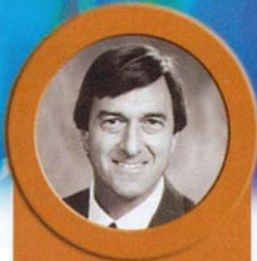


EXOTIC LOANS Roundtable

Three industry experts discuss “exotic” or nontraditional mortgage products — sharing insights on the diversified loans that have influenced mortgage origination over the last few years.

What is your definition of “exotic” loans, and how has that changed recently?



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Shevin

Exotic loans are those with payment options that enable the consumer a high degree of choice in monthly repayment. For example, loans with 40-year terms, amortized

over 30 years that enable a customer monthly to choose to make a fully amortizing payment; make an interest-only payment; make a payment of an amount less than the accrued interest, thereby creating negative amortization; or pay an amount greater than an amortizing payment. The concepts of a loan with these types of alternative payment options available to a customer have grown in availability and acceptance in recent months and years.

Fratantoni

I have never found the term “exotic” to be descriptive of these new products. “Nontraditional,” is a more descriptive and accurate term. The past 15 years has been marked by dramatic changes in mortgage originations, which have significantly lowered the cost of homeownership for consumers and developed a broad range of products that meet a diversity of homebuyer needs. The evidence of success of these changes is the record high homeownership rate the U.S. currently enjoys. The mortgage market is constantly developing loan features that may be termed nontraditional, but that are beneficial to consumers.

In recent years, homeowners seeking additional flexibility have turned to nontraditional mortgages, particularly interest-only and payment-option loans. These loans permit homeowners to manage their home equity to a greater extent than do traditional mortgage products. Many homebuyers in high-cost states have also favored these products because they extend a buyer’s purchasing power, allowing them to lower their initial payments, when they first buy a home, in exchange for increased and potentially greater variability in payments over time.

Albinson

The term “exotic” has recently been broadly applied to mortgages that have terms and payment features beyond those found in traditional fixed-rate and adjustable-rate mortgages. These features include, among others, interest-only payment periods and monthly payment options that, if chosen by the borrower, can actually increase the underlying loan balance (negative amortization). However, some of these features, such as adjustable-rate mortgages that can negatively amortize, have actually been around and successfully used for more than 25 years in the thrift industry. Consequently, OTS prefers the term “non-traditional” rather than “exotic” to categorize mortgages with features beyond those found in the more traditional fixed- and adjustable-rate mortgages.

What is the biggest problem facing the consumers/industry in regards to these loans?

Shevin

A great problem is how to fully disclose on a monthly basis, the repercussions of selecting the options from month to month. Another problem is how to price for the risk of these variable products. Of course, another issue to consider is the increased government scrutiny. Five federal agencies have proposed guidance to regulated lenders. What has prompted the agencies to propose Guidance on Non-Traditional Mortgage Products is their concern for the safety and soundness of the institutions that they regulate, when the inevitable market turnaround occurs. The agencies are concerned with what will happen to over-extended consumers.

The statistics are troubling. Delinquencies for new non-prime ARMs in the first nine months of 2005 were 6.2 percent compared with 3.7 percent for the same period in 2004. A further disturbing statistic is that among the \$220 billion in non-prime mortgage ARMs that reset after two years, delinquencies went from 10.2 percent before the resetting, to 16.6 percent six months later; and, the dollar amount of non-prime ARMs in 2005, what will reset in 2007, has now doubled to \$440 billion. The agencies have concluded that many of the risks associated with these non-traditional products are exacerbated by their being offered to a wider spectrum of borrowers, including some who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans and some who may not fully understand the associated risks (i.e., nonprime borrowers).

Fratantoni

These products have performed well thus far. Mortgage lenders have successfully offered such products for decades, through several market cycles. Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers generally have higher credit scores and lower loan-to-value (LTV) ratios. These reports confirm that mortgage lenders understand that risk layering requires lenders to contemplate mitigating factors.

Albinson

Non-traditional mortgages can contain features that increase their risk, primarily the potential for negative amortization and the payment shock that can arise when the loan terms are reset. Loan terms can reset early because of the amount of negative amortization that has take place or at its contractually set point, typically five years after origination. In either case, required monthly payments can increase sharply at reset.

The currently unknown ability of consumers to absorb a substantial payment shock is the biggest problem facing them as well as those institutions holding such mortgages. The recent economic environment has been extremely benign, with low interest and unemployment rates, and rising house prices across the country, especially where these products have had the most growth. As a result, these products have, to date, performed very well. However, they have not been stress-tested in any meaningful way.

What types of regulation are we facing in the future?

