borrower is aware of the risks and benefits of the nontraditional loan product because the inherent complexity of such products require specific explanations that will be too overwhelming and detailed in a written context.”¹²¹ The NAMB recommended that any additional disclosure also be accompanied by consumer testing¹²² so that it will not “be just another paper added to a pile of disclosures that is already largely ignored by consumers.”¹²³ The NAMB felt that better enforcement of existing laws could also solve some of the problems that the Final Guidance seeks to address.¹²⁴ For example, the NAMB suggested increasing the use of the Agencies’ already existing power under section 5 of the FTC Act, which regulates unfair and deceptive trade practices.¹²⁵

Despite these protests regarding the Final Guidance adding additional disclosure requirements, the Agencies did not wane in their requirement of new nontraditional mortgage-specific disclosures.¹²⁶ The Agencies’ primary justification is that “guidelines are needed *now* to ensure that consumers will receive the information they need about the material features of nontraditional mortgages as soon as possible.”¹²⁷ Other than adding *nontraditional mortgage-specific* disclosure information,¹²⁸

119. *NAMB Comment, supra* note 99, at 5-9.

120. *Id.* at 7.

121. *Id.* at 6.

122. Consumer testing would consist of the process of evaluating the effectiveness of additional disclosures to borrowers. *See id.* at 7-8. The Agencies could get the opinions of the average borrower on the effectiveness of the disclosures and whether they add anything of benefit prior to adding them as part of the Final Guidance. *Id.*

123. *Id.* at 8.

124. *Id.* at 8-9.

125. *NAMB Comment, supra* note 99, at 8-9.

126. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,612 (Oct. 4, 2006).

127. *Id.*

128. This is certainly the most significant addition to consumer disclosures that the Final Guidance adds to borrower protection. *See generally id.* at 58,612 (indicating

the only significant addition to existing lending laws that the Final Guidance provides is in terms of the “timing” of such disclosures.¹²⁹ It was the Agencies’ intention to have these additional disclosures assist the consumer in the product-selection process, which may occur before disclosures are required under TILA or other lending laws.¹³⁰ “The [G]uidance focuses on providing information to consumers during the pre-application shopping phase and post-closing with any monthly statements lenders choose to provide to consumers.”¹³¹ The Final Guidance suggests that the disclosure information about the risks of nontraditional mortgage products should be provided “when a consumer is shopping for a mortgage . . . not just upon the submission of an application or at consummation.”¹³²

B. Effectiveness of the Final Guidance

1. Is the Guidance Enforceable?

An initial question regarding the Final Guidance must be about how it will be enforced.¹³³ The only references to enforcement in the Final Guidance are passing statements indicating that noncompliant institutions “will be asked to take remedial action”¹³⁴ and “will be subject to elevated supervisory attention and potential examiner criticism.”¹³⁵ The lack of language regarding enforcement in the Final Guidance is most

one of the differences of the Final Guidance’s disclosures is the timing). It is arguable, however, that this still could have been accomplished through the modifications of existing lending law disclosures like the CHARM booklet. See *NAMB Comment, supra* 99, at 10-13.

129. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,617.

130. *Id.* at 58,616.

131. *Id.* at 58,612.

132. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,617.

133. See *NCLC Comment, supra* note 82, at 5 (arguing that the Final Guidance does not lead to any enforceable sanctions).

134. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,613.

135. *Id.* at 58,615.

likely due to the nature of a guidance document itself.¹³⁶ Law professor Robert A. Anthony writes that the use of nonlegislative documents, such as guidances, “to bind the public violates the Administrative Procedures Act,”¹³⁷ and that “[a]n agency may not make binding law except in accordance with the authorities and procedures established by Congress.”¹³⁸ He adds that with the exception of “a legislative rule (which binds legally) or an interpretive rule (which may bind practically) . . . , [a]ll other substantive rulemaking documents – such as policy statements, guidances, manuals, circulars, memoranda, bulletins, and the like – are . . . ‘policy statements’ which the agency is not entitled to make binding.”¹³⁹ In issuing the Final Guidance, the Agencies clearly had the intention of effecting change *now*.¹⁴⁰ Logically, the Agencies understood that a formal rule or an amendment to current lending laws most likely would have taken significantly more time to complete.¹⁴¹ The Final Guidance, although perhaps not legally enforceable, serves the purpose of addressing nontraditional mortgage risk concerns and providing Agency direction to lenders until current lending laws can be amended or supplemented.¹⁴²

