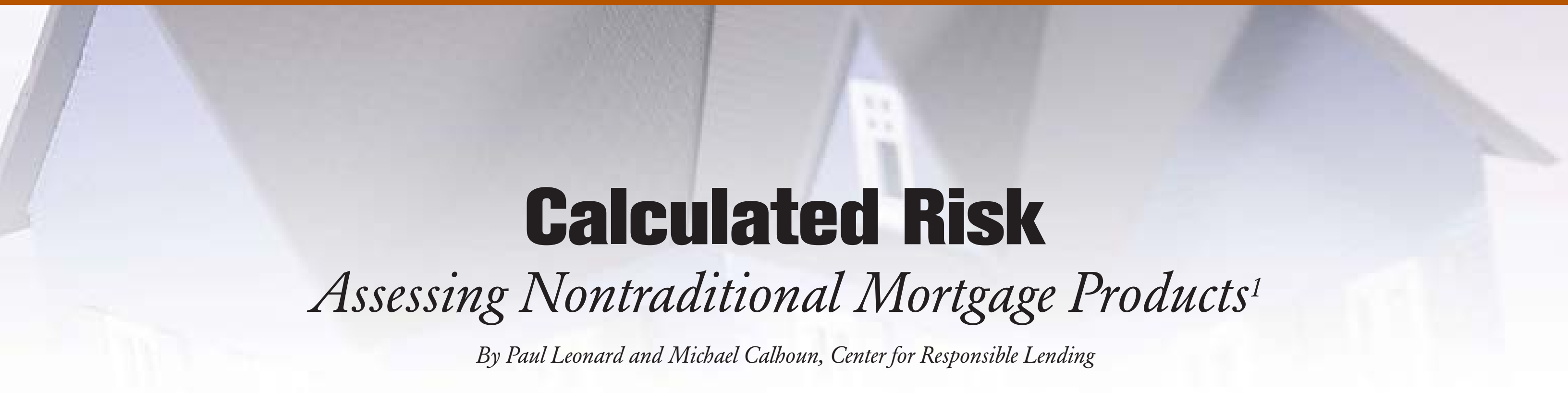


Calculated Risk

Assessing Nontraditional Mortgage Products[1]

By Paul Leonard and Michael Calhoun, Center for Responsible Lending

Over the last ten years, there has been an explosion in the availability of mortgage credit for low- and moderate-income and minority borrowers who have less than perfect credit. The emergence of a robust subprime mortgage market has allowed many with imperfect credit to take out higher-priced loans that allow them to become homeowners. Subprime lending is no longer a small problem that affects only a few homeowners. In 2005, one in every four home loans originated was a subprime loan, and there are $1.2 trillion in subprime mortgages currently outstanding.[2] In recent years the subprime market has seen a rapid introduction of nontraditional products, including interest only and payment-option adjustable rate mortgages. Another relatively new product in the subprime market is the hybrid ARM, with fixed teaser rates, but sharp payment increases when it becomes an ARM.

Because many subprime lenders fail to consider whether the borrower will be able to afford the mortgage payment after the ARM adjusts, households with these loans are likely to face increasing rates of foreclosure and will lose significant accumulated equity in the coming years. The impact will not only be on those who lose their homes because the prices of neighboring homes are also affected by foreclosures. These loans will have a particularly damaging impact on communities of color, where consumers are disproportionately likely to borrow in the subprime market. According to the most recent HMDA data issued by the Federal Reserve, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[3] while four in ten loans to Latino[4] borrowers were higher-rate. Worse, many borrowers who receive subprime loans could have qualified for a more affordable and responsible product in the first place.[5]

In this article, we examine three key features of the subprime credit market that we believe are particularly harmful to low-income borrowers, and provide policy recommendations for state and federal regulators. The need to act is urgent, and the likely damage caused by high-risk ARMs in the subprime market is real. Nontraditional mortgages in the subprime market are acting to reverse the traditional benefits conveyed by mortgages, leaving vulnerable families worse off rather than giving them the opportunity to become more financially secure.

I. "Exploding ARMs": Hybrid ARMs in the subprime market result in payment increases that borrowers will not be able to afford.

