

# COMMUNITY INVESTMENTS

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

**Preventing Foreclosure**  
Initiatives to Sustain Homeownership

**Calculated Risk**  
Assessing Nontraditional Mortgage Products

**Nontraditional Mortgage Guidance**

# COMMUNITY INVESTMENTS

This publication is produced by the Community Development Department of the Federal Reserve Bank of San Francisco. The magazine serves as a forum to discuss issues relevant to community development in the Federal Reserve's 12th District, and to highlight innovative programs and ideas that have the potential to improve the communities in which we work.

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## CI Notebook

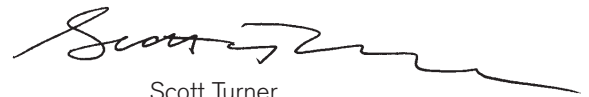
by Scott Turner

Research Manager

This issue of *Community Investments* is a special issue on homeownership preservation. Inside, we explore some of the recent trends in homeownership and mortgage lending, with special attention to the risks that have emerged through the increased availability of alternative mortgage products and expansion of the subprime market. The articles also examine policies and programs to prevent foreclosure and summarize the recent regulatory agency guidance on nontraditional mortgage products. We include a perspective from the Center for Responsible Lending, a research and policy organization dedicated to protecting homeownership and family wealth.

One of the priorities for the Community Development Department in 2007 is to support efforts to preserve homeownership. Our four regional managers—Jan Bontrager, Melody Winter Nava, Craig Nolte and Lena Robinson—welcome opportunities to help promote partnerships and programs that hold promise for building and sustaining household assets through homeownership. We encourage you to contact them with ideas for collaboration—their email addresses are on the left-hand column of this page, and their phone numbers are available on our website: <http://www.frbsf.org/community/mission.html>. We look forward to hearing from you.

All the best in the New Year,



Scott Turner

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## Home

By Tamara Simon

This issue's cover art is a painting entitled "Home", by Tamara Simon, an artist at the National Institute of Art and Disabilities (NIAD). NIAD is an innovative visual arts center assisting adults with developmental and other physical disabilities in Richmond, California. The NIAD program develops the capacity for creative expression in people with developmental and other physical disabilities, and provides a gallery and other exhibition opportunities for their work.



Tamara Simon came to NIAD in 1993 at the age of 22. Simon works at NIAD five days a week, where she paints, sculpts, and makes costumes and collages. Her work has appeared in numerous NIAD exhibits and at several Bay Area locations. Born and raised in the Richmond area, Simon's painting entitled "Home" was recently selected as one of four images reproduced as a card currently available at NIAD's gift store. She shows her home at night, filled with light and surrounded by stars.

For more information about NIAD and its artists, please visit their website at <http://www.niadam.org/index.html>.

# Homeownership at High Cost

## Recent Trends in the Mortgage Lending Industry

By Naomi Cytron and Laura Lanzerotti

Promoting homeownership has long been a policy priority in the United States. Because homeownership is thought to benefit not only individuals and families, but also communities and the nation as a whole, a number of federal, state, and local initiatives have been directed toward helping households achieve homeownership. Much progress has been made, and the past decade has seen a significant increase in homeownership rates. (See Figure 1.1) While national rates have started to come down slightly from a high of nearly 70 percent in 2004, the Joint Center for Housing Studies notes that among certain groups and in certain areas, homeownership rates have continued to climb even over the past year.

Most notably, minority and low-income households have achieved significant gains in homeownership. While gaps in homeownership between whites and minorities persist, minorities made up nearly 50 percent of the 12.5 million rise in the number of homeowners over the past decade.<sup>1</sup> Mortgage lending statistics from the early years of the recent housing boom are more telling about these gains; from 1993 to 1999, home purchase lending to white borrowers grew by just 42 percent, while lending to African-American borrowers increased by 98 percent and lending to Hispanic borrowers increased by 125 percent. The gains for lower-income households are equally notable; while the number of mortgage

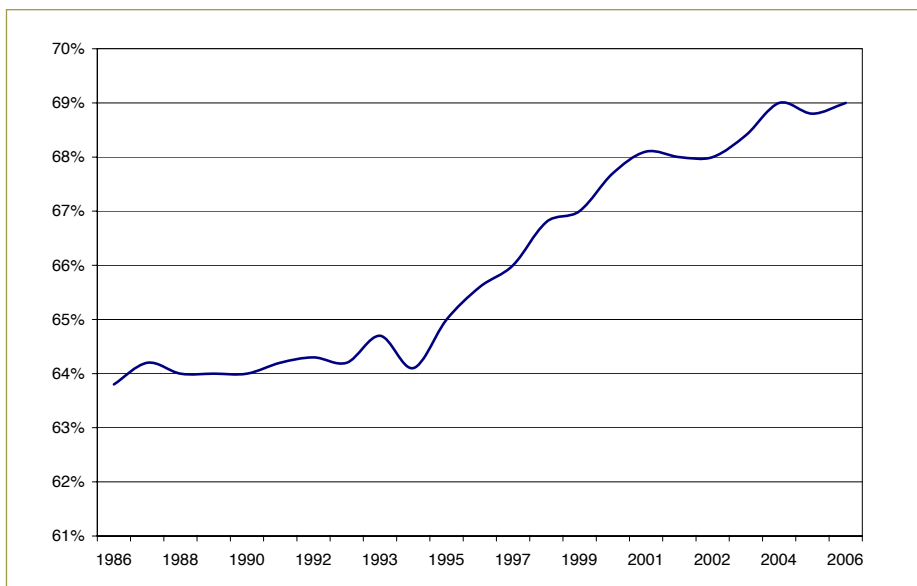
loans to high-income borrowers (those earning more than 120 percent of Area Median Income, or AMI) grew by 52 percent between 1993 and 1999, loans made to home buyers earning less than 80 percent of AMI grew by 94 percent.<sup>2</sup>

A number of factors have contributed to these gains, including economic growth, record low mortgage interest rates, and regulatory changes. Innovations within the mortgage industry have played a key role as well. Automated underwriting, risk-based pricing, and the expansion of the secondary mortgage market have increased access to and availability of credit, and have likely propelled recent gains in homeownership rates across the board.<sup>3</sup>

### Product innovation

Housing advocates, lenders, and regulators also point to mortgage product innovation for its role in boosting the availability of credit. While the U.S. mortgage market was dominated for decades by the 30-year fixed-rate mortgage, it now includes an array of products broadly referred to as nontraditional or alternative mortgage products (AMPs). Many of these products are variations of adjustable rate mortgages (ARMs) which trade off long-term stability in monthly housing costs for lowered initial monthly payments. Interest-only mortgages, for example, allow borrowers to defer repayment of the loan principle for a portion of the loan

Figure 1.1



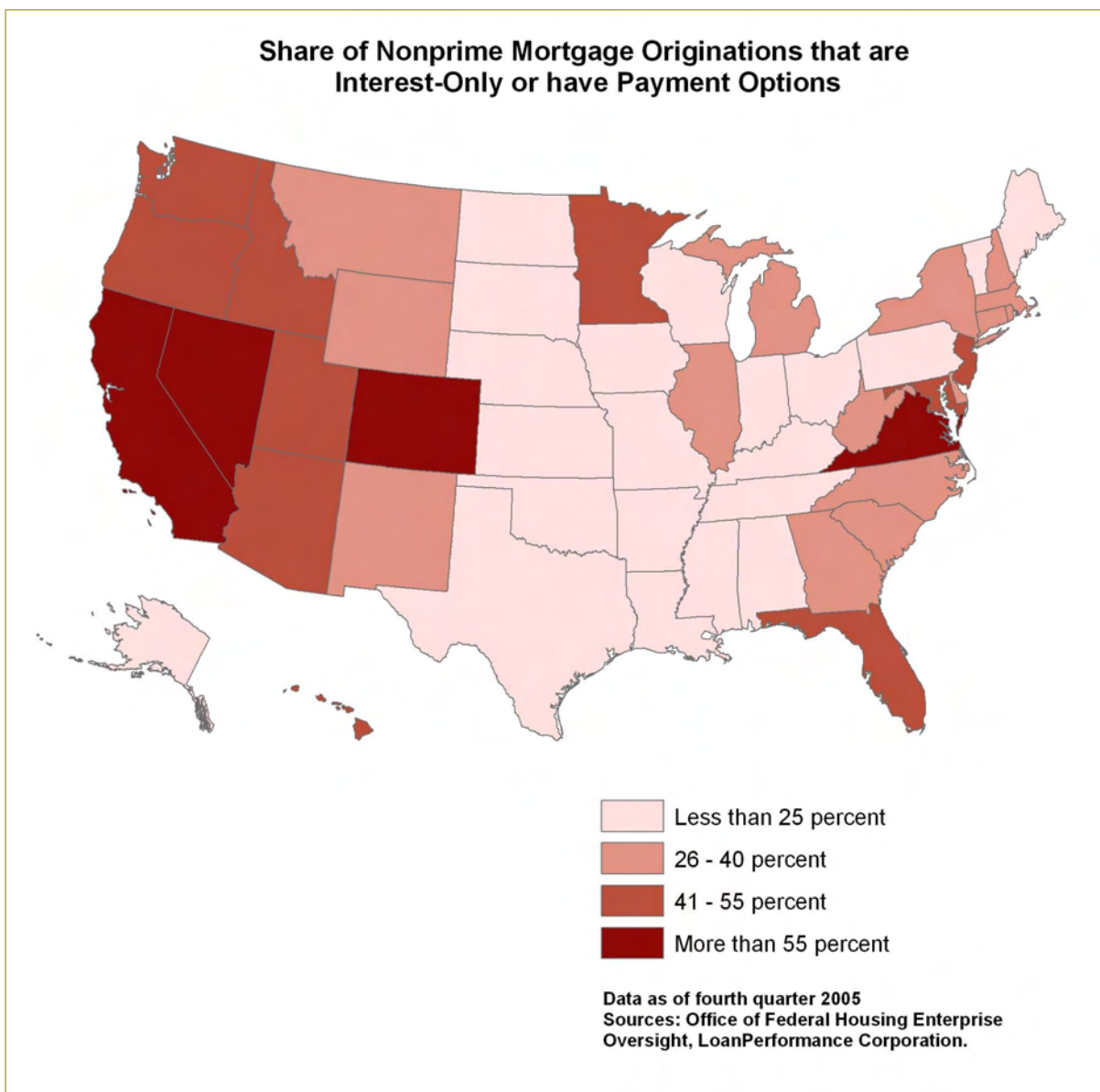
Homeownership Rate in the United States, 1986 – 2006 (Q3)

Source: U.S. Census.