2. Applicability to Nonfederally Regulated Lenders

Another major complaint that the ABA had regarding the Final Guidance was that it would not apply to those lending institutions and brokers not subject to the Agencies’ regulation.¹⁴³ The Final Guidance applies only to “federally-insured institutions

136. See generally Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like – Should Federal Agencies Use them to Bind the Public?*, 41 DUKE L.J. 1311, 1312-15 (1992) (explaining the effectiveness of guidance as binding law).

137. 5 U.S.C. § 553 (2000).

138. Anthony, *supra* note 136, at 1312.

139. *Id.* at 1315.

140. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,612 (Oct. 4, 2006).

141. *Cf. id.* (suggesting that the immediacy of the threat posed to consumers by these products requires present action).

142. *Id.*

143. ABA Comment, *supra* note 44, at 12.

and their holding companies and their nonbank subsidiaries.”¹⁴⁴ The mortgage broker¹⁴⁵ community, however, plays a major role in the consumer-mortgage loan process and is often the major point of contact for a borrower.¹⁴⁶ In fact, “85 to 90% of loans are ‘brokered loans,’ which includes mortgage brokers, correspondent lenders, and any lender that does not service the loan for a period longer than three months.”¹⁴⁷ As the major point of contact for consumers, consumer protection policy must reach this group of individuals to be effective.

Mortgage brokers as a whole, however, have some conflicts of interest that leave little incentive for them to voluntarily implement strong consumer protection policies.¹⁴⁸ First, lenders may provide an incentive structure to mortgage brokers that encourage them to market one type of mortgage over another to consumers.¹⁴⁹ One assistant U.S. attorney has suggested that “[i]n 2004 banks began offering fatter sales commissions on payment-option ARMs to encourage brokers to push them.”¹⁵⁰ Thus, a mortgage broker, acting in the broker’s own self-interest, may recommend a nontraditional mortgage to a consumer not because it fits the consumer’s needs, but because the mortgage broker will earn a higher commission.¹⁵¹ The NAMB readily admits that the

144. *Id.* at 10.

145. National Association of Mortgage Brokers FAQ page, <http://www.namb.org/namb/FAQs1.asp?SnID=1854943273> [hereinafter NAMB FAQ page] (last visited Dec. 21, 2006). “A broker is a real estate financing professional acting as an independent contractor There are circumstances when brokers may act as bankers, funding their loans. However, the majority perform origination services up to the point of funding.” *Id.*

146. *See id.*

147. *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Subcomm. on Housing and Transportation and Subcomm. on Economic Policy of the H. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 2 (2006) (statement of George Hanzimanolis, President-Elect, Nat’l Ass’n of Mortgage Brokers), available at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=239>. Estimates of the actual percentage of loans originated by mortgage brokers differ, but it is safe to say that, whatever the actual percentage, it is well over a majority of all consumer mortgages. *See, e.g.*, NAMB FAQ page, *supra* note 145 (indicating that two out of every three consumers use a broker).

148. *See generally* Der Hovanesian, *supra* note 1 (arguing that commissions and incentives provided to brokers by lenders present conflicts of interest).

149. *See id.* at 70.

150. *Id.* (quoting Gail McKenzie, an assistant U.S. attorney in Atlanta).

151. *Id.* *But see* Response by Harry Dinham, President, NAMB, <http://www.namb>

broker works neither for the borrower nor the wholesale lender.¹⁵² Thus, mortgage brokers must balance the interests of both lender and borrower.¹⁵³

