

**COMMENTS of the National Consumer Law Center
to the**

**Office of the Comptroller of the Currency
Docket No. 05-21**

**Office of Thrift Supervision
No. 2005-56**

**Federal Reserve System
Docket No. OP-1246**

Federal Deposit Insurance Corporation

National Credit Union Administration

Interagency Guidance on Nontraditional Mortgage Products

March 29, 2006

The **National Consumer Law Center** ("NCLC")¹ submits the following comments on behalf of its low income clients, as well as the **National Association of Consumer Advocates**.² We appreciate the efforts the agencies have made to identify and address the real and potential problems of the new nontraditional mortgages. The proposed Guidance rightly points out the key role that underwriting should play in originations of these risky products and our comments focus on this need, as well as the general penetration of nontraditional products in the mortgage market and the serious risks posed by current loans and future payment shock.

¹**The National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Repossessions*(6th ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by Alys Cohen and Margot Saunders.

²**The National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

Risk to Consumers is the Issue

This Guidance is a good beginning for what should be a major effort by the federal financial regulators to evaluate what changes need to be made in the regulation of the mortgage marketplace. The huge—and continuing—escalation of home mortgage foreclosures is inflicting devastating havoc on individuals, families and communities. The number of home foreclosures must be decreased—and it is the federal financial regulators who should take the lead in identifying meaningful measures to effectuate this decrease. The Agencies consistently say that they do not only protect the safety and soundness of the nation’s financial institutions, but also the consumers with whom these institutions do business.

The evaluation of what is appropriate regulation regarding a particular credit product has traditionally been based upon the extent to which this regulation is necessary to protect the safety and soundness of the financial providers of the product. However, it is time to highlight the significant difference in *risk to consumers* as compared to *risk to lenders*. The *risk to consumers* must be prominent in the evaluation of appropriate regulations for mortgage products, as well as the risk to the industry.

Risk to consumers is vastly different than risk to industry. Virtually all business risk can be protected against by a lender: loans can not be made, more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way. It is all numbers to the institution. However, to consumers, some risks cannot be measured simply in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon, and it is not one which most people in this national believe policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy is doing. It allows some products on the market which are known to lead to foreclosure for a substantial number of borrowers (the same can be said for many subprime loans). While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The evaluation of appropriate policy should be through the prism of how the policy protects against risk to consumers, as well as risk to lenders. The risk from bad mortgage loans to consumers is measured in loss of equity and foreclosures. The word “foreclosure” does not adequately convey the devastation caused by a foreclosure. It is not just permanently devastating to the family, but is also takes a real toll on communities. For example, researchers estimate that property values in low and moderate income neighborhoods in Chicago declined nearly \$1,600 per foreclosure in 1999.¹ Research on FHA foreclosures in Minneapolis estimated average city costs due to

¹ Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values* (Dec. 30, 2005), *forthcoming in* Housing Policy Debate.

one foreclosure of \$27,000 and neighborhood costs of \$10,000.² Higher foreclosure rates directly result in higher neighborhood crime rates.³

We urge the agencies to use *risk to consumers* as the yardstick by which it measures the adequacy of this proposed Guidance, as well as the sufficiency of other policy measures to address the problems in the mortgage lending industry.

Alternative Mortgage Products Dominate the Subprime Market and Present Huge Risks to Consumers and the Economy

In the last five years, alternative mortgage products—especially interest-only loans—have moved from a marginal role in the mortgage market to a place of dominance.⁴ Interest-only loans now constitute 27% of loans nationwide and 30% of subprime loans.⁵ In 2005, 63% of new mortgages were interest-only and adjustable-rate mortgages.⁶ Over an 18-month period in 2004 and 2005, approximately one-third of homebuyers did not put any money down for their loan.⁷ In the secondary market, 11 percent of all securitized subprime originations in 2004 were interest-only loans.⁸

The fact that this has occurred in an environment of low interest rates raises serious questions about how and why consumers are receiving these products. Interest-only loans and adjustable rate mortgages generally are geared for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes and those with fluctuating incomes do not see substantial swings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan. While originators

² Anne Moreno, *The Cost-Effectiveness of Mortgage Foreclosure Prevention*, Minneapolis: Family Housing Fund, 1995.