Sometimes referred to as "exploding ARMs" due to the significant increase in the monthly payment after an introductory period with an artificially low payment, hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector."[6] Hybrid ARMs made up 81 percent of the subprime sector's securitization in the first half of 2006, up from 64 percent in 2002.[7] The most common type of hybrid ARM is a 2/28, which is a two-year fixed rate loan with an artificially low "teaser" rate for the initial two years of the loan, followed by rate adjustments that occur every six months for the remaining 28 years of the loan. The initial reset of the loan after two years results in a large payment "shock" for borrowers even if interest rates decline over that period. (See Figure 3.1)

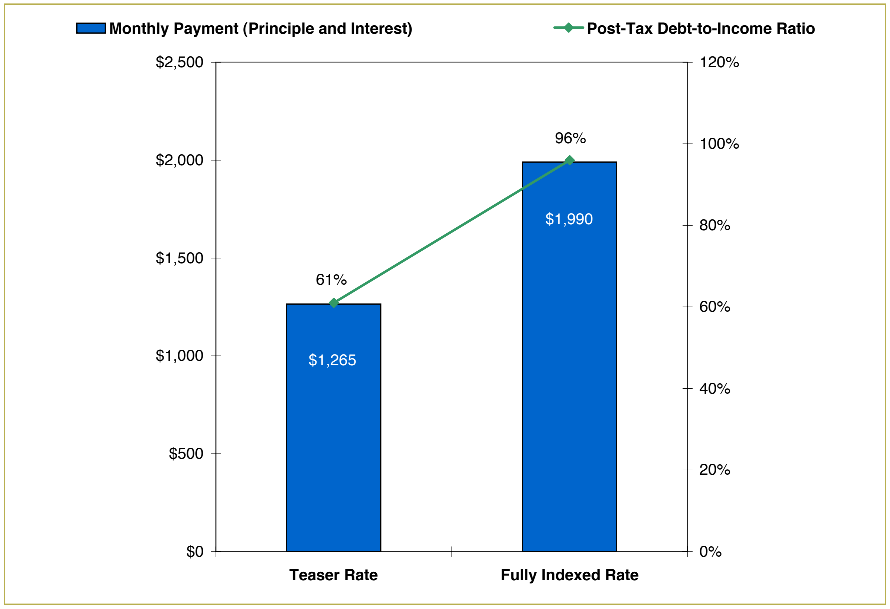
While interest-only loans are clearly of concern, representing one in four subprime loans,[8] the even more common 2/28 subprime mortgages themselves pose a significant risk to families. The low initial rate virtually guarantees that payments will rise significantly when the rate resets, even if interest rates remain constant and do not rise at all. Of course, if interest rates rise, the payment shock will worsen.

The Center for Responsible Lending is particularly concerned that payment shock for borrowers with subprime loans will be widespread in the next two years. According to Barron's, by 2008 reset of two-year teaser rates on hybrid ARMs will lead to increased monthly payments on an estimated $600 billion of subprime mortgages.[9] Fitch Ratings has stated that in 2006 payments would increase on 41 percent of the outstanding subprime loans–29 percent of subprime loans are scheduled for an initial rate reset and another 12 percent of subprime loans will face a periodic readjustment.

II. Exploding ARMs violate the fundamental underwriting precept that lenders should consider the ability of the borrower to repay the loan.

Lenders who make exploding ARMs often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they are qualifying borrowers at or near the initial start rate, even

Figure 3.1



2/28 Mortgages With Low "Teaser Rates" Can Result in Large Increases in Monthly Payments and Debt-to-Income Ratios

Note: This assumes a 2 percent rise in the market index rate.

when it is clear from the terms of the loan that the interest rate, and therefore monthly payments, will rise significantly.[10] As shown above, at the end of the introductory teaser rate on an ARM, borrowers may face a large jump in costs, particularly if interest rates rise.

A lender's failure to account for the incredible payment shock that most borrowers with an exploding ARM will face is compounded by three other practices.

Limited Use of Escrow Accounts: Most subprime lenders sell loans based on low monthly payments that do not take taxes or insurance into account.[11] According to industry sources, only one in four subprime loans includes an escrow or impoundment account for property taxes and insurance payments.[12] In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at the borrower's debt-to-income ratio and ability to repay.