Another factor that may decrease a broker's incentive to reduce costs for the borrower is the "yield-spread premium."¹⁵⁴ Yield-spread premiums are "side payments by lenders to mortgage brokers for persuading borrowers to agree to higher interest rates when the lenders in fact are willing to extend credit to the borrowers at lower rates."¹⁵⁵ While perfectly legal, problems arise because lenders provide different yield-spread premiums for different types of loans, which may give a broker an incentive to sell one loan over another.¹⁵⁶ The NAMB contends, however, that mortgage brokers also have incentives to provide consumers with the best possible customer service, as the broker is not compensated until the loan closes.¹⁵⁷ The consumer, however, often does not become unhappy with a nontraditional loan until rates adjust.¹⁵⁸ At that point, it is the bank's name, as opposed to the mortgage broker's, which is on the loan, and the bank bears the brunt of the consumer's complaints.¹⁵⁹ So if mortgage brokers are so bad for consumers, why do so many continue to use them? Some suggest this is because "[o]ftentimes, borrowers may receive a better rate and term on their loan program by going through a mortgage broker rather than if they went directly to a lender. This is because lenders provide brokers with wholesale rates and terms

.org/Images/namb/IndustryNews/Harry_Dinham_Newsweek_Letter.pdf (last visited Jan. 22, 2006) (rejecting many of the accusations that mortgage brokers steer consumer to loans that pay the highest commissions).

152. NAMB FAQ page, *supra* note 145.

153. *See generally id.* (suggesting that the broker, as an independent contractor, provides services both to the lender and the borrower).

154. *See* Peter J. Hong, J.D., & Marcos Reza, *Hidden Costs to Homeowners: The Prevalent Non-Disclosure of Yield Spread Premiums in Mortgage Loan Transactions*, 18 LOY. CONSUMER L. REV. 131, 136 (2005).

155. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1264 (May 2002).

156. Hong & Reza, *supra* note 154, at 136.

157. NAMB FAQ page, *supra* note 145.

158. *Cf.* Der Hovanesian, *supra* note 1 (showing examples where borrowers first go to their lenders with complaints when rates adjust).

159. *Id.*

that are not available to the general public.”¹⁶⁰ Though yield-spread premiums may encourage brokers not to offer the lowest interest rate that they have available, brokers contend that the consumer’s ability to shop around for lower rates encourages the brokers to maintain competitive rates.¹⁶¹

The NAMB also believes that the borrower is not the only one who needs to be educated on the use of nontraditional loans, an opinion echoed by the Agencies in the Final Guidance.¹⁶² Supplementary, nontraditional loan-specific education needs to be provided to all loan originators so that originators can properly convey the information to borrowers.¹⁶³ Disclosures to consumers will only be effective if the originator is properly trained and educated.¹⁶⁴ The NAMB seems to believe that when a broker suggests a nontraditional mortgage product for an inappropriate consumer, it is not due to misplaced incentives or intentions, but rather an unintentional act by a broker not properly educated about those products.¹⁶⁵ The NAMB suggests pre-licensure education requirements as a possible solution.¹⁶⁶ Additionally, for those situations where a mortgage broker intentionally acts against the consumer’s interest, the NAMB suggests criminal background checks as a solution.¹⁶⁷ These background checks, however, would only be effective in preventing those already convicted of a crime from becoming brokers. Further, brokers who provide inappropriate, nontraditional loans to borrowers may not view themselves as having committed a wrong.¹⁶⁸ Rather, brokers might see themselves as having helped a borrower obtain a home that might not otherwise have been attainable.¹⁶⁹

160. Hong & Reza, *supra* note 154, at 131-32.

161. NAMB FAQ page, *supra* note 145.

162. See Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,618 (Oct. 4, 2006) (recommending additional training on these products to lending personnel).

163. *NAMB Comment*, *supra* note 99, at 2-3.

164. *Id.* at 11.

165. *Id.* at 3.

166. *Id.*

167. *Id.* at 4.

168. Cf. *NAMB Comment*, *supra* note 99, at 9 (suggesting that nontraditional mortgages are innovative products that provide more affordable credit to consumers).