## 12th District Trends in Mortgage Lending

Box 1.1

A number of analyses have indicated that states in the Federal Reserve's 12th District have seen particularly high uptake of nontraditional mortgage products. California, for instance, was reported to have the highest incidence in the nation in the percentage of total new and refinanced mortgages that have payment options.<sup>1</sup> Subprime mortgage originations that have payment options or are interest-only are especially common on the West Coast; an analysis by the Federal Deposit Insurance Corporation (FDIC) indicated that these types of products composed over half of the non-prime mortgages originated in California, Nevada, Washington and Arizona as of the 4th quarter of 2005.<sup>2</sup> Overall, the FDIC's analysis indicates that in states where home prices have surged in recent years, like those in the 12th District, a greater share of home buyers has opted for nontraditional mortgages to afford homes otherwise priced out of reach. Additionally, the FDIC notes that "despite favorable delinquency and default trends thus far, analysts fear that the current rising interest rate environment, combined with cooling home price appreciation, will limit borrowers' options when they face large monthly payment increases. Homeowners who have not built up sufficient equity to either cover the cost of refinancing or pay down additional debt could face delinquency, particularly in the subprime market."<sup>3</sup> Given the trends in the 12th District, these concerns merit further attention.



Unfortunately, the growth of subprime lending has been associated with an increase in what is termed “predatory” lending. There is no universally accepted definition of “predatory lending” that marks a bright line between what is predatory and what isn’t. A loan with particular features might be predatory for one borrower but appropriate for another. Whether or not a loan is predatory depends on the characteristics of the borrower, and the extent to which he/she will be able to repay the loan and is fully aware of the terms of the loan. It also depends on the characteristics and business practices of the lender. Despite not having a universal definition, there are a range of lending practices that raise concerns for regulators and consumer advocates: Was the lender transparent in disclosing the terms and fees associated with the loan? Did the lender steer the borrower toward a loan that was not in his/her best interest? In general, did the lender try to take advantage of borrowers’ lack of financial sophistication, for example, by targeting the elderly, minorities, and households with limited English proficiency? Predatory lenders may fit one or more of these characterizations.

Some of the other practices commonly associated with predatory lending are: structuring loans so that they are not in the best interest of the borrower; rapidly “flipping” loans;<sup>1</sup> charging exorbitant fees, and using fraudulent or deceptive practices to target and lure borrowers.

term before resetting to a fully amortizing payment schedule. Payment-option mortgages allow borrowers to structure their repayment schedule such that they can make minimum monthly payments that do not cover either the principle or interest, but rather add an unpaid portion to the balance of the mortgage. Lenders are also increasingly originating “piggyback” mortgages, which are second mortgages that reduce or replace down-payments, and low- and no-documentation loans, which require little or no verification of income.

The volume of AMP originations has tripled in recent years, growing from less than 10 percent of residential mortgages in 2003 to about 30 percent in 2005, according to a study released in September 2006 by the Government Accountability Office (GAO).<sup>4</sup> The GAO notes that these products were once offered primarily to wealthier borrowers or borrowers with irregular earnings as financial management tools, but have in recent years been more broadly marketed as “affordability tools” to less wealthy and less creditworthy borrowers in higher-priced real estate markets. (See Box 1.1: 12th District Trends in Mortgage Lending) These products allow borrowers to qualify for homes that they otherwise would not have been able to afford using more traditional mortgage products.

### *Subprime market expansion*

Another significant change has been the expansion of the subprime mortgage market. The subprime market provides credit to prospective borrowers who present more risk—for example, due to impaired credit histories—than those served by the prime market. (See Box 1.2: Predatory Lending) Lenders charge subprime borrowers a “risk premium” in the form of higher interest rates and additional fees.

Subprime lenders’ share of the mortgage market remains relatively small, but it has been growing rapidly. In 1994, subprime loans accounted for less than 5 percent of all mortgage originations; by 2005, subprime loans accounted for 20 percent of loan originations.<sup>5</sup> In terms of loan volume,

subprime loan originations grew from \$35 billion in 1994 to \$625 billion in 2005.<sup>6</sup> These increases have far outpaced growth in the originations and dollar value of loans made by prime lenders.<sup>7</sup>

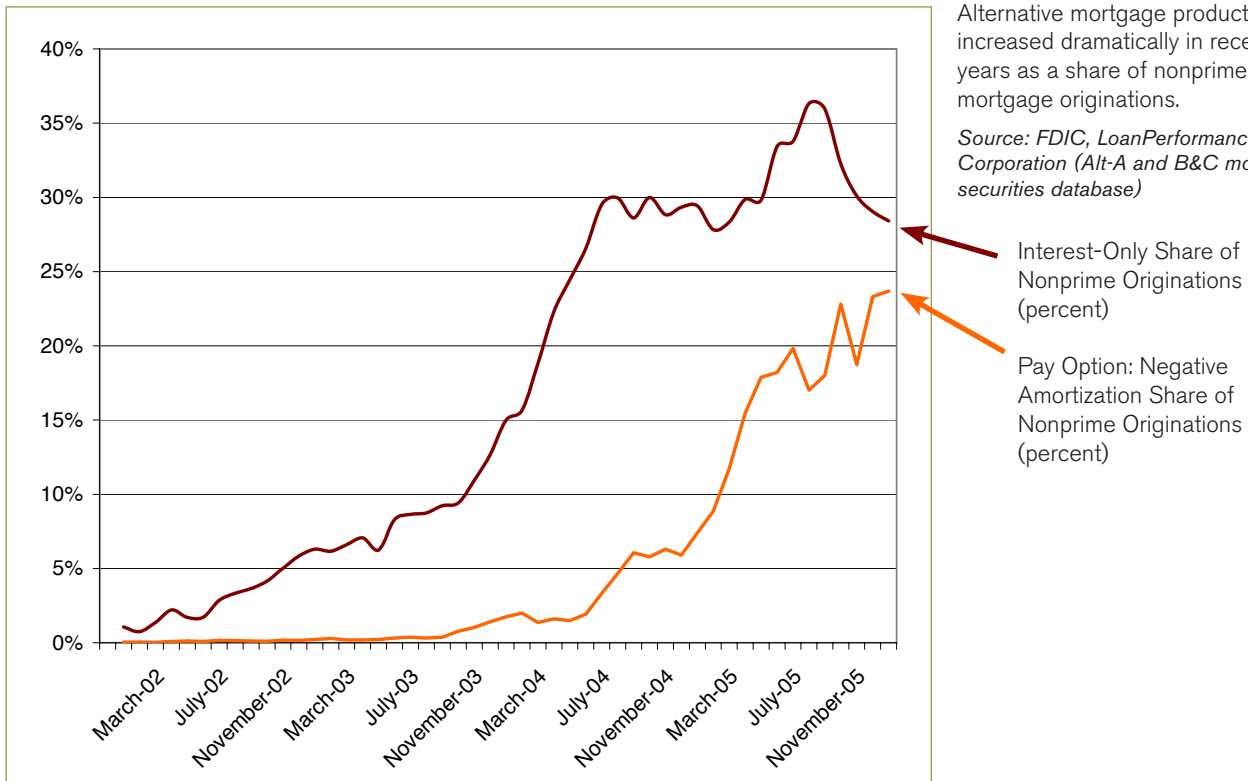
Mortgage product innovation and the growth in subprime lending are linked. Over the past several years there has been significant growth in the share of nonprime<sup>8</sup> originations that are interest-only or have payment options. The FDIC reported that in 2002, interest-only and pay-option ARMs represented only 3 percent of total securitized nonprime mortgage originations. However, during the past two years the interest-only share of credit to nonprime borrowers has risen to 30 percent of securitized nonprime mortgages, and the share of payment option products has similarly increased. (See Figure 1.2)

### **Are these gains sustainable?**

Many homebuyers have benefited from expanded access to alternative mortgage products and growth in the subprime market. The downside to these trends is that some of these households are put at risk of being burdened with loans that they cannot afford, and in some cases are paying more than they need to for their home loans. The extreme consequence for households in these circumstances is that they may lose their homes to foreclosure.

Many of the alternative mortgage products on the market allow borrowers to defer repayment of principal and/or interest for the first several years of the loan term. When the payments adjust to include these dues, however, borrowers may be faced with payment increases steep enough to be described as “payment shocks.” Consider the following case: If a borrower were to take out a \$180,000, 30-year, 6.4 percent loan that requires payment only of interest for the first five years, the monthly payment for the first five years would be \$960. However, this payment would jump to \$1,204 at the end of the five year period. If interest rates were to go up by 2 percent over the same time period, the payment would rise

Figure 1.2



to \$1,437.<sup>9</sup> This is a conservative example—many loans in the subprime market have artificially low “teaser rates” with amortization schedules that reset at the second year of the loan and adjust frequently thereafter for the life of the loan, which further complicates management of payments. (See article: Calculated Risk: Assessing Nontraditional Mortgage Products)

These types of payment shocks are of particular concern for low income-borrowers, who are increasingly devoting more than half of their income to housing costs; one-in-five first-time homebuyers have faced such a burden in recent years.<sup>10</sup> This trend is related both to rising housing costs and a growing tendency for lenders to allow higher debt-to-income ratios. Rather than limiting housing costs to the traditional maximum of no more than 30 percent of income, lenders are commonly qualifying homebuyers for loans that lead to housing costs of 40 to 50 percent of income.<sup>11</sup> It is easy to imagine that for low-income households living at the margins of their budgets, even small increases in monthly housing costs can have a significant effect on their ability to cover living expenses and keep up with their monthly payments.<sup>12</sup> If one considers the potential for other payment shocks, such as unforeseen medical expenses, the risks of default and foreclosure are even greater.

The costs of foreclosure are high. Borrowers are most directly affected by foreclosure, and risk losing not only their equity but also incurring additional penalties and fees. Over the long-term, the borrower may face higher credit costs in the future as a result of a lower credit score. Borrowers may also

suffer from non-financial costs such as emotional and physical stress; children in households that are forced to move as a result of foreclosure may also experience negative effects.<sup>13</sup>

Foreclosed and vacant properties also can affect the surrounding community and negatively impact local homeowners and businesses. In a study of foreclosures in Chicago in 1997 and 1998, researchers estimated that the cumulative effect of 3,750 foreclosures in those years was that nearby property values were reduced by a total of more than \$598 million.<sup>14</sup> For municipalities, costs may be imposed through an increased need for policing and fire protection, demolition contracts, and building inspections, and revenue may be lost due to diminished property taxes. Researchers studying FHA foreclosures in Minneapolis estimated that the average foreclosure costs the city \$27,000 and costs the neighborhood \$10,000.<sup>15</sup>

One of the key reasons for heightened concern about the expansion of subprime lending is its association with increased foreclosure risk. Recent data from the Mortgage Bankers Association show that as of the second quarter of 2006, 0.99 percent of all loans were in foreclosure. However, while the foreclosure rate for prime loans was 0.41 percent, the rate for subprime loans was nearly nine times as high at 3.56 percent.<sup>16</sup> In addition, a number of researchers have found a tendency for subprime lending to be more common in low-income and minority neighborhoods than in others.<sup>17</sup> Taken together, these factors point to the potential for concentrated risk of foreclosure in low-income and minority neighborhoods. (See Box 1.3: Foreclosure Risk in California)

Foreclosure is, however, only the most extreme endpoint for households with unmanageable mortgage payments. Even if homeowners do not end up losing their homes, there is concern that many households are simply paying more than they should for their loans. Put another way, the problem of redlining—the systematic denial of mortgage credit to individuals and groups in low-income and minority neighborhoods—has shifted; advocates are concerned less about access to credit and more about access to credit on fair and equal terms.