Stated Income Loans Often Overstate Borrowers' Incomes: Inadequate documentation of a borrower's income only compounds the problem of underwriting based on the borrower's ability to make payments before adjustment. In reviewing a sample of stated income loans, the Mortgage Asset Research Institute recently found that over 90 percent of the loans in the sample were underwritten using borrower incomes that were inflated by 5 percent or more, and almost 60 percent had exaggerated income by more than 50 percent.[13]

Prepayment Penalties Either Strip Equity or Trap Borrowers in Subprime Loans: The typical inclusion of prepayment penalties in subprime mortgages further compounds the problems of exploding ARMs. Approximately two-thirds of subprime loans include a penalty[14] for paying the loan off before a certain period, trapping the borrower in the loan when they might be able to refinance into a better product. Borrowers who conclude that they would be better off escaping a subprime hybrid ARM (before the rate reset makes it unaffordable) and shifting into a fixed rate product, for example, must sacrifice significant equity to pay the penalty.

III. Because subprime lenders are placing borrowers in loans that they objectively cannot repay, families are losing their homes to foreclosure in ever greater numbers.

Lenders' failure to ensure that borrowers can afford their monthly payment when their loans adjust means that borrowers have one of three options when interest rates reset: refinance, sell the house, or face foreclosure. As families lose home equity and housing markets slow, foreclosure will become the only option for many.

Strong housing price appreciation on the coasts and largely favorable interest rates have prevented widespread defaults and foreclosures to date, though the cooling market has led to rapid increases in foreclosures in certain markets, including California.[15] Until recently, most subprime borrowers could refinance, usually into another subprime loan, though borrowers would lose significant equity as they incur a whole new set of lender fees, broker fees, and third-party closing fees with each loan. In turn, this loss of equity means that the borrower loses their single largest source of wealth and ends up trapped in a cycle of subprime loan after subprime loan.

However, as interest rates begin to increase and housing markets slow, the option to refinance is in danger of disappearing for many borrowers with subprime loans.

As home prices flatten, borrowers will be less likely to have the options of selling or refinancing.

Rather, as subprime ARMs begin to reset there will likely be a significant rise in foreclosures. A study by researchers at the University of North Carolina has shown that "ARMs have a strong association with heightened foreclosure risk and potential loss of borrowers' homes," finding that subprime ARMs were 49 percent more likely to foreclose than fixed-rate subprime loans after controlling for other differences in loan terms, creditworthiness, and economic conditions.[16] In addition, there is a well-documented relationship that shows that foreclosures increase as housing appreciation slows.[17]

There is already evidence that borrowers with subprime loans cannot sustain payments as rates reset. According to delinquency data from the Mortgage Bankers Association, in the fourth quarter of 2005 the delinquency rate (90+ days) for subprime ARMs was 2.71 percent, compared with 0.37 percent for prime ARMs, more than 7 times higher. In addition, in 18 states, more than 15 percent of homeowners with subprime ARMs were behind in their payments in the second quarter.[18] An astounding 11.32 percent of the subprime ARMs in Ohio were in foreclosure at the end of the second quarter of 2005.[19]

Up to now, borrowers have largely been able to offset lost equity from fees and prepayment penalties by selling their homes in a hot market or by refinancing. However, as home prices flatten, borrowers will be less likely to have the options of selling or refinancing. With these options off the table, borrowers who hit the rate reset wall will only have the option of going into foreclosure.

IV. Federal and state regulators can and should address this problem now.

While brokers, lenders and secondary market investors have profited from the rapid growth in subprime lending, borrowers bear the greatest risks associated with what are often unsuitable and unsustainable loans. Immediate action is needed by mortgage regulators, policymakers and lending institutions to mitigate the likely damage associated with these exploding ARMs. For example, lenders and servicers must act to prevent widespread foreclosures by providing concessions to borrowers who cannot meet their loan terms, such as loan modifications, reductions in payments and low/no cost refinancing while waiving prepayment penalties.