169. *Id.*

The NAMB concedes that mortgage brokers are not regulated by the Agencies and, therefore, are not subject to the Final Guidance.¹⁷⁰ Mortgage brokers, however, are far from unregulated and without oversight – “[t]he [mortgage broker] industry is regulated by seventeen federal laws and numerous state and federal regulations.”¹⁷¹ The states have taken on the role of regulating the state-licensed mortgage brokers and nonbank lenders and were actively involved in the Proposed Guidance discussion leading up to the Final Guidance.¹⁷² State regulation, however, is not comprehensive and can be rather piecemeal, with applicable laws varying from state to state.¹⁷³ The states, however, are attempting to address the issues discussed in the Final Guidance.¹⁷⁴ The Conference of State Bank Supervisors (CSBS),¹⁷⁵ in conjunction with the American Association of Residential Mortgage Regulators (AARMR),¹⁷⁶ developed a companion

170. *Id.* at 2.

171. NAMB FAQ page, *supra* note 145. These laws include the aforementioned RESPA, TILA, HOEPA, FCRA, ECOA, and FTC Act, as well as state oversight by their mortgage regulator, attorney general, and/or their state agency where applicable. *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Subcomm. on Housing and Transportation and Subcomm. of Economic Policy of the H. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 3-4 (2006) (statement of George Hanzimanolis, President-Elect, Nat’l Ass’n of Mortgage Brokers).

172. See Comment submitted by Neil Milner, President and CEO, Conference of State Bank Supervisors, to the Fed. Reserve Bd. (Feb. 14, 2006) [hereinafter *CSBS Comment*], available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> (follow “view comments” hyperlink located beneath “Interagency Guidance on Nontraditional Mortgages” hyperlink).

173. Cf. John C. Dugan, Comptroller, Office of the Comptroller of the Currency, Remarks at the 2006 America’s Community Bankers Convention, at 8 (Oct. 17, 2006), available at <http://www.occ.treas.gov/ftp/release/2006-115a.pdf>. (indicating that state regulators are developing a companion guidance, but that they will have to urge the individual state agencies to adopt the guidance when completed in order to have uniform regulation).

174. See Conference of State Bank Supervisors, *Guidance on Nontraditional Mortgage Product Risks* (Nov. 14, 2006) [hereinafter *CSBS Guidance*], http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/CSBS-AARMR_FINAL_GUIDANCE.pdf.

175. “The CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation’s 6,250 state-chartered commercial and savings banks and over 400 state-licensed branches and agencies of foreign banks.” *CSBS Comment*, *supra* note 172.

176. The AARMR is a corporation formed to promote the exchange of information among state employees who are responsible for the administration and

guidance aimed at state-licensed residential mortgage brokers and mortgage companies not affiliated with a bank holding company or an insured financial institution.¹⁷⁷ The parallel guidance, when and if adopted by the individual state regulators, will force the mortgage broker and state-licensed lender community to put similar procedures in place as those in the Final Guidance, and, therefore, eliminate any significant competitive advantage that the Final Guidance would have provided to them.¹⁷⁸

It is the above concerns that led the ABA, who has many member lenders subject to the Final Guidance, to argue that if any new consumer protection requirements are implemented, they should be accomplished pursuant to a formal rulemaking or an amendment to a current disclosure rule, rather than in the form of an Agency guidance.¹⁷⁹ The Guidance's non-uniform application will force federal banks and their subsidiaries to make additional disclosures – more than those already required by all lenders, regulated and non-regulated alike.¹⁸⁰ Consumers may, in turn, perceive the banks' nontraditional mortgage products as more expensive or riskier, and, perhaps, this will have the ironic effect of pushing consumers toward the non-regulated lenders who are not subject to the disclosures recommended by the Final Guidance.¹⁸¹

regulation of mortgage brokers and mortgage lending. See AARMR Homepage, <http://www.aarmr.org> (last visited Dec. 21, 2006).

177. *CSBS Guidance*, *supra* note 174.

178. *See id.* Similar to the enforceability of the federal Final Guidance, the CSBS guidance's enforceability will depend on the states and their regulatory entities individually passing laws with similar substance. See Letter from Neil Milner, President and CEO, CSBS, to Stephen J. Adler, Editor-in-Chief, Business Week (Dec. 19, 2006), http://www.csbs.org/AM/Template.cfm?Section=Press_Releases_Archives&Template=/CM/ContentDisplay.cfm&ContentID=9438 (indicating that nineteen states have thus far adopted the CSBS guidance). Both the CSBS and the AARMR are organizations designed to assist those state entities responsible for regulating state-chartered banks and mortgage brokers respectively. Any guidance suggested by the CSBS and AARMR is only effective insofar as the state regulatory members of these organizations adopt laws mirroring their recommendations. See AARMR homepage, *supra* note 176; CSBS – What Is CSBS, <http://www.csbs.org/Content/NavigationMenu/AboutUs/WhatIsCSBS/WhatIsCSBS.htm> (last visited Dec. 21, 2006).

