

Exotics and Toxics and

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NONTRADITIONAL MORTGAGE LOANS—

whether called “affordability products,” “exotic mortgages,” “toxic loans,” or “nightmare mortgages”—are one of the most discussed issues in mortgage lending today. Some view these exotic mortgage products as offering useful choices for borrowers, serving as valuable investment and wealth management tools that have helped increase homeownership. Others say these loans “might be the riskiest and most complicated home loan product ever created”¹ and declare them “the most dangerous type of loan ever introduced.”² This leaves us wondering: Do exotic mortgages lead consumers skipping happily down the yellow brick road to home ownership or leave them lost and confused, tempted to say along with Dorothy, “Toto, I don’t think we’re in Kansas anymore.”

Why all the Fuss?

The concern stems from the recent rapid growth of exotic mortgages.³ The worry is that these products are being sold to unsophisticated consumers who do not understand the terms,⁴ placing both borrowers and lenders at financial risk.⁵ On September 26, 2005, former Federal Reserve Board Chairman Alan Greenspan expressed concern that recent exceptionally low mortgage interest rates resulted in a froth of homebuilding and home turnover, causing home prices in some areas to rise to unsustainable levels. Noting the dramatic increase in exotic mortgage products, Greenspan said these products “are seen as vehicles that enable marginally qualified, highly leveraged borrowers to purchase homes at inflated prices. In the event of widespread cooling in house prices, these borrowers, and the institutions that service them, could be exposed to significant losses.”⁶

According to a September 2006 report by the Government Accountability Office,⁷ from 2003 through 2005 alternative mortgage products, primarily interest only loans (I/Os) and option adjustable rate mortgages (ARMs), grew from less than 10 percent to about 30 percent of residential mortgage originations. At the same time, the housing market appears to be cooling. The Federal Deposit Insurance Corporation’s (FDIC’s) Economic Indicators for Real Estate show that nationwide the growth in home prices dropped from 14 percent in the second quarter of 2005 to 10.1 percent in the second

Exotic Mortgage Products

For the purposes of this article, the term “exotic mortgage products” refers to interest only (I/O), option ARM, and hybrid mortgage products.

I/O mortgage loans permit borrowers to pay only the interest on the loan, with no reduction to principal, for the first few years before recasting the payment schedule to cover principal and accrued interest.

Option ARM mortgage loans permit borrowers to make a minimum payment, often based on an extremely low (1-2 percent) interest rate for the first month, with interest accruing at a stated index rate plus margin beginning the second month. Each month, the borrower has the “option” of selecting between four payment amounts: the initial minimum payment, which results in negative amortization and an increasing loan balance; an interest only payment; making a fully amortizing payment, covering both principal and accrued interest, with the option of a payment for either a 15 year or 30 year amortization.

Hybrids are option ARMs that have an initial interest only period ranging from two to seven years.

Nightmares

Oh My!



quarter of 2006.⁸ Reports show that defaults, auctions, and bank repossessions are trending higher.⁹ Though things sound dire, statisticians following housing and foreclosure trends say that these troubling numbers need to be put in perspective. Any surge in foreclosure prevalence is not expected to overwhelm the market¹⁰ due to the tempering effect of continued low interest rates and low unemployment numbers in most areas of the United States.¹¹

Federal Agencies Take Action

On December 29, 2005, the federal agencies—The Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration—issued a proposed *Interagency Guidance on Nontraditional Mortgage Products*¹² and requested public comment on all aspects of the proposed guidance. After reviewing the comments, the agencies published a final *Interagency Guidance on Nontraditional Mortgage Product Risks* on October 4, 2006.¹³ State regulators are joining the excursion, alleviating concerns that regulation of federally chartered institutions only would create an uneven playing field. On November 17, 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed guidance to the state agencies that regulate residential mortgage brokers and lenders.¹⁴ The CSBS/AARMR guidance substantially mirrors the agencies' guidance and as of this writing has been adopted by 27 states.¹⁵

The final guidance expresses concern about the widespread use of exotic mortgage products and covers three broad areas of action:

- increased vigilance in underwriting standards¹⁶
- appropriate portfolio and risk management practices¹⁷
- consumer protection issues, including providing consumers with clear and balanced information about the relative risks and benefits of nontraditional mortgage products¹⁸

Loan Terms and Underwriting Standards

Exotic mortgages can be effective financing tools, giving consumers the ability to invest, manage uneven income flows, and lower their monthly mortgage payments.¹⁹ However, exotic mortgages should be offered only to borrowers who need, understand, and can afford them.