Federal and state regulators must also act more proactively to protect borrowers. In September, 2006, federal banking regulators issued guidance on nontraditional mortgages. (See Article: Nontraditional Mortgage Guidance) However, this guidance has two serious shortcomings. First, because the guidance can be read to have narrowly defined "nontraditional mortgages," regulators need to confirm that the guidance applies to 2/28 exploding ARMs. Second, the guidance only applies to mortgages made by federally

HOEPA Hearings

Box 3.1

This past summer the Federal Reserve Board held a series of hearings under the Home Ownership and Equity Protection Act (HOEPA), which was enacted in 1994 in response to reports of predatory home equity lending practices in underserved markets. HOEPA amended the Truth in Lending Act (TILA) to impose additional disclosure requirements and limits on certain high-cost, home-secured loans. HOEPA also directs the Board to periodically hold public hearings to examine the home equity lending market and the adequacy of existing regulatory and legislative provisions for protecting the interests of consumers, particularly low-income consumers.

The Board's 2006 hearings focused on three topics: (1) predatory lending and the impact of the HOEPA rules, and state and local anti-predatory lending laws on the subprime market; (2) nontraditional mortgage products such as interest only mortgage loans and payment option adjustable rate mortgages, and reverse mortgages; and (3) how consumers select lenders and mortgage products in the subprime mortgage market.

The Board heard from consumers, consumer advocacy organizations, lenders and others on a number of issues concerning consumer protection, financial education, the mortgage lending market and regulatory reforms. Transcripts of the hearings can be found on the Board's website: http://www.federalreserve.gov/events/publichearings/hoepa/2006/default.htm.

regulated entities. The Conference of State Bank Supervisors- American Association of Residential Mortgage Regulators (CSBS-AARMR) has issued guidance that mirrors the federal guidance but is intended to apply to state-chartered financial institutions and state licensed-mortgage brokers. It is expected that forty-nine states and the District of Columbia will issue the model guidance in some form. That guidance, unfortunately, retains the ambiguity present in the federal guidance.

Bank regulators need to immediately clamp down on these abusive subprime products. Specifically, we recommend that:

1. The federal banking agencies should confirm that their recent guidance applies to subprime ARMs for which there is a significant risk of payment shock.
2. States that issue the guidance developed by CSBS-AARMR likewise should make clear that the guidance applies to subprime exploding ARMs.
3. Through the Federal Reserve Board's rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA), the Federal Reserve should adopt an "ability to repay" standard that ensures borrowers are reasonably likely to be able to repay an ARM after it adjusts. This standard should at a minimum consider the fully adjusted interest rate and the full debt represented by the mortgage, including taxes and insurance, and it should also consider the borrower's debt in relation to his/her reasonably verified income.[20] (See Box 3.1: HOEPA Hearings)

Conclusion

Mortgages are complex financial transactions, and are among the most important that most families enter. If brokers and lenders are permitted to market high-risk products without considering the homeowner's ability to repay, there are serious consequences for individual families. Ultimately, these consequences will affect entire communities–and entire communities will be left out in the cold.

State and federal policymakers and regulators can and should address this problem now by requiring that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan, and also by strengthening enforcement against unscrupulous actors who convince homeowners to accept these loans that set homeowners up to fail.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

Since its establishment in 2002, CRL has conducted or commissioned landmark studies on predatory lending practices and the impact of state laws that protect borrowers. CRL has also supported state efforts to combat predatory lending and worked for regulatory changes to require responsible practices among lenders nationwide. CRL is based in Durham, North Carolina but has recently opened an office in Oakland, California.

Homeownership at High Cost: Recent Trends in the Mortgage Lending Industry

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10 Herbert, Christopher and Eric S. Belsky (2006). "The Homeownership Experience of Low-Income and Minority Families: A Review and Synthesis of the Literature." U.S. Department of Housing and Urban Development, Office of Policy Development and Research.

11 Johnson, Hans and Amanda Bailey (2005). "California's Newest Homeowners: Affording the Unaffordable," Public Policy Institute of California.

12 Because many of the AMP loans originated in recent years have not yet reset, it is not yet clear how much of an impact these types of payment shocks are having on delinquencies and foreclosure rates.