179. *ABA Comment*, *supra* note 44, at 12.

180. *Id.* at 10.

181. *Id.* at 11.

3. Federal Lenders' Regulation of Their Broker Counterparts – Control Systems

The Final Guidance requires regulated lenders to provide “oversight of third parties,” which includes mortgage brokers or correspondents.¹⁸² According to the Final Guidance, “[o]versight of third parties should involve monitoring the quality of [loan] originations so that they reflect the institution’s lending standards and compliance with applicable laws and regulations.”¹⁸³ Federally-regulated lenders had argued that this “would force lenders to have an awareness and control over third-party practices that is neither realistic nor practical.”¹⁸⁴ In only a few years’ time, one bank can do business with several hundred mortgage brokers.¹⁸⁵ To expect a bank to monitor the origination and disclosure practices of all those brokers would be time-consuming and very costly.¹⁸⁶ The ABA believes that the net effect of requiring such monitoring is that banks will choose to do business with fewer mortgage companies since banks can only justify the monitoring cost for brokers who provide significant loan volume.¹⁸⁷ The counterargument, however, is that those noncompliant brokers would change their disclosure practices and origination polices – which was one of the goals of the Proposed and Final Guidances in the first place – in order to maintain those business relationships.¹⁸⁸ Based on the Agencies’ unwillingness to change the control systems requirements in the Final Guidance, it appears lenders are “responsible for overseeing the marketing and borrower disclosure practices of third parties,”¹⁸⁹ despite the high cost of such monitoring about which lenders complained.

182. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,615 (Oct. 4, 2006).

183. *Id.*

184. *Id.* at 58,612; see *ABA Comment, supra* note 44, at 12.

185. *ABA Comment, supra* note 44, at 12.

186. *See id.*

187. *Id.*

188. *See generally* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,618 (Oct. 4, 2006) (requiring lenders to monitor their third-party originators like brokers to ensure compliance).

189. *Id.* at 58,612.

C. *Sufficiency of the Final Guidance – The Suitability Standard*

Consumer advocacy groups questioned whether the Final Guidance would actually help protect consumers since it “does not carry the same force as a law or regulation.”¹⁹⁰ Therefore, while the goals of the Final Guidance were commended, some argue the Agencies need to go further and establish a suitability standard.¹⁹¹ It is suggested that the “mortgage lenders follow the lead of the securities industry and require that mortgage borrowers be not only eligible for a product but also suitable – meaning the loan won’t impose hardship.”¹⁹² The National Association of Securities Dealers (NASD)¹⁹³ has expressly enacted a suitability requirement for the customers of the security brokers that it regulates.¹⁹⁴ The requirement in essence says that “a salesperson ‘should recommend only securities that are suitable to the needs of the particular customer.’”¹⁹⁵ While the Securities and Exchange Commission has not itself expressly adopted a suitability standard, it has read a suitability requirement into section 10(b) of the Securities Exchange Act of 1934¹⁹⁶ and its corresponding Rule 10b-5¹⁹⁷ that is substantially similar.

190. *Hearings, supra* note 3, at 15; *see supra* notes 133-42 and accompanying text.

191. One of the main concerns of the ABA was “that the agencies are creating a new ‘appropriateness’ or ‘suitability’ standard.” *ABA Comment, supra* note 44, at 9. The Final Guidance, however, does explicitly reject the idea of suitability. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,612.

192. Der Hovanesian, *supra* note 1; *see also* Engel & McCoy, *supra* note 155 (arguing for a suitability standard in the subprime lending market similar to that in the securities industry).

193. The NASD is “the primary private-sector regulator of America’s securities industry. [It] oversee[s] the activities of more than 5,075 brokerage firms . . . and more than 662,800 registered securities representatives.” NASD – About NASD, <http://www.nasd.com/AboutNASD/index.htm>.

