Statement
of
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Before The
Subcommittee on Economic Policy and Subcommittee on Housing
and
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Chairman Allard, Chairman Bunning, Senator Reed, Senator Schumer and members of the Subcommittees, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the growth in nontraditional mortgage products and the federal agencies' draft guidance to address this issue.

My testimony will review recent developments in the use of nontraditional mortgage products. In addition, I will discuss the respective risks posed by these products to borrowers and to financial institutions. My testimony also will describe the draft guidance on nontraditional mortgage products issued by the bank and thrift regulators late last year as well as the comments we have received.

Background

One-to-four family mortgages, both fixed rate and adjustable rate, historically have had some of the lowest loss rates among the assets held by banks and thrifts. With the recent housing boom, the performance of one-to-four family mortgage loans continues to be strong with charge-off rates less than one tenth of one percent (0.06) of all one-to-four family mortgage loans as of June 30, 2006.

In recent years, there has been an increase in the prevalence of new mortgage products beyond the typical fixed rate and adjustable rate mortgages (ARMs). These nontraditional mortgage products are designed to minimize mortgage payments by deferring repayment of principal, and sometimes part of the interest, during the early years of the loan. These products include interest-only mortgage loans, payment-option adjustable rate mortgage loans and extended maturity mortgage loans (terms beyond 30 years). Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Borrowers pay no principal for the first five to ten years under an interest-only loan. Payment-option ARMs have existed for many years. However, until recently, payment-option ARMs were used primarily by financially sophisticated borrowers as a financial management tool. Payment-option ARMs provide the borrower with flexible payment options, although there is an accompanying potential for negative amortization if the borrower chooses a minimum payment that is less than the interest accrued so that the loan balance increases as a result.

Since 2003, there has been a growing use of nontraditional mortgage loans among a wider array of borrowers. Nontraditional mortgage products have been especially popular in states with the strongest home price growth (see Chart 1). With the growth in home price appreciation, nontraditional mortgage products have been marketed as an affordable loan product. Specifically, some borrowers, often first-time home buyers, used these products to purchase higher-priced homes than they could have qualified for using more traditional mortgage loans. Investors also used nontraditional mortgage products as a way to purchase properties with lower upfront and monthly payments. According to the publication Inside Mortgage Finance, an estimated $432 billion of interest-only loans and payment-option ARMs were originated during the first half of 2006. This represents approximately 29 percent of all mortgages originated during the same period.

It is difficult to establish a clear cause and effect relationship between the increased prevalence of nontraditional mortgage products and the surge in home prices in certain areas of the country in recent years. Two FDIC reports issued under its FYI series in early 20051 were among the first to raise the possibility that the post-2003 acceleration in U.S. home price increases might be related to changes that were taking place in the mortgage markets. The reports noted a sharp rise in subprime loans in 2004 and the emergence of interest-only and payment-option mortgages that borrowers were in some cases using to cope with home price increases in boom markets. Despite observing these trends during the same period of time, we have no way, as yet, to statistically test the relationship between the trends. In addition, there are other factors that contributed to the increase in home prices, including availability of land, increased costs of building materials and population increases.

Based on the limited information available, the acceleration of the U.S. home price boom does appear to have been related to changes in the mortgage markets -- and causation probably runs both ways. The greater availability of flexible mortgage structures probably allowed price increases to outstrip growth in incomes to a greater extent than would otherwise have been the case. In addition, high-priced homes probably induced at least some borrowers to use interest-only or payment-option mortgages in order to afford their home.

Nontraditional mortgage products are available to borrowers from a number of sources. While banks and thrifts (and their mortgage subsidiaries) offer these products, nontraditional mortgage products also are provided by independent mortgage companies and brokers that are outside the purview of the federal banking agencies. Additionally, many insured institutions that originate nontraditional mortgages act as conduits by selling the loans they originate to the secondary market through private-label securitizations, thereby removing them from the institutions' books.

It also is important to appreciate the role played by the issuers of non-government sponsored enterprise (GSE) asset-backed securities in fueling the growth in the mortgage market in the last several years. While the share of outstanding U.S.

mortgage debt financed through private asset-backed securities trusts more than doubled between the end of 2003 and the end of 2005 (from 8.6 percent to 17.4 percent), the holdings of the GSEs and GSE mortgage pools fell from 53 percent to 43 percent during the two-year period. Clearly, market share shifted toward the private asset-backed securities issuers where the nontraditional products were being securitized. The ability to securitize pools of nonprime and nontraditional mortgages certainly helped to make these loans available to borrowers through both FDIC-insured institutions and through mortgage brokers. It also helped to spread the credit risks associated with nontraditional mortgages to investors across the financial system and around the world.