As home prices have increased, according to an October 2006 *Richmond Times* article, “exotic loans have been the only means by which some people could afford to buy houses.”²⁰ And, some say the flexibility of such mortgages reflects “the creativity and dynamism of our financial markets in finding ways to expand access to credit to facilitate home ownership.”²¹ Yet clearly lenders must balance the need for creativity in exotic mortgage loan terms with adequate underwriting standards that protect both the lender and

the borrower from loss—and therein lies the rub.

The most common exotic mortgage loan terms defer repayment of principal or interest through lower initial monthly payments. Whether hybrid option ARMs with minimum payments based on an initial rate (or some other method), interest-only loans, negatively amortizing loans, 40/30 loans, or a combination of any of these features, lenders traditionally offered these types of loans to sophisticated borrowers with specific cash flow needs or to borrowers expecting to remain in their homes for a short time. Although these flexible loan terms may help some consumers buy homes at prices they could not otherwise afford, the real concern is extreme “payment shock” when the loan reaches its fully indexed rate and payment, making their homes suddenly unaffordable and potentially ruining the consumers' finances.²²

Consider the potential for payment shock in a typical \$200,000 3/1 I/O ARM mortgage in which payments could increase by more than 60 percent when the ARM interest rate resets from 5.15 percent to 7.15 percent and the monthly payment rises from \$858.33 to \$1,395.25. Already some industry analysts predict that the higher monthly payments resulting from these resets could cause at least one in eight of these loans to end up in default.²³

Lending Practices

Competitive market pressures have led to a third consecutive year of eased credit underwriting standards.²⁴ During underwriting, the lender analyzes the borrower's ability to repay the debt using key determinants such as the loan-to-value (LTV), debt-to-income (DTI), payment-to-income ratios, the borrower's credit score, and the value of the collateral.²⁵ Prudent lending practices include consideration of the borrower's ability to repay a loan from sources other than the borrower's home pledged as collateral.²⁶

A fundamental concern when underwriting exotic mortgage loans is the borrower's repayment capacity. The borrower should have the ability to repay the loan by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule, including any balance increase that may accrue from any negative amortization provision.²⁷ Loans to individuals who do not demonstrate the capacity to repay as structured from sources other than the collateral pledged are generally considered unsafe and unsound.

Multiple Exotic Features May Lead to Increased Foreclosure Rates

Exotic mortgage loans tend to combine risky credit features, such as interest-only adjustable-rate loans with negative amortization and reduced documentation or a simultaneous second-lien loan. When a mortgage loan contains multiple “exotic” characteristics, a lender should look for other factors to support the underwriting decision and the borrower's repayment capacity. Some mitigating factors include higher

credit scores, lower LTV and DTI ratios, significant liquid assets, and mortgage insurance. A lender should consider all of these factors in the qualification process and develop a range of reasonable tolerances for each factor.²⁸

Some experts believe reduced-documentation (stated-income) loans may account for up to 40 percent of the entire mortgage loan pool.²⁹ Stated-income loans have been around for many years and were originally intended as a convenience to self-employed borrowers with higher credit scores and large down payments.³⁰ A qualifying borrower needed only to submit a business license, an accountant's letter confirming a two-year business history, and an IRS form to verify the income source.³¹ With the availability of W-2 statements, pay stubs, or tax returns, a lender should maintain a reasoned policy concerning what circumstances minimize the need for direct verification of repayment capacity.