194. *See* NASD Manual, Rule 2310, *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466. The rule states that “[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his or her security holdings and as to his financial situation and needs.” *Id.*

195. Engel & McCoy, *supra* note 155, at 1318.

196. Securities Exchange Act of 1934, § 10(b), 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-78nn (2000)).

197. 17 C.F.R. § 240.10b-5 (2006); *see* Engel & McCoy, *supra* note 155, at 1322-28.

With those ideas in mind, the NCLC describes its idea of suitability in the mortgage industry as follows:

[T]he originator or lender owes a duty of good faith and fair dealing to borrowers in the origination of a home loan. The creditor will reasonably ensure that the loan is suitable for the borrower's purpose, including but not limited to the borrower's circumstances, borrower's objective in obtaining the loan and the borrower's ability to repay.¹⁹⁸

Authors of one law review article take it a step further, saying “[c]ourts have held that an agency relationship exists between a mortgage broker and the broker's client when the broker has a duty to act primarily for the benefit of his or her client in matters connected with mortgage loans.”¹⁹⁹ Regardless of the existence of an agency relationship, “the concept of suitability” would provide “a way to hold lenders accountable and to secure redress for borrowers that are harmed.”²⁰⁰ The NCLC adds: “[l]ending without regard to repayment ability is only permitted by lenders because they can collect on the collateral – someone's home. Because lenders can protect themselves from losses through collateralization, securitization,²⁰¹ and other means, there is little market incentive to ensure the affordability of the loans.”²⁰²

Lenders and brokers, however, do not support a suitability standard.²⁰³ They believe that ultimately it is the borrowers whom must take responsibility for the loan decisions that they make.²⁰⁴

198. Brian Collins, *ARMs Raise "Suitability" Issue*, MORTGAGE LINE, Sept. 11, 2006.

199. Hong & Reza, *supra* note 154, at 135 (citing various cases).

200. Collins, *supra* note 198.

201. “Securitization is the process of converting packages of loans into securities that are backed by collateral in the form of loans.” Engel & McCoy, *supra* note 155, at 1274. By selling nontraditional loans to the secondary market, lenders both free up cash for additional lending and reduce or eliminate the risk inherent in these types of loans. *Id.* The purchasers of these loans in the secondary market can better offset the risk of nontraditional loans by bundling them with safer, conventional loans. *Id.*

202. NCLC Comment, *supra* note 82, at 7.

203. See, e.g., ABA Comment, *supra* note 44, at 9.

204. Collins, *supra* note 198.

Joe Falk, Legislative Chairman of the NAMB, was quoted as saying, “[w]e believe reasonable protections should be available to both sides of the transaction,” which he indicated included lenders that act in a responsible manner.²⁰⁵ The ABA is in agreement and stated in its comment that “[w]e are concerned that the Agencies are creating a new ‘appropriateness’ or ‘suitability’ standard that we are very reluctant to see applied in lending, if ‘suitability’ is to mean something other than creditworthiness.”²⁰⁶ The ABA points out that

[w]e would expect the first response of an applicant who is told that while the lending institution deems him or her to be creditworthy, nonetheless the lender is denying the application on the grounds that the mortgage product is simply ‘not appropriate’ for the applicant, will be to file a fair lending complaint.²⁰⁷

In the Final Guidance, the Agencies ultimately came down on the side of the lenders and brokers. The Agencies explained that they in no way were attempting to establish a suitability requirement – “[i]t was not the Agencies’ intent to impose such a standard, nor is there any language in the guidance that does so.”²⁰⁸ The Agencies went so far as to remove any language from the Final Guidance that might even be interpreted as suggesting lenders have a duty to provide only products deemed “suitable” to borrowers.²⁰⁹

205. *Id.*

206. *ABA Comment, supra* note 44, at 9.

207. *Id.*

208. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,612 (Oct. 4, 2006).

209. *Id.* It is interesting to note that nowhere in the Proposed Guidance was there any language specifically referencing suitability. This may have been a preemptive strike by the ABA to assure that no such language entered the Final Guidance – especially in light of the considerable discussion given to the issue in consumer advocacy groups’ comments on the Proposed Guidance.