13 Apgar, William and Mark Duda (2005). *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom.* Report prepared for the Homeownership Preservation Foundation. Available: http://www.hpfonline.org/PDF/Apgar-Duda_Study_Final.pdf

14 Immergluck, Daniel and Geoff Smith (2005). "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values." Chicago: Woodstock Institute. Available at: http://www.woodstockinst.org/publications/research_reports

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16 Mortgage Bankers Association. National Delinquency Survey, Second Quarter 2006.

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18 Loans are identified as "high cost" in the Home Mortgage Disclosure Act (HMDA) dataset if the spread between the interest rate on the loan and the prime rate exceeded a specified amount (i.e. 3% for first-lien loans and 5% for second-lien loans).

19 Avery, Robert, Kenneth Brevoort and Glenn Canner (2006). "Higher-Priced Home Lending and the 2005 HMDA Data." *Federal Reserve Bulletin.* Federal Reserve Board.

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12th District Trends in Mortgage Lending – Box 1.1

1 "Nightmare Mortagages." (9/11/2006) *BusinessWeek,* online at http://www.businessweek.com/magazine/content/06_37/b4000001.htm

2 *FDIC Outlook Summer 2006–Breaking New Ground in U.S. Mortgage Lending.* Federal Deposit Insurance Corporation (2006). http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html

3 *Ibid.*

Predatory Lending – Box 1.2

1 "Loan flipping" refers to lenders who encourage borrowers to rapidly refinance loans; loan flipping may result in equity-stripping because refinancing costs money and often these charges are refinanced into the amount of the loan.

Foreclosure Risk in California – Box 1.3

1 This research focuses on a subset of the subprime market—loans that are "high cost." For the first time in 2004, loans are identified as "high cost" in the Home Mortgage Disclosure Act (HMDA) dataset if the spread between the interest rate and the prime rate exceeded a specified amount (i.e. 3 percent for first-lien loans and 5 percent for second-lien loans).

2 According to a recent study by the Public Policy Institute of California, forty percent of households with mortgages in the state, and 52 percent of recent homebuyers pay more than the HUD recommended guideline of spending 30 percent of their income on housing costs. Twenty percent spend more than half of their income on their housing costs. Among low-income households, the percentages of those spending the majority of their income on housing costs is even higher. Baldassare, M. "Statewide Survey November 2004: Special Survey on Californians and Their Housing," Public Policy Institute of California. Available at: http://www.ppic.org/content/pubs/survey/S_1104MBS.pdf

3 Notices of Default are not a perfect indicator of foreclosure risk because many households that have home loans they cannot afford do not ever get to the point where they receive a notice of default. Some homeowners are able to refinance or sell their home before receiving this official warning. Here, the term "foreclosure risk" is used as shorthand to describe areas in which households have received notices of default. Areas are described as having a "higher level of foreclosure risk" if they have a higher rate of notices of default.

Preventing Foreclosure: Initiatives to Sustain Homeownership

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2 Cutts, A C. & Green, R. K.. (2005). Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?. in *Building Assets, Building Credit: Creating Wealth In Low-Income Communities,* Retsinas, N. & E. Belsky, eds. Brookings Press. 348-377.

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4 Immergluck, D. & Smith, G.. (2005). *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime.* Federal Reserve Community Development Conference, Washington, DC from www.chicagofed.org/cedric/files/ 2005_conf_paper_session1_immergluck.pdf

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6 Courchane, M., Surette B., and Zorn, P. (2004). "Subprime Borrowers: Mortgage Transitions and Outcomes," *Journal of Real Estate Finance and Economics* 29 (4): 365-92.

7 Apgar W. C. and Fishbein, A.J. (2005). Hilgert, M.A., Hogarth J.M., & Beverly S.. (2003). "Household Financial Management: The Connection between Knowledge and Behavior." *Federal Reserve Bulletin,* 89 (7) 309–322. M. Wiranowski, 2002, *Sustaining Home Ownership Through Education and Counseling.* Joint Center for Housing Studies, Harvard University.