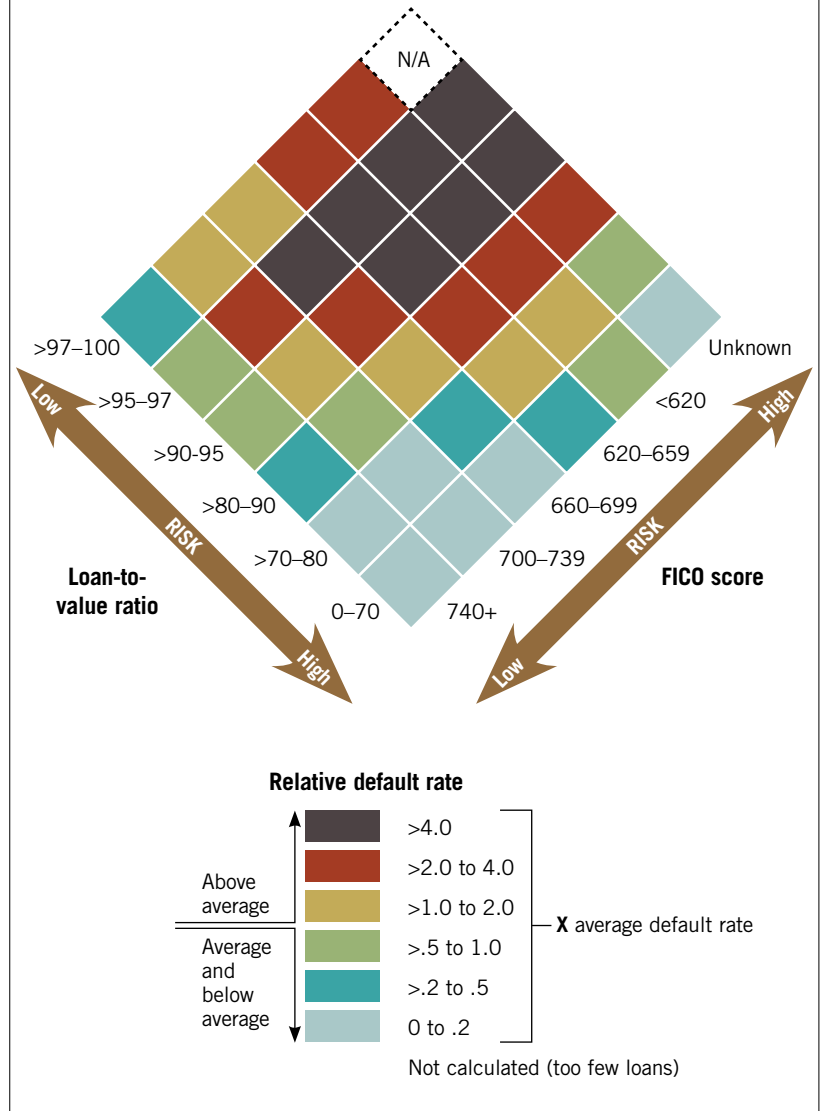
While a lender may use higher pricing to address elevated credit risk levels, higher pricing does not address the increased likelihood of foreclosure. The higher the LTV ratio, the less cash borrowers will have invested in their homes and the more likely it is that they may default on their mortgage loans, especially during times of economic hardship (e.g., unemployment, divorce, or home price stagnation or depreciation). Figure 1, taken from a February 2005 GAO report on mortgage financing, analyzes the results of the four-year default history of 1997 to 1999 originations. The GAO concluded that overall, conventional mortgages with higher LTVs and lower credit scores have higher default rates.³² Further, the GAO found that mortgage loans with LTV ratios greater than 80 percent and credit scores below 660 had a default rate more than twice the average.³³

Prudent lending practices, with a spotlight on a borrower's ability to repay the loan by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule including any balance increase that may accrue from any negative amortization, should prevent the American dream of home ownership from turning into an American nightmare of foreclosure.³⁴ The key is to make sure borrowers have enough extra cash on hand to continue making mortgage payments even if financial emergencies such as unemployment, higher interest rates, or home or property stagnation or depreciation occur.³⁵ Hopefully this will prevent the possibility of a foreclosure "wormhole," the 21st century equivalent of Dorothy's tornado, which could take borrowers far, far away from their homes.

Portfolio and Risk Management Practices

Lenders continue to face the challenge of managing risk exposure while remaining profitable and competitive.³⁶ Financial innovation, which increases the complexity and sophistication of an organization's products, also increases the dimension of risk.³⁷ Because there is little long-term experience with the current concentration of exotic mortgage

FIGURE 1: Four-Year Relative Default Rates by LTV Ratio and Credit Score for Conventional Mortgages (1997, 1998, and 1999)



loans, lenders who make or purchase exotic mortgage loans face unforeseen challenges and would do well to analyze and modify their portfolio and risk management practices to limit potential exposure.³⁸

As a first step, lenders should review their policies and set acceptable levels of risk for the origination and purchase of exotic mortgage loans by type and volume through operating practices, accounting procedures, and policy exception tolerances.