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*Advocates are concerned less about access to credit and more about access to credit on fair and equal terms.*

Data collected through the Home Mortgage Disclosure Act (HMDA) have indicated disparities in loan-pricing outcomes. Enacted in 1975, HMDA has been greatly expanded in recent years, both in terms of the institutions that are required to participate and in the information that they are required to submit. As of 2004, lenders are required to report pricing information for loans that are “high cost” at time of origination.<sup>18</sup> The 2005 HMDA data show that black and Hispanic borrowers are more likely, and Asians borrowers less likely, to obtain high-cost loans than are non-Hispanic white borrowers.<sup>19</sup> These disparities were greater than they had been in 2004. While the HMDA data do not include many of the factors considered by lenders in underwriting and pricing loans, these figures have increased concerns about the fairness of the lending process.

Researchers conducting more in-depth analysis of mortgage data have found that a large percentage of subprime borrowers are paying more for their home loans than necessary based on the credit risk they present to their lenders, and that many of these borrowers are low-income and minority households.<sup>20</sup> One researcher estimated that between 15 and 35 percent of subprime borrowers could have qualified for a prime rate loan; Fannie Mae and Freddie Mac have estimated that between 30 and 50 percent did not need to use the subprime market.<sup>21</sup>

Why would so many borrowers who could qualify for a lower rate end up paying more for their mortgage? Researchers point to both borrower- and lender-driven factors. Low-income and minority borrowers may have lower education levels and less familiarity with different types of mortgages,

which can result in either a misunderstanding of loan terminology or susceptibility to steering on the part of lenders. Lack of access to prime lenders may be another factor—if there are fewer prime lenders in a low-income or minority neighborhood, borrowers may not be able to “shop around” or may see higher-cost loans as their only option. There is also some concern that lenders may not be adequately informing borrowers of the true cost of the mortgage products they are selling, or that higher-priced products are being targeted toward lower-income and minority borrowers.<sup>22</sup>

### Future directions

Much of the research noted here points to heightened risk for lower-income and minority households seeking mortgages in the current housing market. However, a growing array of programs and policies is being directed at helping borrowers make choices that will lead to more sustainable patterns of homeownership. (See article: Preventing Foreclosure: Initiatives to Sustain Homeownership) In addition, regulatory guidance has been issued for financial institutions regarding the use of alternative mortgage products. (See article: Nontraditional Mortgage Guidance) However, there are a number of issues that still must be resolved in order to best help those looking to become homeowners. What are the most effective types of programs for educating first-time homebuyers? Should homeownership counseling also include efforts to dissuade would-be purchasers from buying a home if there is some risk of foreclosure? What kinds of safety nets could be built to protect households from vulnerability to payment shocks? How far should regulations go in restricting the extension of nontraditional mortgage products?

For many households, innovations in the mortgage market have served as a catapult for reaching the ranks of equity-building homeowners. But it is apparent that there are risks generated by these innovations that can push households to the brink of their budgets and threaten the sustainability of homeownership. Further attention must be paid to how low-income and minority borrowers enter and maintain homeownership in an effort to ensure that the benefits of homeownership to these individuals and the communities they live in are not unduly compromised. **□**

*Laura Lanzerotti recently received a Master of Public Policy degree from the Goldman School of Public Policy at UC Berkeley. She conducted research on high cost lending and foreclosure risk in California as part of her degree program, with sponsorship from the Federal Reserve Bank of San Francisco. She works for a nonprofit organization providing strategy consulting services to help other nonprofits and foundations achieve greater social impact.*

California provides an interesting opportunity for investigating patterns of high cost lending<sup>1</sup>, foreclosure risk, and the relationship between the two trends for several reasons. Rising prices in the housing market have not stifled Californians' interest in becoming homeowners. Many have entered the housing market by relying on subprime and high cost loans, and they are spending significant portions of their income on housing costs.<sup>2</sup> With so many people stretching so far to purchase a home, one might expect to see high rates of loan delinquency and default. However, in the last decade, the number of Notices of Default (an official record that a borrower is in mortgage default) has been at a historic low across the state. Within the context of California's strong housing market, homebuyers who find themselves unable to afford their mortgage payments have been able to sell or refinance. As a result, the equity-stripping effects and problematic aspects of high cost and predatory lending are masked. However, if the housing market continues to cool, as many have predicted, it is likely that many more households will be at risk of losing their greatest asset.

Since 2004, the number of Notices of Default in California has been rising. While it is too early to say whether this trend will continue, it is cause for concern. A relatively small percentage of homeowners who receive notices of default actually lose their home to foreclosure. However, in California, where actual foreclosures currently are rare occurrences, Notices of Default provide important information about the extent to which homeowners have home loans that they cannot afford.<sup>3</sup> To the extent that there are discernible patterns in terms of which communities are affected, these areas may serve as the proverbial canaries in the coalmine, indicating where households may face the most trouble in the event of a slowdown in the California housing market.

The study summarized here (the full report can be accessed at <http://www.frbsf.org/community>) set out to determine if there is a statistically significant relationship between the prevalence of high cost lending and foreclosure risk. Data on Notices of Default were analyzed for three California counties – Alameda, Fresno, and Riverside. The three selected counties are in different regions of the state, differ based on their socio-economic characteristics and housing markets, and also rank differently in terms of the levels of foreclosure risk and high cost lending that are present. Although they are not presumed to be representative of the state as a whole, the three counties were selected because they exemplify some of the diversity of California.

The results of this data analysis indicated that in Alameda, Fresno, and Riverside counties, high cost loans and Notices of Default are more concentrated in neighborhoods where there are higher percentages of minority residents, particularly those who are Black and Hispanic, and areas where median incomes are lower. Controlling for key socio-economic, demographic, and housing market characteristics, models that tested the relationship between high cost lending and foreclosure risk confirmed that there is a small but significant relationship between the two. In other words, there are larger numbers of Notices of Default in areas where there are more high cost loans, even after controlling for factors such as income and race. While it is difficult to determine whether the relationship is causal, there is enough information to suggest policy intervention could be beneficial and that these issues are worthy of further study.

### Directions of Causality

It is important to note that determining the extent to which there is a causal relationship between subprime lending and foreclosure starts, and, further, the direction of that causality, is quite challenging. Lenders argue that subprime borrowers present a higher foreclosure risk, and therefore, higher interest rates and fees are a legitimate approach to mitigating lenders' financial risk. On the other hand, subprime borrowers may be at greater risk of foreclosure because they are paying more for their home loans.

Findings of this research suggest some policy action, such as making pre-purchase counseling available to every California consumer before they obtain a high cost loan.

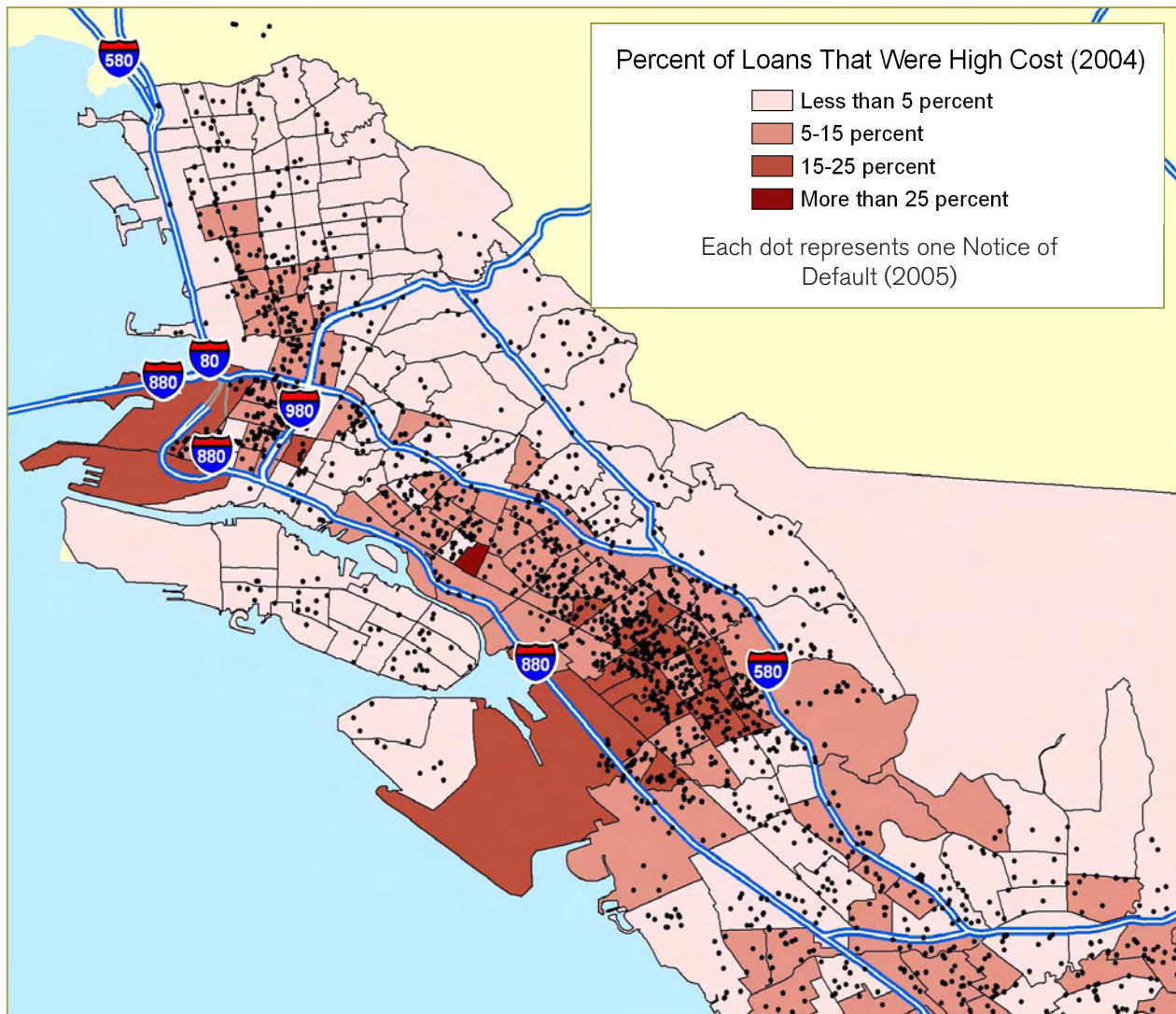
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This study also points to the need for further research, including learning from the experiences of other states that have restricted predatory and high cost lending and continuing to monitor and assess high cost lending and foreclosure risk in California. Suggestions for further research include:

- *Make full use of data that are available through the Home Mortgage Disclosure Act (HMDA).*
- *Continue efforts to study the relationship between borrower characteristics, loan terms, and loan performance.*
- *Develop non-proprietary datasets on Notices of Default and actual foreclosures in California.*
- *Conduct a qualitative study drawing on the expertise of housing counselors to understand why homebuyers default on their loans.*

While foreclosure rates are still at historic lows in the state, the level of high cost lending and recent increases in the number of Notices of Default within California signal that these are issues that merit more attention from policymakers and researchers than they have been receiving. Increasing the rate of homeownership among low-income and minority households in the state is a worthy goal, but it should not be achieved at such a high cost.