³ Dan Immergluck and Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, Oct. 21, 2005, *forthcoming in Housing Studies* (higher neighborhood foreclosure rates lead to higher rates of violent crime); *see also* Gregory D. Squires and Charis E. Kubrin, *Privileged Places: Race, Residence, and the Structure of Opportunity* (Lynn Rienner Publishers, forthcoming July 2006), <http://www.rienner.com/viewbook.cfm?BOOKID=1570&search=Kubrin> (access to lending decreases crime rates).

⁴ In fact, a huge range of alternative mortgage products is available, including loans with flexible “pick-a-payment” options, no points up front, a fixed rate conversion option, or a short introductory period of a fixed rate followed by ARM terms. *See, e.g.*, World Savings, Loan Features, available at <http://www.worldsavings.com/servlet/wsavings/loans-new/popular-combinations.html>.

⁵ Greg McBride, CFA, www.bankrate.com, Presentation to FRB Consumer Advisory Council (Oct. 26, 2005); *see also* Kirstin Downey, *Interest-Only: Borrower Beware: Popular but Risky Mortgage Draws Government Scrutiny*, Wash. Post, Dec. 21, 2005, at D1 (23% of borrowers in 2005 chose interest only mortgages, compared to 1% in 2000); Kenneth Harney, *Banks Warned They Must Scale Back on Payment-option Mortgage*, S. F. Chron., Dec. 11, 2005, at K12 (payment option mortgages account for roughly a third of new home loans issued by some major lenders in 2005).

⁶ Michael Powell, *A Bane Amid the Housing Boom: Rising Foreclosures*, Washington Post, May 30, 2005.

⁷ Edmund L. Andrews, *A Hands-Off Policy on Mortgage Loans*, New York Times, July 15, 2005.

⁸ Inside B&C Lending, 2005.

may adjust for this possibility by raising interest rates to cover future default or foreclosure, this process stands apart from underwriting that considers repayment ability.⁹

Because many nontraditional mortgage products, and adjustable rate mortgages in general, are made without adequate underwriting, they are characterized by traits that present major risks to consumers and to the economy. The growth of ARMs and interest-only products in a low-rate environment means that rate increases hold the potential of leading to huge increases in defaults and foreclosures. Such a result would devastate individual consumers, their families, and communities. Moreover, consumers show extreme sensitivity to interest rate variations; upwards adjustments in rates often result in unaffordable monthly payments. Because consumers are a major stabilizing force in the economy, a sharp upswing in rates leading to a significant rise in defaults could have broad implications for economic instability. Some subprime lenders underwrite adjustable rate loans only for the teaser rate, making default highly likely.¹⁰ Even prime lenders do not underwrite the loan for the maximum possible payment, but only for the fully indexed payment. The result is that neither consumers nor the market are taking the risk of interest rate increases into account, leading to major safety and soundness concerns. This is evidenced by Standard & Poor's requiring, as of last August, increased credit enhancements for option-ARMs.¹¹ Further, lenders do not disclose to the borrower that the borrower has not been qualified for the eventual payments she will need to make. Only the originator's investors are privy to such information.

Delinquency rates for subprime ARMs demonstrate the huge risk posed by nontraditional products. At the end of 2005, 12.63% of subprime ARMs nationwide were past due, more than 4.5 times the rate for prime ARMs.¹² An increase in interest rates can only magnify this problem. Subprime ARMs also are much more likely than subprime fixed rate mortgages to go into default, magnifying the already high rate of default among ARMs.¹³ Some local studies attribute a significant fraction of the increase in local foreclosure rates since the mid-1990s to subprime ARMs.¹⁴ In addition, a subprime borrower who refinances a first lien with an adjustable rate loan instead of a fixed rate

⁹ Below we discuss the various factors that should be considered when determining the affordability of a loan.

¹⁰ See, e.g., Aames Mortgage Trust 2001-1 Mortgage Pass-Through Certificates, Series 2001-1, Aames Capital Corporation as Sponsor, Countrywide Home Loans, Inc. as Servicer, Prospectus Supplement to Prospectus dated March 13, 2001, S-10.

¹¹ Remarks by Federal Reserve Governor Susan Schmidt Bies (Oct. 12, 2005), available at <http://www.federalreserve.gov/BoardDocs/Speeches/2005/200510122/default.htm>.

¹² Mortgage Bankers Association, National Delinquency Survey, Fourth Quarter 2005.