Shevin

The government agencies are taking a hard look at alternative mortgage products from both a safety and soundness view and a consumer protection view. We are likely to face both, particularly the regulated financial institutions. There will be more disclosure and probably proscriptive limitations on the loan programs.

Fratantoni

The federal banking regulators recently proposed guidance regarding nontraditional mortgage products. It is prudent for the regulators to look to examine the role of these mortgage products, but not to impose prescriptive requirements that would force lenders to change proven standards. The risks of these products are manageable, as they are for any other mortgage product. Where guidance or regulation imposes a standard that is not aligned with mortgage markets, the net effect is to limit the ability of mortgage lenders to create viable products that respond to consumer demand.

Albinson

Over the years, many savings associations that specialize in the mortgage markets have worked diligently at finding creative solutions to meet the demand for financing homeownership. We do not, at this time, see the need for changing the fundamental regulations concerning residential lending. However, OTS and the other federal banking agencies have recently published draft guidance for the institutions that we regulate that focuses on the additional risks of nontraditional mortgage lending and have asked for comment on that guidance. The guidance underscores the importance for institutions to properly underwrite such loans, especially evaluating the borrower's ability to withstand payment shock, as well as ensuring that the borrower is fully cognizant of the additional risks such products might pose.

Should these loan products be offered as long as conditions/ guidelines are met?

Shevin

Believing in the free market system as I do, these loan products should be available, as long as full and complete disclosure of the repayment options is provided in a meaningful manner. It is virtually impossible for a lender to ensure that any loan will not cause a problem for a borrower in the future. Conditions change. Affordability is a credit extension determination—suitability is not. As long as we live in a free market, capitalist system, borrowers should be free to make their own decisions, and should be accountable to themselves and for themselves, for the decisions they have made. Similarly, lenders are accountable for their decisions if the loan turns out to have been improvidently made.

Fratantoni

It is possible that some consumers may not fully understand the features of some of the interest-only or payment-option mortgage products they are considering, and that reasonable improvements to current disclosure requirements may be warranted. Mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position.

Unfortunately, today we are in a situation where there are so many disclosures that consumers don't often effectively take in the information. Any proposal to merely add another disclosure would likely not add to consumer understanding.

Any attempt to improve the present system of disclosures should be undertaken on an industry-wide basis so that consumers are informed of product features in a consistent and uniform manner while choosing their mortgage. A uniform and streamlined disclosure system that provides clear and appropriate disclosures would benefit consumers.

Albinson

OTS requires institutions to fully disclose the risks to borrowers, to follow prudent underwriting standards and to carefully and fully evaluate the ability and willingness of borrowers to repay loans. As the draft guidance on nontraditional mortgage lending suggests, there are circumstances in which a particular nontraditional mortgage product is inappropriate for a particular borrower. It is OTS's

expectation that full disclosure and strong and effective underwriting standards will make such circumstances obvious to both the consumer and the lender.

How should brokers! lenders work together to avoid these problems?

Shevin

The goal should always be to create new products that serve the customer's evolving needs. Brokers and lenders should work to provide the borrowing public what it wants. In a marketplace of increasing values in homes, there is more call for aggressive alternative mortgage offerings. In no sense should competitors work together to limit offerings. The marketplace works best to provide new and exciting mortgage products when it functions in a competitive environment. However, I do understand that eliminating fraud is important because it is the drive to meet competition that can sometimes cause good lenders to start to make bad credit decisions.

I don't believe it is the broker's! lender's responsibility to assure "suitability." I don't want them to take on that role. Additional training is fine, and toughening licensing standards would help the professionalism of the industry, but again, I don't think they should limit offerings. Regulators should watch over their regulated institutions for safety and soundness where appropriate. They already have the existing powers to set capital requirements and reserves for products that they deem too risky. The investor in the marketplace ultimately regulates private companies or publicly traded companies that are not banks or thrifts.

Fratantoni

The MBA, along with others from the mortgage industry, responded to a request by the Federal Reserve for feedback on a consumer publication on nontraditional mortgage products that is being developed. The publication would be available on the Federal Reserve's Web site for access by lenders and consumers. Such a booklet may provide a model disclosure that would benefit prospective homebuyers.

Brokers, lenders and regulators should work together to streamline the current disclosures to create fewer, more meaningful disclosures that allow consumers information about the important features of the products they choose.

Albinson

Information is critical. The more information brokers/lenders have about the risk and performance of nontraditional mortgage products, the better able they will be to manage and/or mitigate the risks involved. For example, OTS expects institutions to have management information systems and portfolio risk monitoring and management capabilities commensurate with the size and risks of lending activities. Effective risk management requires a full understanding of the products involved, relying on experience, external information and industry-wide research. OTS encourages institutions to gather and use both internal and external data and research in their efforts to effectively manage the risks of their activities.