Lenders that originate and purchase higher volumes of exotic mortgage loans may limit their risk by tracking portfolio characteristics such as high combined loan-to-value (CLTV) ratios, high DTI ratios, negative amortization, lower credit scores, and multiple exotic features in addition to portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Accurate assessment of credit risk is vital.

A lender's quality control, compliance, and audit procedures for exotic mortgage loans should focus on monitoring compliance with underwriting standards and any exceptions

SOURCES: GAO ANALYSIS OF FANNIE MAE AND FREDDIE MAC DATA

Clearly, lenders must balance

the need for creativity in exotic

mortgage loan terms

with adequate underwriting

standards that protect

both the lender

and the borrower

from loss—

and therein

lies the

rub.

made to those standards. Relaxed underwriting criteria, reduced documentation requirements, and multiple exotic features in the same loan product can magnify risk levels, especially for unseasoned retail portfolios.³⁹ At a minimum, a lender should sample exotic mortgage loans from all origination channels to confirm that policies are being followed and any deficiencies corrected in a timely manner. Policy exceptions to exotic mortgage loan servicing and collection such as re-aging, payment deferrals, and loan modifications should also be closely monitored in order to avoid increased risk.

Lenders need policies and due diligence procedures to manage their relationships with mortgage brokers or correspondents—third-party originators (TPOs)—they use to originate exotic mortgage loans. A lender's oversight of a TPO involves monitoring the quality, source, and borrower characteristics of originations to ensure the TPO complies with applicable laws and regulations and follows the lender's underwriting standards. Such oversight should assist in the detection of incomplete documentation, fraud, credit problems, and consumer complaints. Early detection of such issues allows a lender to proactively address them through more thorough application reviews, more frequent re-underwriting, or even termination of the TPO relationship.

A lender may limit its credit risk by selling exotic mortgage loans to the secondary market.⁴⁰ Lenders with significant secondary-market activities should have risk management practices commensurate with the nature and volume of such activities.⁴¹ Although exotic mortgage loan sales to the secondary market may transfer a portion of the credit risk, a lender remains exposed to reputation risk when credit losses on sold exotic mortgage loans or securitization transactions exceed expectations.⁴² In 2005, according to Thompson Financial, \$460 billion of home-equity asset-backed securities were sold, up from \$74 billion in 2000, and \$991 billion of mortgage-backed securities were issued, up from \$185 billion five years prior.⁴³ The agencies' final guidance, a possible housing slowdown, and Wall Street capital that has flooded the market and reduced the return on riskier securities may cause a slowdown of the tremendous growth seen by private-label mortgage-backed securities as well as the mortgage bond market.⁴⁴



To manage risk exposure, lenders also need reporting information systems to monitor loans by loan type, multiple exotic features, underwriting characteristics, and borrower performance to detect changes in the risk profile of their exotic mortgage loan portfolios.⁴⁵ Lenders should track portfolio volume and performance against internal lending standards and policy limits.⁴⁶ Such reporting systems should assist management in recognizing deteriorating performance in any of these areas before it has gone too far.⁴⁷

Accurate assessment of credit risk is vital.⁴⁸ In recent years, rapidly escalating home prices may have suppressed delinquencies and foreclosures, but there are early signs this may be changing as the housing market cools.⁴⁹ A lender must maintain sufficient capital and loan loss reserves to adequately mitigate the risk of offering exotic mortgage loans.⁵⁰ Lenders should also consider the higher risk of loss posed by multiple exotic loan terms when establishing such loan loss reserves.⁵¹ Solid loan loss reserves are critical to safety and soundness, said Comptroller of the Currency Dugan. "That is especially true today, at a time of rising credit risk, easing underwriting standards, concentrations in some loan products, and a lack of performance experience with others."⁵²

The large number of borrowers with exotic mortgage loans facing large payment increases over the next few years combined with the cooling housing market threaten to increase foreclosure rates.⁵³ James J. Saccacio, chief executive officer of RealtyTrac, noted that its third-quarter U.S. Foreclosure Market Report shows a 43 percent increase from the same quarter in 2005.⁵⁴ Costs of foreclosure vary depending on state laws, thereby complicating the assessment of risk and default costs.⁵⁵ Loan defaults that lead to foreclosures can have negative implications for both lenders and neighbors of foreclosed properties, with the costs borne not just by the homeowners, lenders, and investors but also by communities.⁵⁶