**Foreclosure Risk and High Cost Loans: Alameda County, CA**

# Preventing Foreclosure

## *Initiatives to Sustain Homeownership*

By Carolina Reid

In 2005, nearly 700,000 households entered the mortgage foreclosure process in the United States, and nearly 10 times as many households were behind on their mortgage payments.<sup>1</sup> While this represents a relatively low percentage of the total mortgages serviced, the costs of foreclosure can be substantial, and not only for the families who lose their homes. Research suggests that lenders can lose an average of \$44,000 to \$58,000 per completed foreclosure, depending on the circumstances.<sup>2</sup> And cities lose money too—estimates of losses to local municipalities range from \$400 to \$34,000 per foreclosure.<sup>3</sup> Foreclosures may have other negative impacts as well, as vacant properties can become sites of crime and distress.<sup>4</sup> Taken together, these consequences yield a strong rationale for lenders and local governments to work together with nonprofits and families to prevent foreclosure.

Within the Federal Reserve's 12th District, the issue of foreclosure prevention has not been as prominent as in some other parts of the country. The rapid rates of house price appreciation in California, Nevada, Arizona, Washington and Oregon have likely hidden borrower distress, since families delinquent on their mortgage payments have been able to sell their properties quickly and most likely at a profit. Overall, rates of delinquency and foreclosure in the 12th District are lower than the U.S. as a whole. Yet if the housing market

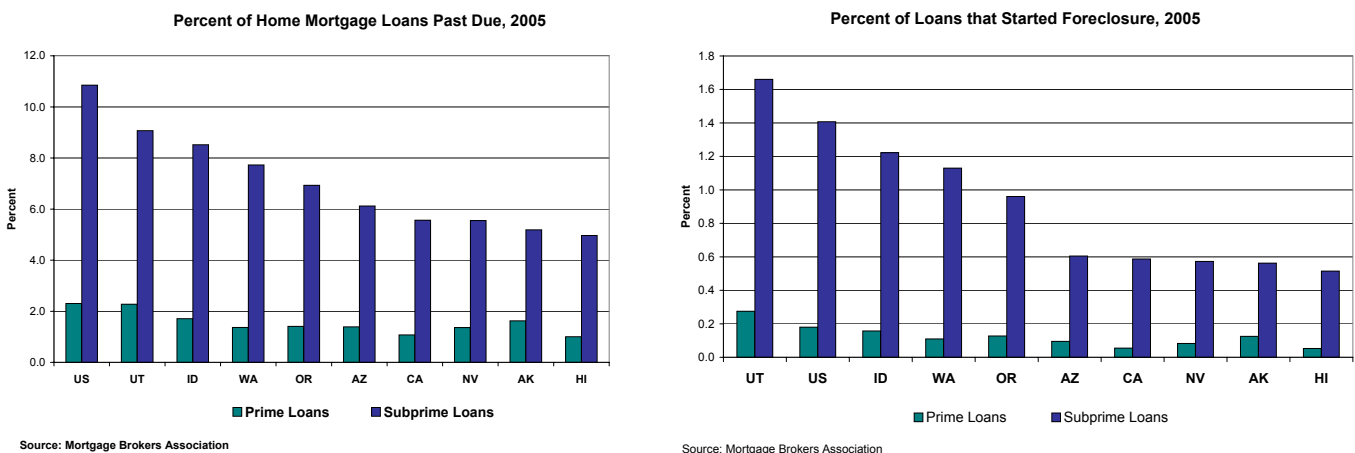
cools, and as adjustable-rate or interest-only mortgages reset, many borrowers may suddenly face mortgage default and foreclosure and risk losing the equity that they have gained. This is of particular concern for borrowers in the subprime market. (See Figure 2.1: Trends in Borrower Distress, The Federal Reserve's 12th District)

In this article, we look at some of the recent innovations in policies and programs across the country that address homeownership preservation. From pre-purchase homeownership counseling to state policies that help to limit predatory lending, these initiatives show the range of possible interventions and partners that can help to keep families in their homes. Expanding and replicating these efforts within the 12th District could help more families to keep their homes and to continue to build equity.

### Pre-Purchase Counseling

Given the bewildering array of mortgage products available—and the potential for falling victim to predatory lenders—there is a clear need for more pre-purchase homeownership counseling that will help families successfully navigate the mortgage market. Evidence suggests that as many as one-third to one-half of subprime borrowers could qualify for prime loans. Many borrowers—particularly low-income and minority families who have been traditionally excluded

Figure 2.1 Trends in Borrower Distress, The Federal Reserve's 12th District



from access to credit—lack the information they need to choose the best mortgage product for their financial situation.<sup>5</sup> For example, researchers have found that compared to prime borrowers, subprime borrowers are less knowledgeable about the mortgage process, less likely to search for the best mortgage rates, and less likely to be offered a choice among alternative mortgage terms and instruments.<sup>6</sup>

Pre-purchase homeownership counseling can help to mediate these information asymmetries and ensure that borrowers have the information they need to make good decisions. However, the evidence on the success of counseling is mixed.<sup>7</sup> One of the difficulties of measuring the impact of counseling programs is that the quality of counseling can vary, and researchers have pointed out that there is an important distinction between providing information and providing education.<sup>8</sup> Yet studies have found that counseling, particularly face-to-face counseling, can improve loan performance and lead to lower rates of delinquency and default.<sup>9</sup> Increasing the amount of funding available for homeownership counseling would increase the reach and impact of these programs.

Across the country, there are a number of consumer education initiatives that are designed to inform borrowers, increase their financial literacy, and protect them from predatory lenders. The U.S. Department of Housing and Urban Development (HUD) certifies agencies throughout the country that provide homeownership counseling.<sup>10</sup> Through these HUD-approved agencies, counselors are able to review loan disclosure statements with clients and assist them in understanding the terms and conditions of the loan they are considering. The Federal Housing Administration (FHA) also runs a Homebuyer Education Learning Program (HELP), which covers topics like budgeting, finding a home, getting a loan, and home maintenance. Completion of the program may entitle the homebuyer to a reduced initial FHA mortgage insurance premium.

For the vast majority of borrowers, however, education and counseling is only available if they seek it out proactively. One of the largest challenges facing the homeownership counseling field is reaching potential clients before they sign the loan documents. Increasingly, initiatives are developing large-scale marketing campaigns to educate consumers about mortgage lending. For example, to promote public awareness of predatory lending, Freddie Mac is rolling out a nationwide campaign called “Don’t Borrow Trouble”. In partnership with local governments and organizations, the campaign uses mailings, public service announcements, transit ads and television commercials to inform the public about predatory practices, and also provides referrals to counselors for additional support. (See Figure 2.2: “Don’t Borrow Trouble” Campaigns in the Federal Reserve’s 12th District)

In addition to educating consumers about the home buying process, a growing number of programs are focusing on post-purchase counseling, helping families *after* they’ve

### “Don’t Borrow Trouble” Campaigns in the Federal Reserve’s 12th District

#### Alaska

#### Arizona

Pima County

#### California

Los Angeles

Oakland

Sacramento

San Francisco

San José/Silicon Valley

#### Nevada

Reno/Northern Nevada

Las Vegas/Southern Nevada

#### Washington

Seattle/King County

bought a home. In Minnesota, the Emerging Markets Homeownership Initiative (EMHI) provides an interesting model that integrates both pre-purchase and post-purchase elements in its effort to help increase the homeownership rate among “emerging market” households,<sup>11</sup> including minorities and new immigrants.<sup>12</sup> EMHI’s goal is to decrease racial and ethnic disparities in homeownership by addressing the barriers to homeownership that emerging market households face. But, rather than seeing homeownership as the end goal, EMHI’s business plan recognizes the need to sustain homeownership after initial purchase. The program will build on existing networks of service providers in Minnesota to provide training on home maintenance, household budgeting, and counseling on emerging debt or mortgage payment issues. The initiative is also looking at ways to offer households financial assistance, such as short-term loans to cover unanticipated expenses or income shortfalls, to keep them in homeownership.<sup>13</sup>

### A Focus on Foreclosure Prevention

While counseling is clearly important, when families enter into mortgage default or foreclosure proceedings, a more intensive strategy is usually called for. Increasingly, nonprofit organizations and government agencies are partnering with lenders to develop foreclosure avoidance programs that work directly with distressed borrowers to help keep them in their homes. These programs generally combine public awareness and counseling components with mortgage workouts or rescue loans.

The Home Ownership Preservation Initiative (HOPI) in Chicago provides an excellent example of this approach. Launched in 2003 by Neighborhood Housing Services (NHS) of Chicago in partnership with the City of Chicago, the Credit Counseling Resource Center and private sector financial institutions, HOPI incorporates a public awareness campaign, phone and face-to-face counseling, loan workouts to help prevent foreclosure, and reclamation of foreclosed homes to restore them as neighborhood assets. Recognizing that one of the largest challenges is reaching distressed

In December 2003, Mr. Marigold<sup>2</sup> was at risk of losing his home of more than 20 years. A series of events—including unanticipated medical expenses and a refinancing based on a fraudulent appraisal—had left Mr. Marigold unable to make the payments on an 11.6 percent APR, \$67,500 loan, and unable to come up with the money to make the balloon payment of \$29,325 due in April. Rather than foreclosing on the property, however, Mr. Marigold's lender contacted the Consumer Rescue Fund (CRF). In collaboration with HSBC North America, the CRF was able to extend Mr. Marigold a loan of \$77,000—enough to cover both the previous loan and the balloon payment—at a low APR of 6.99 percent, and keep him in his home.