8 Hilgert, M.A., Hogarth J.M., & Beverly S. (2003).

9 Hirad, A. and Zorn, P. (2001). *A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling.* Hartarska, V., Gonzalez-Vega, C., and Dobos, D. (2002). *Credit Counseling and the Incidence of Default on Housing Loans by Low-Income Households.*

10 For a list of organizations and agencies that provide HUD certified homeownership counseling in your state, visit http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm.

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12 Todd, R. and Grover, M. (2005). "A Case for Post-Purchase Support Programs as Part of Minnesota's Emerging Markets Homeownership Initiative," *Federal Reserve Bank of Minneapolis Community Affairs Report No. 2005-1.*

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14 W. Pitcoff (2006), "Homeownership Rescue," *Shelterforce Online* Issue Number 147. National Housing Institute.

15 Neighborhood Housing Services of Chicago (2006). *Home Ownership Preservation Initiative: Partnership Lessons & Results, Three Year Final Report.*

16 For more information on ACORN's HFC Foreclosure Avoidance Program, please visit http://acornhousing.org/TEXT/fap.php.

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24 S.F. Braunstein (2006). *Nontraditional mortgage products.* Testimony before the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 20, 2006.

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The Consumer Rescue Fund – Box 2.1

1 For a more detailed description and analysis of the Consumer Rescue Fund, see Josh Silver and Marva Williams (2006), Asset Preservation: Trends and Interventions in Asset Stripping Services and Products, National Community Reinvestment Coalition and The Woodstock Institute.

2 The name of the consumer has been fictionalized for privacy reasons.

3 Alabama, Arizona, California, Florida, Georgia, Illinois, Indiana, Maryland, Massachusetts, Nevada, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, and Wisconsin.

Calculated Risk: Assessing Nontraditional Mortgage Products

1 This article was adapted from testimony that was given in September 2006 before the Senate Committee on Banking Housing and Urban Affairs. The full text is available at: http://www.responsiblelending.org/policy/testimony/page.jsp?itemID=30380832

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3 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.

4 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.

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8 *Ibid.*

9 Laing, Jonathan R. "Coming Home to Roost," *Barron's* (New York, NY), Feb. 13, 2006, at 26.

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11 See, eg., Chase Home Finance Subprime Lending marketing flier, "Attractive Underwriting Niches," at www.chaseb2b.com (available 9/18/2006) stating "Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!" (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower).

12 See, eg.," B&C Escrow Rate Called Low" (February 23, 2005) *Mortgage Servicing News Bulletin,* July 23, 2005 "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments….Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25 percent of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

13 Mortgage Asset Research Institute, Inc, *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association,* p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

14 Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, see Inside Mortgage Finance MBS Database, 2006.

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18 Knox, Noelle and Barbara Hansen, "More Fall Behind on Mortgages," *USA Today* at B1 (September 14, 2006). The *USA Today* figures refer to total delinquency figures (30 days + delinquent through foreclosure).

19 See MBA survey cited in Noelle Knox and Barbara Hansen, More Fall Behind on Mortgages, *USA Today* at B1 (September 14, 2006).

20 Income verification could include nontraditional methods including bank accounts, records of consistent bill paying that are not recorded by standard credit agencies or other methods that will reasonably verify income to meet mortgage requirements.

Nontraditional Mortgage Guidance

1 The guidance was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. The guidance is available online at http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf.

2 Interagency Guidance on Subprime Lending, March 1999. http://www.federalreserve.gov/boarddocs/srLETTERS/1999/sr9906a1.pdf

3 February 14, 2006 letter to the Agencies. http://www.federalreserve.gov/SECRS/2006/February/20060224/OP-1246/OP-1246_10_1.pdf

4 See http://www.csbs.org/AM/Template.cfm?Section=Press_Releases&Template=/CM/ContentDisplay.cfm&ContentID=9010.

Comments on Interagency Guidance on Nontraditional Mortgages – Box 4.1

1 See http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP%2D1246&doc_ver=1&ShowAll=Yes.

Glossary

1, 2, 6, 7, 19: "Consumer Handbook on Adjustable Rate Mortgages" (2005). Board of Governors of the Federal Reserve System: http://www.federalreserve.gov/pubs/arms/glossary_english.htm.

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