¹³ Statistical evidence suggests that subprime ARMs are significantly more likely to result in foreclosure than subprime fixed rate mortgages. Roberto Quercia, et al. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, January 2005, at 28-29 (subprime refinance ARMs are 50% more likely than fixed rate loans to result in foreclosure), available at www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

¹⁴ See, e.g., Lynne Dearborn, *Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000*, July 2003, p. 23 (from 1996 to 2000, the proportion of foreclosure judgments attributable to adjustable rate mortgages rose from 11% to 30%; at the same time, the proportion of fixed-rate foreclosure judgements decreased almost 20%).

mortgage is 25% more likely to experience foreclosure than a borrower whose loan has an extended prepayment penalty.¹⁵

The Inter-Agency Proposed Guidance

The major benefit offered by the proposed Guidance is the implicit warning regarding these products that the Guidance has elicited. Everyone in the mortgage lending community should now be aware that these products differ in a material way from the more traditional, fully amortizing mortgage product. This should have the effect of making lenders, investors, as well as consumers, at least somewhat more cautious when dealing with these products.

The benefits of the proposed Guidance, however, are limited. While the Guidance does have some mandatory requirements for those institutions covered by its terms (insured depository institutions), those requirements will have limited impact on the marketplace.

Not Enforceable By Consumers

The proposed Guidance is only that—a recommendation made by the agencies regulating some lenders. Failure to follow the Guidance does not lead to any enforceable sanctions. Even a consumer who has been directly harmed by an institution's failure to follow the explicit, modest requirements in the Guidance has no means of using it to obtain relief for that institution's failure.

Leaves Out The Most Essential Lenders

The proposed Guidance only covers depository institutions; it does not cover affiliates of depository institutions, the vast array of lenders who are not depository institutions, and the secondary market. Thus, to the extent that it does establish standards that might be helpful in the mortgage industry, it still does not apply to many sectors. This approach merely gives a competitive edge to unregulated institutions, those most likely to make such loans. Only mandatory, universal limitations on non-traditional products will effect the market change that is needed.

Provides Inadequate Consumer Protections

The substantive requirements of the proposed Guidance do not adequately protect consumers. First it should be noted that the institutions covered by the Guidance have all said in a public meeting that the Guidance will not require that they change their procedures in a meaningful way regarding the provision of nontraditional mortgage products.¹⁶ To the extent that depository institutions and their subsidiaries have been engaged in lending which was risky, these public admissions illustrate that the Guidance will not meaningfully change that scenario.

¹⁵ Quercia, *supra* n. 12, at 29.

¹⁶ Consumer Federation of America Meeting on Nontraditional Mortgage Products, January 26, 2006.

More importantly, while the Guidance does actually require a) specific underwriting requirements, and b) additional disclosures, these requirements do not adequately protect consumers.

Failure to Require Meaningful Underwriting

The proposed Guidance does require "fully indexed" underwriting. This means that if the mortgage product offers an initial teaser interest rate applicable to the mortgage products, that the lender must evaluate the borrower's ability to repay the loan based on what the payments will be if the teaser rate were not in effect. This underwriting requirement is certainly better than simply allowing the lender to evaluate the borrower's ability to make the initial payments, as some lenders do now. Unless, however, lenders underwrite for 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.

Most of these mortgage products bear at least four separate triggers for increasing the borrower's minimum monthly payments. Minimum underwriting standards should require that borrowers are evaluated for their ability to pay the monthly payments after all applicable triggers are applied:

- *Teaser rate.* The teaser rate will no longer be applicable on some adjustable rate mortgages, so that the applicable interest rate will increase, even if the underlying index for the interest rate has not increased.
- *Adjustable rate.* The interest rates on most of these mortgage products are adjustable. The ability of a borrower to repay an adjustable rate mortgage should be evaluated based on what the payments will be under the worst possible scenario—which means that the interest rate will increase at the fastest allowable rate under the mortgage.
- *Negative amortization.* The minimum payments for some products, for some periods of time on the mortgage, can be less than the amount of interest that is due. This means that the balance on these mortgages are likely to increase over time, rather than decrease, which in turn can lead to higher assessments of interest on the outstanding balance, and higher payments at later times during the mortgage.
- *Postponed principal payments.* Some of the mortgage products require that the loans become amortizing at some point during the loan term—significantly increasing the minimum monthly payment from either interest only, or in some cases, some amount less than interest, to an amount necessary to amortize the mortgage over a specific term. As noted above, some lenders only underwrite for the teaser rate and no lenders consider the maximum payment under the loan.