Mr. Marigold's story illustrates how the CRF can help borrowers who are at risk of foreclosure due to predatory loans. Launched by the National Community Reinvestment Coalition in 2001, the CRF has helped more than 1,000 consumers in 17 states preserve their homes.<sup>3</sup> The program is built on a strong partnership between NCRC, its member organizations, and HSBC North America. Often, the first line of defense is NCRC's member organizations, predominately housing counselors and community development corporations that work in the community. Through these community partners, NCRC's Fair Lending specialists learn about families facing foreclosure and review their loan documents including the Good Faith Estimate and income verification statements.

If the specialists conclude that the loans are predatory, there are a number of options to help the consumer, including:

- **Mediation.** NCRC will work directly with the lender or servicer to have abusive terms eliminated and to prevent foreclosure proceedings.
- **An affordable refinance loan.** NCRC has partnered with HSBC North America, which refinances the loans of predatory lending victims. The predatory loans are replaced with market-rate or below market-rate loans, and do not contain prepayment penalties, balloon payments, or credit insurance.
- **Litigation.** If NCRC discovers a pattern and practice of abusive lending or servicing on the part of a financial institution, NCRC will pursue legal redress and file a complaint with the Department of Housing and Urban Development.
- **Financial education.** NCRC will provide consumers with financial education as part of their case management work, guiding them through the remediation process and coaching them on how to avoid predatory lending situations in the future.

The CRF has had a significant impact on helping to preserve homeowner equity. A recent analysis shows that CRF rescue loans have helped to lower families' interest rates by an average of 3.84 percent, decreasing their monthly payments by an average of \$275 dollars. Particularly for low-income families, this reduction in the cost of credit can provide enormous benefits to household financial well-being and greatly increase the likelihood that they will keep their homes.

According to Josh Silver, the Vice President of Research and Policy at NCRC, one of the key challenges for CRF moving forward is to expand the scale at which the program operates. "We know that predatory practices are increasing, and we have a successful model that can help families preserve wealth," said Silver. "What we'd like to see now is the participation of additional lenders in the program, and to expand our reach in states like California and Nevada."

borrowers, HOPI launched a mortgage default hotline using Chicago's non-emergency "311" telephone service. In addition, the City of Chicago sent 25,000 postcards promoting counseling to targeted zip codes, and used public service announcements, media events and bus and subway advertisements to reach borrowers. To fund the initiative, NHS created a capital pool by establishing mortgage-backed certificates, funded with a three-year, \$100 million commitment from Chicago's financial community and \$3 million from the city's CDBG fund.<sup>14</sup> During the three year HOPI pilot phase, the program provided counseling and education to more than 4,300 families in Chicago, and helped to pre-

vent the foreclosure of more than 1,300 homes.<sup>15</sup>

NeighborWorks America, NHS's parent organization, recently launched the Center for Foreclosure Solutions to expand the HOPI model nationally. Beginning in Ohio, the Center is supporting a coordinated foreclosure prevention and intervention strategy in communities nationwide. The strategy entails a widespread public outreach campaign. In partnership with the Homeownership Preservation Foundation, the Center promotes a toll-free hotline (1-888-995-HOPE) that offers free foreclosure prevention services and counseling to consumers. In addition to raising public awareness, the Center is working to build the capac-

Financial institutions are important partners in efforts to help preserve homeownership, particularly among low- and moderate-income borrowers. Banks can receive CRA consideration for financial contributions that fund nonprofit credit counseling agencies that advise low- or moderate-income borrowers on homeownership issues. For example, financial contributions to programs like Chicago's HOPI "311" hotline and Freddie Mac's "Don't Borrow Trouble" can be CRA eligible when they help low- or moderate-income borrowers by providing financial counseling. Financial contributions from banks that help capitalize loan-rescue funds for low- or moderate-income borrowers mired in predatory loans can also receive CRA consideration. Participation in a loan-rescue fund that is part of a municipal plan to revitalize and stabilize a low- or moderate-income geography would also be viewed positively under CRA.

In addition, when banks must take a deed in lieu of foreclosure, the property can be donated, or sold at a discounted price, to a nonprofit community development organization for a qualified CRA purpose, such as providing affordable housing for low- or moderate-income homebuyers. For example, a bank could donate a vacant house to a nonprofit organization that would rehabilitate the property and sell it to a low- or moderate-income family for affordable housing. The transfer of such a property, when part of a formal revitalization and stabilization plan, also can help stabilize low- or moderate-income neighborhoods when the nonprofit resells the home to new residents, preventing further neighborhood deterioration.

Adapted from Karen Tucker (2006), "Compliance Corner—Homeownership: Preserving the American Dream", The Office of the Comptroller of the Currency *Community Development Investments Online*.

ity for foreclosure counseling at the local level, and is using research to help identify local "hotspots"—areas that are experiencing a high concentration of foreclosure activity—for targeted interventions.

Other organizations are also taking the lead on helping families and communities prevent foreclosure. The Consumer Rescue Fund, spearheaded by the National Community Reinvestment Coalition, focuses on helping families that have fallen victim to predatory loans. (See Box 2.1: The Consumer Rescue Fund) ACORN Housing—with local offices in Arizona, California, Nevada, Oregon and Washington—has similarly launched a nationwide foreclosure mitigation program.<sup>16</sup> Financial institutions—in addition to helping to fund a wide range of foreclosure prevention activities—have also begun to examine ways to help their own borrowers. (See Box 2.2: Asset Preservation Efforts and the Community Reinvestment Act) JPMorgan Chase, for example, has established a Homeownership Preservation Office designed specifically to help Chase mortgage customers who are delinquent or at risk of foreclosure.<sup>17</sup>

State and local governments are also developing innovative programs to help borrowers who are facing foreclosure. Perhaps the only program of its kind in the nation, Pennsylvania's Homeowners Emergency Mortgage Assistance Program (HEMAP) provides distressed borrowers with loans that bring their delinquent mortgage payments current to a specified date. For those who qualify, the program also offers continuing loans that subsidize borrowers' monthly mortgage payments for a set time period. Counseling agencies work out forbearance agreements with lenders and also counsel families regarding their financial situations. The program is funded by both state appropriations and the repayment of HEMAP loans.<sup>18</sup>

### State and Federal Policies and Regulations

While pre- and post-purchase counseling and foreclosure prevention initiatives are valuable components of a homeownership preservation strategy, there is also a place for policies and regulations that prohibit predatory lending practices. Certain lending practices, such as prepayment penalties and balloon payments, are more likely to lead to foreclosures than loans without those terms, even after controlling for key risk factors such as credit scores. Predatory lending—particularly with fraudulent intent—is a particularly serious problem that disproportionately affects low-income and minority borrowers. In these instances, access to credit works in direct opposition to the goals of asset building and community revitalization, and requires more intervention than just additional counseling.

Congress has enacted a wide range of federal laws and subsidy programs that affect the provision of credit and that serve to regulate and prohibit abusive lending practices. Michael Barr has usefully distinguished between the different regulations in the following way:<sup>19</sup>

- **Affirmative obligation**, like the Community Reinvestment Act (CRA), which encourages federally insured banks and thrifts to meet the credit needs of the entire communities that they serve, including low- and moderate-income areas;
- **Negative prohibition**, like the Equal Credit Opportunity Act (ECOA), which prohibits creditors from discrimination based on "race, color, religion, national origin, sex or marital status, or age";
- **Disclosure**, which can either serve to inform the consumer, like the Truth in Lending Act (TILA), or which

can increase the ability of the public, regulators, and fair lending enforcement agencies to assess whether lenders are engaged in discriminatory practices, like the Home Mortgage Disclosure Act (HMDA); and

- **Product regulation**, like the Home Ownership and Equity Protection Act (HOEPA), which imposes product restrictions on certain categories of loans.

Barr also notes that subsidies, such as government insurance through the Federal Housing Administration and flexible underwriting criteria for loan purchases by Fannie Mae and Freddie Mac, can influence the supply of credit for homeownership. As a whole, these regulations and subsidies have helped to increase access to credit in low-income and minority communities, combat discrimination, and address market failures. And as Barr points out, these laws can reinforce one another; for example, disclosure laws can be used to enhance negative prohibitions regarding racial discrimination.<sup>20</sup>

Yet, many advocates and researchers argue that existing regulations don't go far enough in protecting consumers. Some note that TILA, for example, has not lived up to its goal of standardizing disclosures on the total cost of credit, since many closing costs are currently excluded when computing finance charges and annual percentage rates.<sup>21</sup> HOEPA, while placing restrictions on high-cost loans, does not apply to home purchase mortgages. HOEPA's triggers have also come under critique as being too high.<sup>22</sup> The challenge for policy-makers, however, is to balance the desire for consumer protection with the desire to provide broad access to credit, particularly among low-income and minority borrowers. Determining the right level of intervention is particularly difficult in high-cost real estate markets like California, where many families wouldn't be able to get into homeownership at all without taking on high debt-to-income ratios or using nontraditional mortgage products.


Still, as the use of alternative mortgage products and subprime loans has grown, regulators and consumer advocates have expressed concern that consumers may not understand the risks of these products, and that there is a need to improve the clarity and comprehensiveness of disclosures.<sup>23</sup> The federal banking regulators recently issued interagency guidance on alternative mortgage product lending that discusses underwriting guidelines, portfolio and risk management, and consumer disclosure practices. (See article: Non-traditional Mortgage Guidance) The Federal Reserve Board is also in the process of an extensive review of Regulation Z, and is considering changes to both the content and format of mortgage disclosures to improve their effectiveness.<sup>24</sup> Legislative bills with varying degrees of control on predatory lending activities are also likely to be introduced during the 110th Congress.<sup>25</sup>

In the absence of additional federal regulations prohibiting predatory lending, some states and municipalities have developed local legislation that sets lower triggers than HOEPA, requires additional disclosures, and/or bans a broader array of abusive practices.<sup>26</sup> For instance, some prohibit prepayment penalties, limit broker "kickbacks" and excessive fees, restrict loan flipping, and ensure that homeowners have a right to pursue meaningful remedies against foreclosure. As of September 2006, 28 states had enacted laws to restrict predatory lending, including California, Nevada, and Utah in the Federal Reserve's 12th District.<sup>27,28</sup>

State laws restricting predatory lending practices vary in their design and stringency, and advocates like the Center for Responsible Lending are encouraging more states to develop legislation similar to that adopted in North Carolina. In 1999, North Carolina became the first state to enact legislation to curb predatory mortgage lending. Research assessing the impact of this legislation has been largely favorable, although not universally so. Two studies, using a subset of loan data from nine lenders, cite a decline in subprime mortgages in North Carolina and argue that reductions in predatory lending had been attained at the expense of legitimate subprime lending activity, particularly to low-income borrowers.<sup>29</sup>

Other researchers using larger datasets, however, have found that the reduction in subprime lending has been beneficial to consumers, in that the law has removed the riskiest loans without a concomitant decline in access to homeownership for low-income borrowers.<sup>30</sup> Researchers at the University of North Carolina, for example, found that from 1998 to 2002, North Carolina did see a reduction in subprime lending, but that the effect was almost entirely in refinance mortgages, with almost 90 percent of the decline attributable to a reduction in predatory loans.<sup>31</sup> As the researchers conclude, the experience in North Carolina shows that it is possible to develop laws that combat predatory lending without unduly restricting the flow of subprime mortgage credit.