In response to the growth of nontraditional mortgage products, the FDIC and other federal banking regulators (collectively, the agencies) conducted a review in mid-2005 of the supervisory data for six of the most sophisticated residential mortgage lenders for trends and current practices.2 These six lenders represented half of the projected 2005 nontraditional mortgage product originations, as well as half of aggregate mortgage originations. The review found indications of loosening in underwriting standards, some instances of borrowers not being qualified based on fully amortizing payments, and an increase in simultaneous second mortgages and other activities that added an additional layer of credit risk. The survey also found geographic concentrations of these products in areas experiencing rapid home price appreciation.

The FDIC also conducted a supervisory review of FDIC-supervised institutions with total assets greater than $1 billion that were located in areas experiencing rapid home price appreciation. Of the 30 FDIC-supervised institutions that met these criteria, nine did not offer nontraditional mortgage products. The remaining 21 institutions, with a combined total asset base of $190 billion, held $24.5 billion in nontraditional mortgage loans. Interest-only products represented $24.4 billion of these loans while payment-option ARMs represented only $120 million. Only two of the FDIC-supervised institutions captured in the review offer payment-option ARMs.

As part of its supervisory review, the FDIC also examined the manner in which nontraditional mortgages were marketed to borrowers. Although institutions generally appeared to be making the disclosures required by current law and regulations, these disclosures were not designed to address the features of nontraditional mortgage products and may not provide adequate information to enable borrowers to make informed decisions.

Risks of Nontraditional Mortgage Products

Risks to Borrowers

Consumers can benefit from the wide variety of financial products available in the marketplace. However, nontraditional mortgage products present significant risks to borrowers because the product terms are complex and can be confusing. Moreover, the required disclosures may be insufficient to help borrowers make informed decisions about whether these products are appropriate. The primary risk to borrowers is payment shock, which may occur when a nontraditional mortgage loan is recast and the monthly payment increases significantly, sometimes doubling or tripling. This risk is heightened as interest rates rise and as home appreciation slows. This is especially true in the case of payment-option ARMs where the unpaid interest is added to the principal balance of the mortgage loan. This results in the total mortgage debt ultimately exceeding the value of the property, or negative amortization. Negative amortization can steadily increase the amount owed and significantly increase future payments.

With payment-option ARMs, the borrower has multiple monthly payment options during the initial option period. These include: (1) a minimum payment option based on a low introductory (teaser) interest rate; (2) an interest-only payment option based on the fully-indexed interest rate; or (3) a conventional amortizing principal and interest payment option, sometimes with more than one term offered (i.e., 15 or 30 years). The minimum payment option amount is typically less than the interest accruing on the loan, resulting in negative amortization. The borrower's monthly payment may increase dramatically when the minimum payment period ends or when negative amortization causes the principal balance to reach its limit. At that time, the borrower's monthly payment is recast to require payments that will fully amortize the outstanding loan balance over the remaining loan term.

For example, a borrower purchases a single family home for $250,000 with a 20 percent down payment and finances $200,000 via a payment-option ARM loan. The loan has a teaser rate of one percent, resulting in a minimum monthly payment of $643 for the first 12 months based on a 30-year amortization period. However, the loan accrues interest at the index rate of five percent, which rises one-half of one percent each year. At the beginning of the sixth year, the borrower's monthly payment will have more than doubled from $643 in the first year to $1,578.[3] In addition, the borrower's outstanding loan balance increased by $14,857 during this timeframe even though every required minimum loan payment was remitted on time.

For interest-only products, the principal loan balance does not decline during the interest-only payment period, which varies in length (i.e., seven or ten years), and the amortization period is shorter (i.e., 23 or 20 years verses the traditional 30 years). When principal amortization begins, the borrower's monthly payment will increase due to the addition of this principal payment. In addition, if the interest rate is adjustable, the monthly payment may increase (or decrease) with the change in the stated interest rate. Interest payments on ARMs rise (or decline) with interest rates until the mortgage loan's cap (or floor) is reached.