A lender that monitors its exotic mortgage loans and addresses credit risks in their early stages lowers the amount of losses that may occur. Lenders should be proactive rather than reactive in addressing the issues associated with exotic mortgage loans. As Comptroller of the Currency Dugan noted late last year "[t]he challenge we face is managing this risk in an effective and timely way and doing it now while credit quality is still good, while loan loss reserves are strong, and while the economy is robust."⁵⁷

Consumer Protection Issues

In issuing final guidance, the agencies expressed concern that consumers may be entering into exotic mortgage loans without fully understanding the risks involved, particularly the risk of payment shock or the consequences of negative amortization. This lack of understanding may be exacerbated by marketing practices that emphasize the benefits of these mortgage loans but don't provide clear information about the potential risks.⁵⁸ This concern was supported by the GAO report.⁵⁹ The GAO reviewed a selected sample of eight exotic mortgage product disclosures. Some of the reviewed advertisements suggested that the exotic mortgage products' initial low monthly payments would allow borrowers to afford larger houses but did not disclose that the monthly payments on the loan could increase substantially over time. One advertisement for an option ARM loan stated on the first page that the interest rate started at 1.25 percent and promised to reduce the homeowner's monthly mortgage payment by up to 45 percent, but the statement that the initial 1.25 percent rate applied only to the first month of the loan was noted in much smaller print and was placed on the second page of the ad. Other offers advertised low monthly payments on large loans, specifying only in tiny print at the bottom of the ad that they involved I/O products. Other advertisements suggested that the initial teaser rate—the "payment rate"—was the interest rate for the full loan term.

Many industry commenters suggested that changes to generally applicable regulations, such as the Federal Reserve Board's (FRB's) Regulation Z (Reg. Z), would be the best way to reach consumer protection goals.⁶⁰ The GAO agreed that revising Reg. Z to make required disclosures more useful to borrowers for complex products like exotic mortgages is a good first step; current disclosures were not designed for the more complex exotic mortgage products. "Without amending Regulation Z to require lenders to clearly and comprehensively explain the terms and risks of [alternative mortgage products]," the GAO report said, "borrowers might not be able to fully exercise informed judgment on what is likely a significant investment decision."⁶¹

The FRB is working to make Truth in Lending Act (TILA) disclosures more consumer-friendly. The FRB currently is performing an overall review and revision of Reg. Z and as part of this review will consider ways to improve the effectiveness of exotic mortgage program disclosures.⁶² In December 2006, the FRB issued a revised *Consumer Handbook on Adjustable Rate Mortgages* (CHARM), which must be provided to all consumers who apply for adjustable-rate mortgage loans, to improve the information consumers receive about exotic mortgage products.⁶³ Also, understanding that mortgage products change over time, the FRB is mindful that disclosure requirements must be flexible enough to provide meaningful disclosures as products change and new products are developed.⁶⁴

In the final guidance, the agencies also emphasized the importance of the timing of disclosures, stating that institutions should provide disclosures not only at the time a consumer submits an application or consummates a loan, but also at a time that will help the consumer choose among products and payment options, such as when the consumer inquires about a mortgage product or when marketing materials for exotic mortgage products are provided to the consumer.⁶⁵ The final guidance sets forth guidelines for providing additional information to supplement current TILA and Reg. Z disclosures, as well as practices to avoid when providing information about exotic mortgage loans:⁶⁶

- Promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of exotic mortgage products, including specific information about payment shock, the potential for an increasing principal balance and commensurate declining home equity in loans where negative amortization is possible, the presence of a prepayment penalty for the loan if applicable, and the pricing premium attached to a reduced documentation loan if such a premium exists.
- Monthly statements for option ARM loans should provide information that permits the borrower to make an informed payment choice, including an explanation of each of the payment options and the impact each option will have on the loan balance.
- Institutions are to avoid practices that obscure the presence of significant risk to the consumer, such as emphasizing low initial payments without also providing clear and comparably prominent information concerning risks.
- Institutions should avoid giving unwarranted assurances or predictions about future interest rates, making one-sided representations about the cash savings or expanded buying power in obtaining an exotic mortgage in comparison to an amortizing product, suggesting that the minimum payment on an option ARM will cover accrued interest, and making claims that the interest rate or payment obligations on these products are "fixed."