## Conclusion

In recent years, increasing the opportunity for homeownership has been a policy priority at the federal, state and local level; within this context, high cost loans and elevated foreclosure risk are in direct conflict with the vision of homeownership as an asset-building opportunity for households and a stabilizing force in communities. Failure to protect consumers from predatory lending and prevent avoidable foreclosures could undermine much of the success that has been achieved in increasing the number of low-income and minority households that are now homeowners. Developing a comprehensive strategy to help sustain homeownership—particularly among low-income and minority homeowners—will ensure that homeownership remains a key vehicle for household financial security and neighborhood stability. 

# Calculated Risk

## *Assessing Nontraditional Mortgage Products<sup>1</sup>*

*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.<sup>2</sup> In recent years the subprime market has seen a rapid introduction of non-traditional 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,<sup>3</sup> while four in ten loans to Latino<sup>4</sup> 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.<sup>5</sup>

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.”<sup>6</sup> Hybrid ARMs made up 81 percent of the subprime sector’s securitization in the first half of 2006, up from 64 percent in 2002.<sup>7</sup> 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)

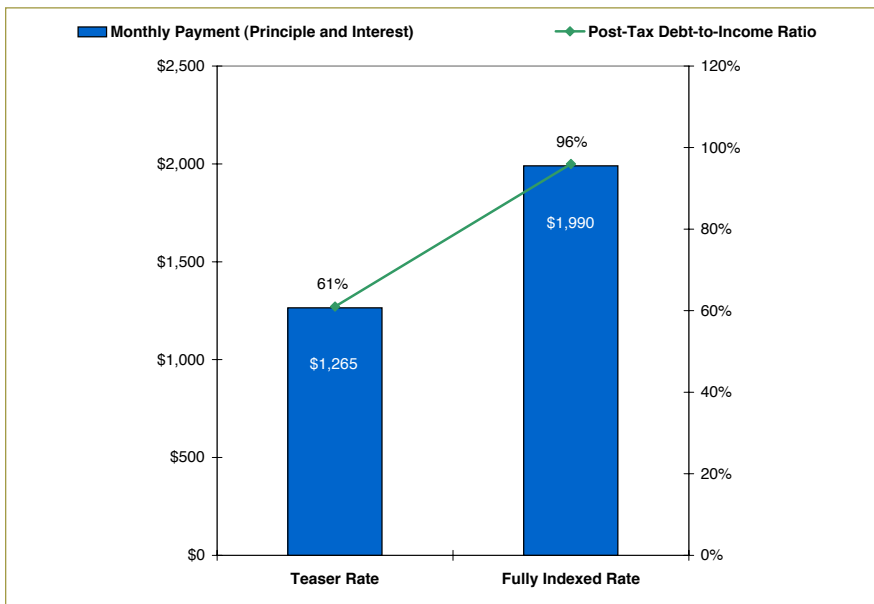
While interest-only loans are clearly of concern, representing one in four subprime loans,<sup>8</sup> the even more common 2/28 subprime mortgages themselves pose a significant risk to families. The low initial rate virtually guarantees that payments will rise significantly when the rate resets, even 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.<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> According to industry sources, only one in four subprime loans includes an escrow or impoundment account for property taxes and insurance payments.<sup>12</sup> 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.<sup>13</sup>

**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<sup>14</sup> 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.<sup>15</sup> 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.



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*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.<sup>16</sup> In addition, there is a well-documented relationship that shows that foreclosures increase as housing appreciation slows.<sup>17</sup>

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.<sup>18</sup> An astounding 11.32 percent of the subprime ARMs in Ohio were in foreclosure at the end of the second quarter of 2005.<sup>19</sup>

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 “non-traditional 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 31*

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.<sup>20</sup> (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.



# Nontraditional Mortgage Guidance

By John Olson

**O**n September 29, 2006, the federal financial institution regulators (the “Agencies”) issued the Interagency Guidance on Nontraditional Mortgage Product Risks.<sup>1</sup> The guidance was developed to clarify how institutions can offer nontraditional mortgage products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume. This article provides a brief summary of the guidance, but financial institutions should refer to the guidance itself for more information, and should work closely with their regulator in developing or changing systems, policies, and procedures in response to the guidance. Consumers and home-ownership counseling organizations may find this summary useful in understanding bank mortgage products as well as consumer rights and responsibilities.

## Background

The need for guidance on nontraditional mortgage products arose from the increasing popularity of mortgage products that allow borrowers to defer payment of principal and, in some cases, interest. These products include interest-only loans and payment option adjustable rate mortgages (ARMs) and contain the potential for substantial payment shock when the loans begin to fully amortize. Nontraditional mortgage products have been available for many years, but these products are now offered to a wider spectrum of borrowers by a much greater number of institutions.

The growth of these loans raises a series of pressing questions for regulators, lenders, and consumers: Do these loans pose special risks to lenders, and how are those risks best managed? Do consumers have enough information to make informed decisions about these products? Are consumers prepared for payment shocks when loans re-set, and do lenders appropriately account for payment shocks? Do these loans help certain segments of the population become homeowners, and would increased regulation inappropriately restrict access to credit? Alternatively, are these loans dangerous for some consumers, putting their dream of homeownership at risk, suggesting the need for more regulation?

## Overview

In response to these questions and concerns, the Agencies issued guidance to financial institutions to emphasize the importance of developing sound underwriting standards and portfolio risk management practices, and to recommend practices for consumer disclosure to ensure that borrowers

are informed about both the risks and the benefits associated with these products.

The guidance applies, in general, to “all residential mortgage loan products that allow borrowers to defer payment of principal or interest,” including interest-only mortgages and payment option adjustable-rate mortgages. The guidance asserts that financial institution management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making product choice.

The guidance is divided into three sections: Loan Terms and Underwriting Standards, Portfolio and Risk Management Practices, and Consumer Protection Issues, as detailed below.

## Loan Terms and Underwriting Standards

**Qualifying borrowers:** An institution’s qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value ratios, high debt-to-income ratios, and low credit scores. The criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower’s characteristics and the product’s attributes. For all nontraditional mortgage products, an institution’s analysis of a borrower’s repayment capacity should include an evaluation of their ability to repay the debt by final maturity and the fully indexed rate.

**Underwriting standards:** Nontraditional mortgages can be an effective financial management tool for some borrowers, but may not be appropriate for all borrowers. When qualifying borrowers for nontraditional mortgages, banks need to make sure the borrower is able to repay the loan. The guidance states that loans should be underwritten at the fully indexed rate, assuming a fully amortizing payment, including the additional payment burden from any negative amortization that can accrue.

**Collateral-dependent loans:** Institutions should avoid the use of loan terms and underwriting practices that may

heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.

**Risk layering:** Risk layering features such as limited documentation and simultaneous second liens should be accompanied by mitigating factors. Mitigating factors can include lower LTV and DTI ratios, higher credit scores, sufficient liquid assets or other credit enhancements.

**Reduced documentation:** Reduced documentation practices should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and payment capacity.

**Simultaneous second-lien loans:** Loans with minimal or no owner equity should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

**Introductory interest rates:** When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Because a wide initial spread means that borrowers are more likely to experience payment shock, institutions should minimize the likelihood of payment shock when setting introductory rates.

**Lending to subprime borrowers:** Mortgage programs that target subprime borrowers should follow the applicable interagency guidance on subprime lending.<sup>2</sup> Institutions should recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

### Portfolio and Risk Management Practices

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active management of these risks is especially important to institutions that have experienced, or project, significant growth or concentration levels. To meet the Agencies' expectations that institutions that originate or invest in nontraditional mortgages adopt more robust risk management practices, institutions should:

- Develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Design enhanced performance measures and management reporting that provide early warning for increased risk;
- Establish appropriate Allowance for Loan and Lease Losses (ALLL) levels that consider the credit quality of the portfolio and conditions that affect collectibility;

- Maintain capital levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility; and,
- Conduct stress tests on key performance drivers such as interest rates, employment levels and housing value fluctuations. Stress testing results should provide direct input in determining underwriting standards, product terms, concentration levels and capital levels.

### Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Institutions should provide consumers with clear, balanced, and timely information concerning the risks of nontraditional mortgage products, including the risks of payment shock and negative amortization. Clear information should be provided at critical decision times, such as when selecting a loan product or when choosing a monthly mortgage payment option—not just upon submission of an application.

Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. Applicable laws and regulations include the Truth in Lending Act (Regulation Z), which governs disclosures that institutions must provide, and Section 5 of the Federal Trade Commission Act, which prohibits unfair and deceptive acts or practices. Other laws, including the fair lending laws and the Real Estate Settlement Procedures Act, also apply.

**Communications with consumers:** Institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Institutions should alert consumers to potential increases in payments for nontraditional mortgages, such as when an introductory rate expires or because of a cap on negative amortization. Negative amortization and its impact on the consumer's loan balance and home equity should also be highlighted. If an institution offers loans with prepayment penalties or reduced documentation loans, the institution should highlight those features, including the premium for a reduced documentation loan. If the institution may impose a prepayment penalty, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

**Monthly statements on payment option ARMs:** Statements should enable consumers to make informed choices about their payment options, explaining the impact of each choice on the loan balance.

**Practices to avoid:** Institutions should avoid practices that obscure significant risks to the consumer. For example, if an institution emphasizes the comparatively lower initial payments, it should also provide clear and comparably prominent information alerting the consumer to the risks.

Institutions should avoid promoting payment patterns that are unlikely to occur. Institutions should also avoid making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products, suggesting that initial minimum payments will cover accrued interest charges, and making misleading claims that interest rates or payment obligations for these products are “fixed.”

**Control systems:** Institutions should put systems in place to ensure that their practices are consistent with the guidance. Among other things, institutions should not use compensation programs that improperly encourage lending personnel to direct consumers to particular products. Institutions that make, purchase, or service loans through third parties should take appropriate steps to mitigate risks relating to consumer protection discussed in the guidance. These

## Comments on Interagency Guidance on Nontraditional Mortgages

Box 41

On December 20, 2005, the Agencies issued for comment proposed guidance on nontraditional mortgage products. The comment period ended on March 29, 2006, and the final guidance was issued on September 29, 2006. Over 60 comments were received by the Agencies, and comments letters are publicly available on the Federal Reserve's website.<sup>1</sup> Comment letters from several prominent organizations are highlighted below.