Federal Reserve Board economists recently found that a sizable number of borrowers do not understand the terms of their adjustable rate mortgages – particularly the percent by which the interest rate can change, whether there is a cap on increases and the index to which the rate is tied.[4] This was especially true for lower income borrowers and those with less education. The Federal Reserve study found that borrowers tend to significantly underestimate the amount by which the interest rate can change. This could result in significant payment shock for some lower income borrowers, for whom a mortgage payment is likely to be a larger portion of their income than upper income borrowers. If borrowers cannot meet their monthly obligations, refinance their loans or sell their property, they may face default and foreclosure.

Because of the potential impact on borrowers' payments, it is critical that borrowers fully understand the risks and benefits of the mortgage products they are considering. Current disclosure requirements, however, were not designed to address the characteristics of nontraditional mortgage products. In some cases, marketing materials for nontraditional products emphasize the benefits on the products and provide minimal information regarding the risks. In addition, some borrowers do not receive information regarding the risk of nontraditional products early enough in the loan shopping process to allow them to fully compare available products. Moreover, some periodic statements fail to provide borrowers with information about the payment options available. Instead, the statements encourage borrowers to make the minimum payment by highlighting that option. Borrowers would benefit from information with their periodic payment materials that explains the various payment choices as well as their consequences, such as negative amortization.

Risks to Lenders

As the prevalence of nontraditional mortgage products has increased, there have been indications that underwriting standards have loosened. Over the years, mortgage lenders that relaxed certain underwriting terms, such as the level of documentation required, would mitigate the additional credit risk incurred by imposing more stringent terms in other areas. However, competition has begun to erode these compensating controls. Many nontraditional loan products require little or no documentation or have been accompanied by practices such as simultaneous second-lien mortgages that create additional layers of risk for lenders.

Although streamlined mortgage underwriting standards are not unique to nontraditional mortgage products, nontraditional mortgage loans written with less stringent underwriting standards are of particular concern. For products that permit negative amortization, some lenders' borrower repayment analyses may not include the full amount of credit that may be extended (initial balance plus the potential negative amortization amount). Lenders that do not qualify borrowers at the full amount of credit that may be extended are not appropriately evaluating the ability of borrowers to repay their loans, resulting in possible losses for both lenders and borrowers.

In traditional mortgage lending, the borrower's repayment capacity, including debt-to-income ratios, has been a key underwriting consideration. However, there is growing evidence of interest-only and payment-option ARMs being made to borrowers with little or no documentation to verify income sources or financial assets (see Table 1). Reduced documentation increases risk since institutions are essentially relying on assumptions and unverifiable information to analyze the borrower's repayment capacity.

Many lenders justify foregoing income verification because they rely on credit scores. Credit scoring models were developed for the credit card industry, and they have been very reliable in predicting risk of default and other adverse events for smaller-denomination consumer lending products such as credit cards and auto loans. However, credit scoring models do not consider income information. In addition, credit scoring models have not been fully tested as a predictor of default for loans that are such a large percentage of a borrower's income, especially when the monthly payment increases substantially in a short timeframe. Over-reliance on credit scores in the context of mortgage lending is an unacceptable underwriting risk.

The combination of several liberalized underwriting terms, or "risk layering," also has become more prevalent. Lenders increasingly are providing simultaneous second-lien mortgages to cover a portion of the home purchase price. A simultaneous second-lien mortgage reduces borrowers' equity in their homes and increases borrowers' monthly debt service. When one loan combines several such features, the total risk is compounded. Some lenders argue that risk-based pricing is a compensating control. However, absent other compensating controls, higher interest rates and fees do nothing to improve the credit quality of a higher-risk loan and can result in higher default rates.

Financial institutions are managing the risks associated with nontraditional mortgage products primarily through underwriting and securitization. Some institutions manage the risk these products pose by following prudent underwriting policies and practices, instituting borrower qualification standards that recognize the possibility negative amortization will contribute to payment shock, and implementing strong management information systems and controls to specifically monitor these products. Other institutions are securitizing their nontraditional mortgage originations and spreading the risks of these products to investors.

