



ISSUE PAPER

Subject: New Guidance on Nontraditional Mortgage Loan Products and Proposed Statement on Subprime Lending

Issue: On October 4, 2006, the Federal financial regulators published in the Federal Register, final guidance (“Guidance”) concerning underwriting, risk management and consumer protection respecting nontraditional mortgage products covering interest only and payment option products. [Following the issuance of the Guidance](#), the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) [proposed a template](#) for similar guidance for implementation by state banking regulators. As of this date, 29 states and the District of Columbia have either implemented nontraditional product guidance or are in the process of doing so. On March 7, 2007, the Federal financial regulators issued a proposed Statement on Subprime Mortgage Lending (Statement) that that would cover hybrid ARMs, no or low-documentation and other subprime mortgage loans.

Background: Coincident with sharply higher real estate prices, there has been an increase during the past several years in the availability and use of innovative mortgage products to buy homes and to access homeowners’ equity. In response to consumer demand, mortgage bankers developed a number of flexible financing products that are more affordable initially than the traditional 30-year fixed rate mortgage. Innovations that began with the adjustable rate mortgage (ARM), introduced broadly in the 1980s, today include a wide range of products and features, such as interest-only mortgages and payment option mortgages. The market also has developed hybrid ARM products to provide borrowers the advantages of a fixed term with lower payments.

In truth, most of these products, which have been termed “new” or “nontraditional” are not new and were originated in the past, particularly in high housing cost areas, such as California. What is new is the degree to which consumers have been using these products to allow them to defer principal and, sometimes, interest payments. MBA’s *Single Family Mortgage Originations Survey* reveals that during 2006, interest-only mortgages accounted for 25 percent of the dollar volume of all originations and option ARM mortgages accounted for 15 percent of originations.

On December 20, 2005, the Federal banking regulators issued proposed guidance for comment, which addressed three areas: loan terms and underwriting standards, portfolio and risk management practices and consumer protection issues.

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The Guidance issued on September 29, 2006, is very similar to the proposed guidance with some significant clarifications, including its coverage. Under the Guidance, “nontraditional products” include mortgage products that allow borrowers to defer payment of principal or interest. The Guidance expressly includes interest-only (IO) and payment option adjustable rate mortgages (Option ARMs), but excludes home equity lines of credit (HELOCs) and reverse mortgages, as well as fully amortizing mortgages. The Guidance also clarifies that the regulators did not intend to establish a “suitability standard.”

The Guidance addresses three major areas: (1) Loan Terms and Underwriting Standards; (2) Portfolio and Risk Management Practices; and (3) Consumer Protection Issues.

1. The Loan Terms and Underwriting Standards provisions require that institutions maintain qualification standards for nontraditional products that include “a credible analysis of the borrower’s capacity to repay the full amount of credit that may be extended considering principal and interest.” Specifically, institutions should qualify borrowers at “the fully indexed rate assuming a fully amortizing payment including potential negative amortization amounts.”
2. The Portfolio and Risk Management Practices provisions require that institutions establish strong risk management standards, appropriate capital levels and allowances for loan and lease losses (ALLL) that reflect the collectibility of the portfolio. Institutions are to ensure risk management practices keep pace with portfolio growth and changing risks of nontraditional mortgage loans.
3. The Consumer Protection provisions require that institutions assure that communications with consumers, including advertisements, oral statements, promotional materials and monthly statements provide clear and balanced information about the relative benefits and risks of these products, including payment shock and the risk of negative amortization to help them make informed decisions about these products.

The Guidance applies to federally regulated institutions, including banks, thrifts and credit unions. Because it requires institutions to have strong systems and controls for establishing and maintaining relationships with third parties, it affects other originators and parties as well.

Along with the Guidance, the regulators published for a 60-day comment period, proposed illustrations of consumer information to assist institutions in implementing the Guidance. The MBA provided comments on the illustrations which, along with the views of other commenters, are under review by the regulators. They have not yet been finalized.

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Following the issuance of the Guidance, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) proposed a template for similar guidance for implementation by state regulators. Some advocacy organizations also pressured Congress and the regulators to expand the coverage of the guidance to include other ARM products including hybrid ARMs. MBA, however, strongly advocated that any such guidance on these products should not simply be added by interpretation to the nontraditional guidance but that a separate proposal providing an opportunity for comment should be issued.

Rather than expanding the guidance, the federal financial regulators proposed the Statement, 72 FR 10563 (March 8, 2007), covering subprime lending including hybrid ARM, 2/28 and 3/27 loan products, as well as low documentation loans.

The Statement proposes underwriting requirements for subprime products that would include qualifying subprime borrowers at the fully indexed rate. Also, the Statement proposes the higher a loan's risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets and liabilities. The Statement suggests controls established by lenders in this sphere should include controls on incentives to mortgage originators to avoid steering borrowers to riskier products. The Statement provides that fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include providing information that enables consumers to understand the material terms, costs and risks of loan products, at a time that will help the consumer select products and choose payment options. Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance as applicable.

CSBS and AARMR are likely to call for adoption of the subjects covered by the Statement as soon as it is issued.

MBA Position: MBA believes that the availability of nontraditional mortgage products, hybrid ARMs and low documentation loans are positive developments. The growth of the U.S. homeownership rate to nearly 70 percent over the last 10 years is due in large part to innovations in the mortgage market. MBA maintains that if these products are properly underwritten and described to consumers, borrowers should continue to have access to them as important affordable financing options. While MBA believes the regulators' efforts to promulgate guidance in this area are well intentioned, the establishment and implementation of such guidance must not be unduly restrictive. **It is particularly important that federal and state guidance on these products be consistent.**

An inconsistent patchwork will significantly increase compliance costs and lessen competition, increasing prices and limiting credit options to consumers.

Status: MBA will assist its members in implementing the Guidance and will strongly advocate its reasonable implementation. MBA will lead the industry in providing useful comments on the Statement prior to the close of the comment period on May 7, 2007. In its comments, MBA will point out, among other things, that it has undertaken "Project

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Clarity” to provide much clearer, plain English information on the risks and benefits of mortgage products that will clearly explain “payment shock,” prepayment penalties, balloon payments and tax and insurance responsibilities. In so doing,, “Project Clarity” will address most of the Statement’s consumer protection concerns. MBA also will continue to strongly advocate that Federal and state guidance be consistent in order to avoid higher costs to consumers.

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