### American Bankers Association (ABA)

While the ABA also pointed out that the consumer protections in the guidance would apply only to regulated financial institutions, it listed a number of its own concerns about the guidance. The ABA asserted that the proposed guidance “overstates the risks of these mortgage products,” would be overly prescriptive, and would inappropriately combine safety and soundness guidance with consumer protection guidance. The ABA also expressed concern that the guidance would result in compliance problems by creating an additional layer of disclosure on top of what is required by Regulation Z and RESPA; it suggested that “the Agencies agree on a generic consumer brochure explaining the risks of both interest-only and option ARMs...and specify a practical time when a lender should give the consumer the standard disclosure brochure.”

### California Reinvestment Coalition (CRC)

While generally supporting the proposed guidance, CRC's comment letter raised several areas of concern about the guidance and about the market for nontraditional loans. “CRC would argue against combining stated income loans or loans with reduced income documentation with *any* nontraditional mortgages and/or subprime mortgages” (emphasis in original). CRC also asked that the Agencies give greater guidance to secondary market participants because it “believes that much of the clamor for these products comes not from borrowers but from investors.” CRC also advocated for a closer link between the guidance and the CRA, citing a Federal Reserve analysis of HMDA data that showed that lending within banks' CRA assessment areas showed significantly smaller race disparities than lending outside the assessment areas.

### Mortgage Bankers Association (MBA)

The MBA expressed concern that the proposed guidance would be overly prescriptive, would introduce an inappropriate third-party oversight standard for depository institutions, and that the guidance does not sufficiently use the authority of the Federal Reserve to improve consumer disclosure. The MBA stated that it is “concerned that these deficiencies will stifle mortgage product innovation and hurt consumers' access to homeownership financing.” While agreeing with the Agencies' recommendation that borrowers should not be underwritten at a teaser rate, the MBA asserted that “the proposed guidance goes too far in detailing underwriting standards,” and will “force lenders to apply credit policies inconsistent with risk.” The MBA also expressed concerns in the consumer protection area, stating that guidance would create “an even more duplicative and fragmented system than the current one and will arguably add confusion rather than clarity.”

### National Consumer Law Center (NCLC)

NCLC called the proposed guidance 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 organization urged the Agencies to focus on the risk to consumers inherent in these products, rather than the risk to lenders. The deficiencies in the guidance alleged by NCLC included the fact that the guidance would not be enforceable by consumers seeking relief from a lender that had not conformed to the guidance; that the guidance would not apply to lenders that are not depository institutions; that the guidance would provide inadequate consumer protections; and that the guidance would fail to require meaningful underwriting (by not requiring “fully indexed” underwriting). While NCLC applauded the Agencies focus on the need for appropriate underwriting, it found the proposed guidance to be “inherently limited in its reach and strength.”

steps would include, for example, monitoring third parties' compliance with agreements and bank policy, and taking corrective action if the third party does not comply.

### **Guidance for Non-bank Entities**

As noted in several comments to the Agencies on the proposed guidance (See Box 4.1), while nontraditional mortgages are offered by a range of institutions, including many non-bank lenders, the Agencies' guidance applies only to insured depository institutions. Since the issuance of the guidance, however, several other regulatory and supervisory entities have issued similar guidance for other participants in the nontraditional mortgage market.


#### *State Supervisors*

In a comment letter responding to draft guidance, Neil Milner, President and CEO of the Conference of State Bank Supervisors (CSBS), wrote: "As the Interagency Guidance is directed towards insured financial institutions and their subsidiaries and their affiliates, it appears that nonbank lenders, most of which are licensed and regulated by state authorities and control a large share of the mortgage origination market, may not be subject to this proposal. CSBS will encourage its members to determine the best course of action for distributing this Guidance, or guidance that is similar in nature and scope, to the financial service providers under their supervision."<sup>3</sup> Indeed, the CSBS and the American Association of Residential Mortgage Regulators jointly distributed guidance to their state agency members that "substantially mirrors" the federal guidance.<sup>4</sup>

#### *Fannie Mae and Freddie Mac*

On December 13, 2006, the Office of Federal Housing Enterprise Oversight (OFHEO) "directed Fannie Mae and Freddie Mac to immediately take action to support practices outlined in an interagency guidance on nontraditional mortgage product risks."<sup>5</sup> Director James B. Lockhart stated that Fannie and Freddie adopting the principles of the guidance into their risk management and business practices will enhance industry underwriting standards, risk management, and consumer protection. Fannie and Freddie are expected to report progress on developing policies in line with the guidance by February 27, 2007.

### **Conclusion**

The interagency guidance on nontraditional mortgages is barely two months old. Consumers, lenders, and industry observers will surely be sensitive to the impact of the guidance on the marketplace over the coming months and years. Bankers need to understand and conform to the guidance, other lenders will surely be sensitive to the ongoing effort by states and other entities to adopt the guidance, consumers need to understand and assert their rights under the law and get the information they need to make good decisions in the mortgage market, and industry observers will need to monitor the impact of this guidance on the nontraditional mortgage market. The concerted and collaborative effort of these groups, along with the Agencies, will help ensure a nontraditional mortgage market that is safe, fair, and profitable on both sides of the table. 

**Adjustable rate mortgage (ARM):** A mortgage that does not have a fixed interest rate. The rate changes during the life of the loan in line with movements in an index rate, such as the rate for Treasury securities or the Cost of Funds for SAIF-insured institutions. ARMs are also known as adjustable-mortgage loans (AMLs) or variable-rate mortgages (VRMs).<sup>1</sup>

**Annual percentage rate (APR):** A measure of the cost of credit, expressed as a yearly rate. It includes interest as well as other charges. Because all lenders follow the same rules when calculating the APR, it provides consumers with a good basis for comparing the cost of loans, including mortgages.<sup>2</sup>

**Amortization:** The gradual repayment of a mortgage loan by making regular payments over time. To be “fully amortizing,” payments must cover both the principal amount and interest due on the loan for the given period. An amortization schedule is an established timetable for making payments.<sup>3</sup>

**Balloon mortgage:** A mortgage with monthly payments based on a 30-year amortization schedule, with the unpaid balance due in a lump sum payment at the end of a specific period of time (usually 5 or 7 years). The mortgage contains an option to “reset” the interest rate to the current market rate and to extend the due date if certain conditions are met.<sup>4</sup>

**Binding mandatory arbitration (BMA):** A clause in a loan contract that requires the borrower to use arbitration to resolve any legal disputes that arise from the loan. Mandatory arbitration typically means borrowers lose their right to pursue legal actions, including any appeals, in a court of law.<sup>5</sup> To learn more about mandatory arbitration, visit [www.responsiblelending.org/issues/arbitration](http://www.responsiblelending.org/issues/arbitration).

**Cap:** A limit on how much the interest rate or the monthly payment may change, either at each adjustment or during the life of the mortgage.<sup>6</sup>

**Conversion clause:** A provision in some ARMs that allow the borrower to change the ARM to a fixed-rate loan at some point during the term.<sup>7</sup>

**Forbearance:** The lender’s postponement of legal action when a borrower is delinquent. It is usually granted when a borrower makes satisfactory arrangements to bring the overdue mortgage payments up to date.<sup>8</sup>

**Fixed-rate mortgage:** A mortgage with payments that remain the same throughout the life of the loan because the interest rate and other terms are fixed and do not change.<sup>9</sup>

**Good faith estimate:** The Real Estate Settlement Procedures Act (RESPA) requires the mortgage lender to give borrower a good faith estimate of all the closing costs within 3 business days of submitting the application for a loan, whether the borrower is purchasing or refinancing a home. The actual expenses at closing may be somewhat different from the good faith estimate.<sup>10</sup>

**Hybrid loan:** A loan with a combination of interest rates. There are two different types of hybrid loan: those that begin as ARMs and convert to a fixed rate and those that begin as a fixed-rate loan and convert to an ARM. A common type of hybrid is the “2/28” ARM, which comes with an initial short-term fixed interest rate for two years, followed by rate adjustments, generally in six-month increments for the remainder of the loan’s term.<sup>11</sup>

**Home Mortgage Disclosure Act (HMDA):** Enacted by Congress in 1975, HMDA requires most mortgages lenders located in metropolitan areas to collect data about their housing-related lending activity, report the data annually to the government, and make the data publicly available. Initially, HMDA required reporting of the geographic location of originated and purchased home loans. In 1989, Congress expanded HMDA data to include information about denied home loan application, and the race, sex, and income of the applicant or borrower. In 2002, the Federal Reserve Board amended the regulation that implements HMDA (Regulation C) to add new data fields, including price data for some loans.<sup>12</sup>

**The Home Ownership and Equity Protection Act (HOEPA):** Enacted as a part of the Truth-in Lending Act, HOEPA prohibits extending credit without regard to a consumer’s repayment ability. HOEPA identifies a high-cost mortgage loan through rate and fee triggers, and it provides consumers entering into these transactions with special protections. HOEPA applies to closed-end home-equity loans (excluding home-purchase loans) bearing rates or fees above a specified percentage or amount.<sup>13</sup> Visit the Board of Governors of the Federal Reserve System for more information: <http://www.federalreserve.gov/events/publichearings/hoepa/2006/default.htm>.

**Interest-only mortgage:** In a nontraditional, interest-only (IO) mortgage, the borrower is required to pay only the interest due on the loan for the first few years during which time the rate may be fixed or fluctuate. After the IO period, the rate may be fixed or fluctuate based on the prescribed index; payments consist of both principal and interest.<sup>14</sup>

**Loan servicing:** The tasks a lender performs to protect a mortgage investment, including collecting monthly payments from borrowers and dealing with delinquencies.<sup>15</sup>

**Loan flipping:** “Loan flipping” refers to the practice of encouraging borrowers to rapidly refinance loans. Loan flipping may result in a loss of equity and an increase in monthly payments because refinancing involves fees and often these charges are refinanced into the amount of the loan.<sup>16</sup>

**Loan modification:** A permanent change in one or more of the terms of a mortgagor’s loan, allows the loan to be reinstated, and results in a payment the mortgagor can afford.<sup>17</sup> For more information on loan modifications, visit HUD at [www.hud.gov/offices/hsg/sfh/nsc/faq/m.cfm](http://www.hud.gov/offices/hsg/sfh/nsc/faq/m.cfm).

**Loss mitigation:** A process to avoid foreclosure; the lender tries to help a borrower who has been unable to make loan payments and is in danger of defaulting on his or her loan.<sup>18</sup>

**Negative Amortization:** Occurs when monthly mortgage payments do not cover all the interest owed. The interest that is not paid in the monthly payment is added to the loan balance.<sup>19</sup>

**Partial claim:** Under the Partial Claim option, a mortgagee will advance funds on behalf of a mortgagor in an amount necessary to reinstate a delinquent loan (not to exceed the equivalent of 12 months PITI). The mortgagor will execute a promissory note and subordinate mortgage payable to HUD. Currently, these promissory or “Partial Claim” notes assess no interest and are not due and payable until the mortgagor either pays off the first mortgage or no longer owns the property.<sup>20</sup> Visit HUD’s website to learn more about partial claims, [www.hud.gov/offices/hsg/sfh/nsc/faqpc.cfm](http://www.hud.gov/offices/hsg/sfh/nsc/faqpc.cfm).