Proposed Interagency Guidance

In light of the increasing originations of nontraditional mortgage products by financial institutions and the increasing use of these products by a wider spectrum of borrowers, the agencies began to develop interagency guidance to address the issues of risk management and appropriate consumer disclosure. On December 29, 2005, the agencies jointly issued for comment proposed guidance entitled, "Interagency Guidance on Nontraditional Mortgage Products." The proposed guidance was intended to convey the agencies' expectations about how financial institutions should effectively address the risks associated with underwriting nontraditional mortgage loan products. Toward that end, the guidance stressed that financial institution management should: (1) assess a borrower's ability to repay the loan, including any balances added through negative amortization, at the fully indexed rate that would apply after the introductory period; (2) recognize that certain nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves; and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

The agencies together received approximately 100 letters from financial institutions, trade associations, consumer and community organizations, state financial regulatory organizations, and others on the proposed guidance. A majority of the financial institutions and industry groups that commented stated that the guidance is too prescriptive and suggested that institutions should have more flexibility in determining appropriate risk management practices. Other industry comments centered on the following observations: (1) nontraditional mortgage products have been offered successfully for many years; (2) the guidance would stifle innovation and result in qualified borrowers not being approved for these loans; (3) the guidance is not an appropriate mechanism for addressing the regulatory agencies' consumer protection concerns; and (4) the guidance will not apply to all lenders, and thus federally regulated financial institutions will be at a competitive disadvantage.5

Some commenters, including most of the consumer groups, argued that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These commenters noted that nontraditional mortgage products: (1) contribute to speculation and unsustainable appreciation in the housing market; (2) could lead to severe problems if and when there is a downturn in the economy; and (3) are harmful to borrowers and borrowers may not understand the associated risks. A number of commenters, including industry trade associations, asked the agencies to include model or sample disclosures or other descriptive materials as part of the guidance to assist lenders in following the recommended practices for communications with consumers. This is an important idea that warrants consideration.

The FDIC and the other bank and thrift regulators have carefully reviewed the commenters' views on the proposed guidance and are nearing completion of the final version of this guidance. The FDIC believes that insured financial institutions and consumers will benefit from the final guidance.

Conclusion

The growth of nontraditional mortgage products has been accompanied by a number of risks for lenders and borrowers. These products are being offered to a broader spectrum of borrowers to address housing affordability issues, especially in locations which have seen significant home price appreciation in recent years. This expansion of credit has been accompanied in some instances by lowered underwriting standards and additional layers of credit risk. In addition, the consumer disclosures are neither adequate for consumers to fully understand the risks associated with these complex loan products, nor provided at the points in time when it is most needed.

The FDIC will continue to monitor FDIC-insured institutions with significant exposures to nontraditional mortgage products and to ensure that institutions follow the final guidelines when they are issued. The FDIC expects institutions to both maintain qualification standards that include credible analysis of a borrower's capacity to repay the full amount of credit that may be extended, as well as to provide borrowers with clear, understandable information when they are making mortgage product and payments decisions.

This concludes my statement. I look forward to any comments provided by the Committee and will be happy to answer any questions.

1. C. Angell and N. Williams, "U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, FYI, February 10, 2005, http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html, and Angell and Williams, "FYI Revisited - U.S. Home Prices: Does Bust Always Follow Boom?," FDIC, FYI, May 2, 2005, http://www.fdic.gov/bank/analytical/fyi/2005/050205fyi.html.

2. In 2005, these six institutions had growth of 69.6 percent in payment-option ARMs, growth of 24.0 percent in interest only mortgages, and combined payment-option arm and interest only loan growth of 38.5 percent.

3. While the borrower's minimum monthly payment increases slightly in response to increases in the index rate, it remains too low to pay all of the accrued interest due to a 7.5 percent payment reset cap for the first five years of the loan. The monthly payment also increases to permit the amortization of principal over the remaining 25-year life of the loan.

4. See "Do Homeowners Know Their House Values and Mortgage Terms?" by Brian Bucks and Karen Pence, Federal Reserve Board, January 2006, published on the internet at: http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf - PDF 382k (PDF Help)

5. The regulatory agencies note that both state financial regulatory organizations that commented on the proposed guidance – the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR) – committed to working with state regulatory agencies to distribute guidance that is similar in nature and scope to the financial service providers under their jurisdictions. Subsequently, CSBS, along with a national organization representing state residential mortgage regulators, issued a press release confirming their intent to offer guidance to state regulators to apply to their licensed residential mortgage brokers and lenders. Refer to CSBS media release dated June 7, 2006.

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