V. CONCLUSION

The effects of the Final Guidance on the mortgage industry, and in particular on the marketing of nontraditional mortgage products, may not be known for months, or even years down the road. Nevertheless, the public comment process leading up to the Final Guidance²¹⁰ has called significant attention to the dangers and risks of nontraditional mortgage products. These results are seen in the prevalence of news coverage that resulted from the debate over what form the Final Guidance should take,²¹¹ in the ongoing modifications to current lending laws,²¹² and in the actions being taken by state regulators in response to the Final Guidance.²¹³

Both prior to and since publication of the Final Guidance, the issues revolving around the dangers of nontraditional mortgages have undergone extensive discussion. Around ninety-one comments, from many different lenders, brokers, and advocates, were generated discussing the issues involved in the Final Guidance.²¹⁴ A plethora of news articles and media coverage have resulted,²¹⁵ and multiple hearings before Congress and the various regulatory agencies were held. As a result of this coverage, ordinary consumers are more aware of the dangers of nontraditional mortgages – a goal which the Final Guidance set out to achieve.²¹⁶

Additionally, some of the suggestions made by lenders, brokers, and advocates about improving disclosures were already

210. See *supra* notes 86-87 and accompanying text.

211. See, e.g., Der Hovanesian, *supra* note 1.

212. See *infra* notes 214-24 and accompanying text.

213. See *infra* notes 225-31 and accompanying text.

214. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,610 (Oct. 4, 2006).

215. One industry expert has even gone so far as to suggest that the news media has been the best source of information for borrowers regarding the dangers of nontraditional mortgages. See James Comtois, *Industry Pro Critical of Regulators*, 16 ORIGINATION NEWS 26, Dec. 2006. The expert suggests the federal regulators have been lax in doing their job. *Id.*

216. See generally Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,610 (indicating that one of the main concerns is that “consumers are provided clear and balanced information about the relative benefits and risks of [nontraditional mortgage] products”).

taking place within the Federal Reserve Board even before issuance of the Final Guidance.²¹⁷ In her testimony before a Senate Committee, Sandra F. Braunstein, the Director of the Division of Consumer and Community Affairs within the Board, indicated that a revision of Regulation Z, the Board's implementing regulation for TILA, is already underway.²¹⁸ She indicated that "immediate steps" are being taken "to improve the information consumers receive about alternative mortgages."²¹⁹ Some of those steps include "revising the CHARM booklet" and "publishing a consumer education brochure."²²⁰ These are the exact steps that the ABA and NAMB had suggested.²²¹ Furthermore, "in determining how to improve disclosures . . . , the Board will conduct extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what wording and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload."²²² This will address both mortgage brokers' and advocates like the CRL's concerns that disclosures not be overburdensome yet still be "meaningful" and "effective."²²³ Most importantly, these TILA disclosure and CHARM booklet changes will apply to all lenders, since all are required to comply with those regulations.²²⁴

In light of the above modifications, the Final Guidance is already well on its way to achieving its goals of alerting consumers to the dangers of nontraditional mortgages and ensuring that

217. See *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Subcomm. on Housing and Transportation and Subcomm. of Economic Policy of the H. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 1 (2006) (statement of Sandra F. Braunstein, Dir., Div. of Consumer and Cmty. Affairs, the Fed. Reserve Bd.) [hereinafter *Braunstein Statement*], available at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=239>.

218. *Id.* at 2.

219. *Id.* at 9.

220. *Id.*

221. See *ABA Comment*, *supra* note 44, at 12-13; *NAMB Comment*, *supra* note 99, at 5-6.

222. *Braunstein Statement*, *supra* note 217, at 9.

223. See *NAMB Comment*, *supra* note 99, at 5-8; *CRL Comment*, *supra* note 32, at 12-13.

224. *Braunstein Statement*, *supra* note 217, at 11; *ABA Comment*, *supra* note 44, at 13.

lenders and brokers are adequately informing borrowers about the risks of these products. The Agencies indicate in the Final Guidance that “they do not anticipate that the information outlined in the guidance will result in additional lengthy disclosures.”²²⁵ A large reason for this is that, with the modification of existing lending laws to include disclosures about the risks of nontraditional mortgage products, the Agencies’ disclosure concerns are going to be adequately addressed in formal, enforceable rule form.²²⁶ The Final Guidance was necessary, however, due to the immediacy of the Agencies’ concerns about these products.²²⁷ The Agencies were able to alert the general public and possibly curb some lender abuses even prior to any formal legislative action. In that sense, the Final Guidance was indeed effective.