**Payment-Option Adjustable-Rate Mortgage:** A payment-option adjustable rate mortgage—also known as a flexible-payment ARM, pay-option ARM, option ARM, or PO—is considered nontraditional in that it allows the borrower to choose from a number of payment options. For example, the borrower may choose either a minimum payment option each month based on an introductory interest rate, an IO payment option based on the fully indexed interest rate, or a fully amortizing principal-and-interest payment option based on a 15- or 30 year loan term plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The IO option avoids negative amortization but does not allow principal amortization. After a certain number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is refigured to require payments that will fully amortize the outstanding balance over the remaining loan term.<sup>21</sup>

**Piggyback loan:** Also known as a simultaneous second-lien loan, a lending arrangement where either a closed-end second lien or a home equity line of credit is originated at the same time as the first-lien mortgage loan, usually taking the place of a larger down payment.<sup>22</sup>

**Points and fees:** Costs to borrowers that are not directly reflected in interest rates. “Points” or “discount points” are fees calculated as a percentage of the loan principal; one point equals one percent of the principal. Fees may include compensation to a broker, charges by the lender, and third-party charges for appraisals, title insurance, etc. High points and fees are frequently the hallmark of a predatory loan, and they can disguise the real cost of credit when they are financed rather than paid outright at a loan closing.<sup>23</sup>

**Preforeclosure sale:** A procedure in which the borrower is allowed to sell his or her property for an amount less than what is owed on it to avoid a foreclosure. This sale fully satisfies the borrower’s debt.<sup>24</sup>

**Predatory lending:** A term for a variety of lending practices that strip wealth or income from borrowers. Predatory loans typically are much more expensive than justified by the risk associated with the loan. Characteristics of predatory loans may include, but are not limited to, excessive or

hidden fees, charges for unnecessary products, high interest rates, terms designed to trap borrowers in debt, and refinances that do not provide any net benefit to the borrower.<sup>25</sup> Learn more about predatory lending at [www.dontborrowtrouble.com/en/anti\\_predatory.html](http://www.dontborrowtrouble.com/en/anti_predatory.html).

**Prepayment penalty:** A fee charged by a lender when a borrower pays off a mortgage before all payments are due, often to refinance the loan at a more affordable rate. Prepayment penalties vary in size and how long they remain in effect.<sup>26</sup>

**Real Estate Settlement Procedures Act (RESPA):** RESPA requires that consumers receive disclosures at various times in the transaction and outlaws kickbacks that increase the cost of settlement services. RESPA is a HUD consumer protection statute designed to help homebuyers be better shoppers in the home buying process, and is enforced by HUD.<sup>27</sup> For complete information about RESPA, go to [www.hud.gov/offices/hsg/sfh/res/respamor.cfm](http://www.hud.gov/offices/hsg/sfh/res/respamor.cfm)

**Reduced documentation:** A reduced-documentation loan feature is commonly referred to as a “low doc/ no doc,” “no income/no asset,” “stated income,” or “stated assets” feature. When applied to mortgages, a lender sets reduced or minimal documentation standards to corroborate a borrower’s income and assets.<sup>28</sup>

**Regulation Z:** The Federal Reserve Board of Governors has adopted Regulation Z to implement the Truth-in-Lending Act. The regulation has specific requirements giving some borrowers the right to rescind certain loans and very specific requirements about how banks must disclose rescission rights. The regulation also includes very detailed requirements for calculating and disclosing annual percentage rates for many loans.<sup>29</sup> Visit the Federal Reserve Board of Governors at [www.federalreserve.gov/events/publichearings/hoepa/2006/default.htm](http://www.federalreserve.gov/events/publichearings/hoepa/2006/default.htm) for more information.

**Steering:** The practice of encouraging borrowers to accept higher-cost sub-prime loans even when they qualify for a more affordable prime loan.<sup>30</sup>

**Truth-in Lending Act (TILA):** Congress enacted the Truth-in-Lending Act (TILA) to allow consumers to assess the true cost of credit, and encourage free competition between lenders. One of the key provisions of TILA is the requirement to disclose a loan’s annual percent rate. Overdraft loans have been exempted from this requirement, allowing financial institutions to charge high interest rates without disclosing them.<sup>31</sup> (See Regulation Z.)

**Underwriting:** A lender’s process for assessing the risk involved in making a mortgage loan to determine whether the risk is acceptable. Underwriting involves an evaluation of the value of the property and the borrower’s willingness and ability to repay the loan.<sup>32</sup>

**Yield spread premium:** A payment a mortgage broker receives from a lender for delivering a loan with an interest rate higher than the minimum rate the lender would accept for that particular loan.<sup>33</sup> Learn more about yield spread premiums at the Center for Responsible Lending’s website: [www.responsiblelending.org/issues/mortgage/ysp.html](http://www.responsiblelending.org/issues/mortgage/ysp.html).



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

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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).
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### 12th District Trends in Mortgage Lending – Box 1.1

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- 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](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](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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- 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>.
- 11 Emerging markets are defined as households of color, non-English speaking households, and households in which English is a second language.
- 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*.
- 13 For more information on EMHI's goals and participating organizations, see the EMHI Business Plan at [www.mhfa.state.mn.us/about/EMHI\\_Business\\_Plan.pdf](http://www.mhfa.state.mn.us/about/EMHI_Business_Plan.pdf).
- 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*.
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- 17 D. Sheline (2006). "Sustaining Homeownership and Communities," *Community Developments Online*, Spring 2006. Office of the Comptroller of the Currency.
- 18 Silver J. and Williams M. (2006), *Asset Preservation: Trends and Interventions in Asset Stripping Services and Products*, National Community Reinvestment Coalition and The Woodstock Institute.
- 19 Barr, M.S. (2005). "Modes of Credit Market Regulation," in *Building Assets, Building Credit: Creating Wealth In Low-Income Communities*, Retsinas, N. & E. Belsky, eds. Brookings Press. P. 206-236.
- 20 Barr, M.S. (2005).
- 21 Engel, K.C. and McCoy, P.A. (2001). *A Tale Of Three Markets: The Law And Economics Of Predatory Lending*. Cleveland-Marshall College of Law, Cleveland State University.
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- 23 United States Government Accountability Office (2006). *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could be Improved*. GAO-06-1021.
- 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.
- 25 For an analysis of the differences between HR 1182, Prohibit Predatory Lending Act (Miller-Watt-Frank) and HR 1295, Responsible Lending Act (Ney-Kanjorski), the two pieces of legislation introduced during the 109th Legislative Session, visit <http://www.responsiblelending.org/issues/mortgage/policy/page.jsp?itemID=29837365>
- 26 Quercia, R.G., Stegman, M.A., and Davis, W.R. (2004). "Assessing the Impact of North Carolina's Predatory Lending Law," *Housing Policy Debate* 15(3): 573-601.
- 27 Other states with predatory lending laws include Arkansas, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, and Wisconsin.
- 28 Information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, A Washington, D.C., law firm that tracks predatory lending legislation, and is current as of September 8, 2006.
- 29 Elliehausen, G. and Staten, (2002) *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, Credit Research Center, Georgetown University.
- 30 For a review of these studies, see Quercia, R.G., Stegman, M.A., and Davis, W.R. (2004).
- 31 Quercia, R.G., Stegman, M.A., and Davis, W.R. (2004).

### 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>
- 2 Inside B&C Lending, 9/1/2006; See also Inside Mortgage Finance MBS Database, 2006.
- 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.
- 5 Hudson, Mike and E. Scott Reckard, "More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans," *L.A. Times*, p. A-1 (October 24, 2005).
- 6 *Ibid.*
- 7 In 2nd quarter of 2006, 80.7 percent of subprime loans were adjustable rate loans. This figure based on Mortgage Backed Securities through the 2nd quarter of 2006, see Inside Mortgage Finance MBS Database, 2006.
- 8 *Ibid.*
- 9 Laing, Jonathan R. "Coming Home to Roost," *Barron's* (New York, NY), Feb. 13, 2006, at 26.
- 10 For example, a recent prospectus shows that a large subprime lender, Option One underwrites to the lesser of the fully indexed rate or one percentage point over the start rate. For a loan with a typical 2/28 structure, the latter would always apply. See Option One Prospectus, Option One Mtg Ln Tr Asset Bk Ser 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.
- 11 See, eg., Chase Home Finance Subprime Lending marketing flier, "Attractive Underwriting Niches," at [www.chaseb2b.com](http://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.
- 15 See "Steep Increase in California Foreclosure Activity," *DataQuick News*, October 18, 2006, <http://www.dqnews.com/RRFor1006.shtm> and "National Foreclosures Increase 17 Percent In Third Quarter" Press Release from RealtyTrac, November 1, 2006, <http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=1362>.
- 16 Quercia, Roberto, Michael Stegman and Walter Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at 30 and 24.
- 17 CRL conducted an OLS regression of state-level changes in housing prices and foreclosure rates among subprime loans originated in 2000 (based on performance through May 2005), which shows a highly significant relationship ( $p < 0.01$ ) with an adjusted r-squared of 0.57 and coefficient of -0.92. In other words, for every percentage point decrease in appreciation rates, the model predicts a 0.92 percentage point increase in foreclosure rates. Mean foreclosure rate=13.57 percent, N=51.
- 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](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](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](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](http://www.federalreserve.gov/pubs/arms/glossary_english.htm).
- 13, 29: Board of Governors of the Federal Reserve System: <http://www.federalreserve.gov/events/publichearings/hoepa/2006/default.htm>
- 12: "Frequently Asked Questions about the New HMDA Data" (2006). Board of Governors of the Federal Reserve System: [www.federalreserve.gov/boarddocs/press/bcreg/2006/20060403/attachment.pdf](http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060403/attachment.pdf)
- 3, 4, 5, 11, 16, 23, 25, 27, 30-33: Center for Responsible Lending: <http://www.responsiblelending.org/glossary.html>
- 8, 9, 10, 15, 18, 24: Fannie Mae: <http://www.fanniemae.com/tools/glossary.jhtml>
- 14, 21, 22, 28: "Overview of Nonprime Mortgage Lending and Nontraditional Mortgage Product Terms". In FDIC Outlook Summer 2006—Breaking New Ground in U.S. Mortgage Lending. Federal Deposit Insurance Corporation: [http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006\\_summer04.html](http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html)
- 17, 20, 27: U.S. Department of Housing and Urban Development: <http://www.hud.gov/offices/hsg/sfh/buying/glossary.cfm>



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