Simultaneously with the issuance of the final guidance, the agencies issued for comment *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products*.⁶⁷ This proposal was in response to suggestions by commenters that the agencies include model or sample disclosures as part of the guidance.⁶⁸ Use of the illustrations is voluntary. The comment period for these proposed illustrations ended on December 4, 2006, and 13 comment letters were submitted, primarily from consumer advocacy groups.⁶⁹ The agencies will review these comments to determine whether to make any changes to the illustrations.


Several community and consumer groups question whether any amount of clarity in the form of written disclosures will suffice, no matter how timely consumers

receive those disclosures.⁷⁰ The agencies are addressing this concern, too. In 2006, the FRB held four hearings across the country on home equity lending, and exotic mortgage products were a major focus of these hearings.⁷¹ In addition, on October 18, 2006, the agencies published a brochure for consumers, *Interest-Only Mortgage Payments and Option Payment ARMs—Are They for You?*⁷² A new resource to help consumers make informed choices about exotic mortgage products, the brochure stresses the importance of understanding mortgage terms, including the features and risks of I/O and option ARM mortgage loans.

What's Next?

Unlike the witches in the Wizard of Oz, exotic mortgage products can't be characterized as good or wicked. The key is making mortgage loans available to as many prospective homeowners as possible without creating undue risk for both consumers and the financial community. As expressed by the Mortgage Bankers Association, "Mortgage lenders want to lend money to those borrowers who are willing and able to pay the loan back. When a homeowner goes into foreclosure, everybody loses—the consumer, the lender, and the investor lose. We all win when the right loan keeps a family in their home."⁷³

Some areas of discussion raised by the guidance are yet to be resolved. One argument made repeatedly in comment letters from consumer advocacy groups and often voiced in the press is that although exotic mortgages might be well and good for more sophisticated consumers, these products "may not only be inappropriate but ... may be a ticking time bomb for families that cannot handle the payment shock."⁷⁴ Although the proposed guidance flirted with the issue of requiring stricter standards in assessing whether an exotic loan product was appropriate for a particular consumer, the agencies stopped short of requiring a "suitability" standard for these products. Suitability is an area ripe for additional discussion and regulation, especially if delinquencies, defaults, and foreclosures on exotic mortgage products continue to rise.

Wouldn't it be great if getting a mortgage loan to buy a new home or refinance an existing home were as easy as slipping on a pair of ruby slippers, clicking your heels together three times, and saying "There's no place like home?" Hey, it worked for Dorothy. 

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- ⁶³ Use of the revised CHARM handbook is optional until October 1, 2007, but becomes mandatory on that date. Federal Reserve Board, *Joint Press Release: Federal Reserve Board and Office of Thrift Supervision Issue Revised Consumer Handbook on Adjustable-Rate Mortgages*, <http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20061226/default.htm>, December 26, 2006; *Consumer Handbook on Adjustable Rate Mortgages*, 71 Fed. Reg. 78437 (December 29, 2006).
- ⁶⁴ Braunstein testimony.
- ⁶⁵ 71 Fed. Reg. at 58617.
- ⁶⁶ 71 Fed. Reg. at 58617, 58618.
- ⁶⁷ 71 Fed. Reg. 58672.
- ⁶⁸ Federal Reserve Board, *Federal Financial Regulatory Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks*, <http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/default.htm> September 29, 2006.
- ⁶⁹ Comment letters can be accessed at [www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP percent2D1267&doc_ver=1&ShowAll=Yes](http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP%20percent2D1267&doc_ver=1&ShowAll=Yes).
- ⁷⁰ 71 Fed. Reg. at 58612.
- ⁷¹ Braunstein testimony; see also GAO report, p. 28.
- ⁷² Federal Reserve Board, “Interest-Only Mortgage Payments and Option Payment ARMs—Are They for You?” www.federalreserve.gov/pubs/mortgage_interestonly/.
- ⁷³ Mortgage Bankers Association, “MBA Testifies on ‘Non-traditional’ Mortgages,” September 9, 2006, www.mbaa.org/NewsandMedia/Press-Center/44702.htm.
- ⁷⁴ Fishbein, Allen, Consumer Federation of America (March 29, 2006), www.federalreserve.gov/SECRS/2006/April/20060411/OP-1246/OP-1246_44_1.pdf.