Additionally, despite its limited scope, the publication of the Final Guidance has also been able to effect meaningful change in the non-federally regulated lending community and the state-regulated broker community. In the Final Guidance,

[t]he Agencies note that both [s]tate financial regulatory organizations that commented on the proposed guidance – the [CSBS] and the State Financial Regulators Roundtable (SFRR) – [are] committed to working with [s]tate regulatory agencies to distribute guidance that is similar in nature and scope to the financial service providers under their jurisdictions.”²²⁸

With the issuance by the CSBS of its parallel guidance that “substantially mirrors” the federal Final Guidance, much of the concern that the nonfederal lending entities not subject to the Final Guidance will gain some competitive advantage from not

225. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,612 (Oct. 4, 2006).

226. See *supra* notes 217-24 and accompanying text.

227. See *id.*

228. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,610.

being required to make similar disclosures should be alleviated.²²⁹ It is a fact that not all brokers are state-regulated, but the Guidance at least has been able to stimulate change in the recommendations provided by the entities that do regulate brokers on the state level.²³⁰ Regardless, as mentioned, the advantages of the revisions currently being done to TILA and the CHARM booklet are that they would apply to all lender entities.²³¹

While the Agencies should be commended for the meaningful changes that the Final Guidance has initiated, it goes too far in requiring additional disclosures in the “shopping phase.”²³² Loan originators will find themselves warning consumers about products even before the borrower has expressed a sincere interest in such products. Further, such disclosures are unnecessary if the proposed changes to existing disclosure laws are carried through.²³³ The Final Guidance, however, did make the right choice on the issue of suitability. The Agencies’ purpose in the Final Guidance was to inform consumers of the risks involved in nontraditional mortgage products, to make sure lenders were properly underwriting the loans, and to make sure the loan originators were adequately informing borrowers of the products’ dangers.²³⁴ It was not the Agencies’ intention to fundamentally overhaul predatory lending laws through establishment of a suitability standard.²³⁵

In summary, despite the questionable enforceability and scope of the Final Guidance, the commentary, hearings, and legislative action that led up to the Final Guidance’s publication accomplished what the Agencies set out to do – alert consumers

229. *CSBS Guidance*, *supra* note 174, at 1.

230. See Brian Collins, *Tough Guidelines on Exotics Pushed*, 16 ORIGINATION NEWS 1 (Nov. 2006).

231. See *Braunstein Statement*, *supra* note 217, at 11; *ABA Comment*, *supra* note 44, at 13.

232. See *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58,609, 58,612 (Oct. 4, 2006) (indicating that the “guidance focuses on providing information to consumers during the pre-application shopping phase”).

233. See generally *ABA Comment*, *supra* note 44, at 11 (arguing additional disclosures during the shopping period may confuse borrowers and reduce effectiveness of existing lending law disclosures).

234. See *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. at 58,609-10.

235. See *id.* at 58,612.

and the mortgage industry *now* to the dangers of nontraditional mortgage products and encourage modification of law so as to account for the products' added risk. One only needs to look at a comment recently made by Frederick Cannon, an analyst with a full-service investment bank, in discussing the effects of the Agencies' Final Guidance: "[t]he publicity is a contributing factor in the downdraft of volumes that we're already seeing [with payment-option loans]. You don't go to a cocktail party and brag about your 1% loan anymore, because somebody will have read *Business*[*Week*]²³⁶ and say, 'I know what you got, and you're nuts.'²³⁷

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236. This is presumably a reference to the *Business Week* article entitled *Nightmare Mortgages*. See Der Hovanesian, *supra* note 1.

237. Joe Adler, *Agencies Reject Calls for Freer Rein on Exotic Mortgages*, AM. BANKER, Oct. 2, 2006, at 1.