Purported Justification of "Stated Income" Loans

The proposed Guidance asks for comments on when it is permissible for loans not to require verification of income.¹⁷ In our opinion, the answer is "never." Everyone can supply either wage forms or tax returns. Stated income loans are really only a means for people who are telling mortgage companies that their income is something different from what they are telling the IRS. At the same time, stated income loans are the tool to put many less-sophisticated borrowers into loans they cannot afford. Stated income loans should never be permitted. Reduced requirements to verify income can instead be allowed, so long as independent verification is obtained. Underwriting standards should always require that income be verified and that it be adequate for: current loan payments; the increase in loan payments that could occur if all events which increase loan payments coincide; other known debt; other home-ownership related expenses (taxes and insurance); and reasonable living expenses (that is, that there be adequate residual income left over after the above expenses are met). The facile use of credit scores as a proxy for affordability deprives the consumer of this full analysis.

The "death of underwriting" is simply an avenue to strip home equity. Limited-documentation loans lead to more frequent delinquencies and defaults, and no-documentation loans are associated with even higher rates.¹⁸ Lending 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 and other means, there is little market incentive to ensure the affordability of the loans. Moreover, before the loan enters foreclosure, the equity can be further stripped through refinancings, increasing the collateral for the lender and removing any cushion for the borrower. This imbalance demands equity.

Insufficient Enhancement of Disclosures

The proposed Guidance recommends that improved disclosures be provided regarding the risks borrowers may face with the changing nature and amounts of payments. This is good, but not sufficient. Disclosures should be required which show both when and what the greatest potential monthly loan payment would be in order to avoid default on the mortgage—in other words, the maximum-minimum monthly payments, and the soonest possible date these payments may be required.

While this information will help certain borrowers better evaluate the risks of a loan, disclosures will never be sufficient to protect homeowners from underwriting failures by originators. Consumers often apply for fixed rate loans and believe they have a fixed rate

¹⁷ Seventy percent of loan pools rated by Standard and Poor's have less-than-full documentation. See Ruth Simon et. al, *Housing Bubble Doesn't Scare Off Foreigners*, Wall Street Journal (Aug. 24, 2005), at 1, 7.

¹⁸ Michelle A. Danis & Anthony Pennington-Cross, *Delinquency of Subprime Mortgages*, Working Paper 2005-022A, at 20, available at <http://research.stlouisfed.org/wp/more/2005-022/> ("Loans with limited documentation also are delinquent and default more frequently than full documentation loans. The impact for loans with no documentation is even larger.")

loan, only to discover upon the first payment adjustment that the loan was an ARM. Even consumers who knowingly obtain variable rate loans are not told the single most important piece of information that they need in order to evaluate the riskiness of the loan—the maximum potential payment. Most consumers minimize the interest rate risk by underestimating the amount by which payments are likely to increase.

Only substantive regulation can balance the scale. As is clear from the Consumer Federation of America July 2004 survey, most consumers cannot calculate the payment change for an adjustable rate mortgage. According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate went from 6% to 8% by approximately 30%. Younger, poorer, and less-educated respondents underestimated by as much as 50%.¹⁹ Most consumers minimize the interest rate risk by underestimating the amount by which payments are likely to increase.

Conclusion

As the proposed Guidance makes clear, the explosion in nontraditional mortgage products poses a serious risk to borrowers, their families and communities, as well as the stability of the market. While we believe that Guidance is inherently limited in its reach and strength, we applaud the Agencies' focus on the need for appropriate underwriting. It is only with substantive protections that equity stripping through the use of these products can be stopped. Enhanced disclosures can better inform people but can not solve this problem. We encourage the Agencies to fully consider the potential impending disaster that awaits as interest rates rise and monthly payments jump, and to require real, enforceable underwriting standards that consider foreseeable events and human risks. Thank you for your attention to this issue and for your consideration of our comments.

¹⁹ Press Release, *Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages*, at 3, Consumer Federation of America (July 26, 2004), available at <http://www.consumerfederation.org/releases.cfm#Consumer%20Literacy>.