Underserved Committee Proposal

Recommendation of "Best Practices" for and with Respect to The Future of Responsible Sub-prime Mortgage Lending

Background:

The members on the Underserved Committee and expert advisors have focused on potential elements to better identify and differentiate responsible and irresponsible sub-prime mortgage lending. The Committee members recommend a new, innovative mortgage product strategy that incorporates a financial literacy life cycle from the shopping phase through the life of the loan, simplified disclosures and educational comparative illustrations of responsible sub-prime products/rates/fees, as well as positive performance incentives for both consumers and lenders/servicers.

The input the Committee received from a series of product, disclosure, intermediaries and financial literacy working groups is reflected in this best practices report. All Committee members agreed to a holistic approach in developing responsible sub-prime lending products; one that can benefit all consumers.

- Product A is designed as a baseline, universal mortgage entry product, and provides a solution most appropriate for the first-time and credit-challenged borrower.

- Product B builds from Product A, with added complex features and more options (a broader choice) that fit more sophisticated borrowing needs.

Proposal:

I. Mortgage Loan Product A (Universal Entry Product)

This product is outlined with simple features that encourage, but do not require, homebuyer/homeowner advice. These features include:

- A fixed rate, fully amortizing mortgage with a term of up to 40 years.

- Minimum one month PITI (principal, interest, tax, insurance) in required borrower cash reserves at closing (borrower's own funds).

- Standard verification of income and assets.

- Borrower would be required to have a minimum down payment.

- A Life Event Clause. For borrowers with good payment performance, under certain circumstances borrowers would be allowed to skip a payment (or payments) for certain specified "life event" reasons, with the amount of missed payments added to loan principal. One approach would be to provide one “payment holiday” for every specified period of months with good payment history.

- Determination of the borrower’s ability to repay. Appropriate underwriting parameters are critical for borrowers with an established, but blemished, credit history. The risk factors should be carefully balanced and include the borrower’s credit score, debt payment capacity (debt-to-income ratios), post-close liquidity, etc.

- Borrower’s with thin credit files and/or non-traditional credit history should be underwritten in a manner that takes into account a borrower’s non-traditional payment history profile – that is, their fixed or regular payment obligations that are not reported to the credit bureaus (e.g. rent or utilities, as well as other periodic payment obligations, e.g. alimony, child support, or remittances).

- A simplified disclosure of terms delivered to borrower early in the process. Note: A one to, maximum, four pages, easy to understand form at the loan shopping stage, with the most pertinent information summarized on page one.

- No prepayment penalty.

- Pre- and post-purchase counseling options to be made available, but are not required for this loan product.

- Ongoing best practices to maintain payment discipline. The ongoing best practices should include, for example, providing periodic free credit reports to help manage credit, with access to credit education specialists that can answer questions about the reports. In addition, education should be provided about banking products that can make money management routine and effective for the borrower.

- A Financial Literacy Scorecard review would be required for this loan product; helping to ensure that borrowers understand the basic terms of the transaction, including a clear differentiation of and between “payment” vs. “interest rate.” Note: per example enclosed.

- No negative amortization or pay option features allowed.

II. Mortgage Loan Product B

A responsible sub-prime product (Product B) could have all the features of Product A with the following ones varying:

Please note that borrower education/advice is also required for Product B with additional focus on the more complex features.

Varying Product Features/Terms of Product B:

- Variable interest rate. This would include options of an adjustable interest rate (6-month or annual payment adjustments; payment shock must be limited, e.g., no more than 1% change in rate each 6 months or 2% annually, with a lifetime cap of 6%) or a hybrid adjustable interest rate (the fixed payment period must exceed three years to mitigate payment shock). Teaser or initial rates on adjustable and hybrids should not be allowed to be substantially below the fully indexed rate and subsequent rate and/or payment adjustments should be limited to reasonable levels.

- Prepayment fee would be allowed, with full disclosure for the borrower on terms and interest rate with and without prepayment fee. Prepayment fee would be limited, such as a 3-2-1 (3% fee first year, 2% second year, 1% third year), so that deeply discounted initial rates are discouraged.

Additional Loan Origination Requirements:

- Borrower Disclosures are provided and explained through homebuyer/homeowner financial education. In addition to those disclosures provided for Product A, Product B disclosures also include projected mortgage payments in different rate scenarios - demonstrating reasonable and manageable payment adjustments.

- Underwriting, which ensures the borrower's ability to repay, also includes for Product A that the loan is underwritten/qualified based on fully amortized payment.

Allowable "Product B" Enhancements

- Interest-only

- Buy-downs of initial interest rate

- 100% financing, including down-payment assistance programs

- First and second simultaneous mortgages, in conjunction with credit policy/underwriting decision and maximum combined loan-to-value ratios. (A maximum loan-to-value ratio will require further review.) This enhanced structure requires homebuyer/homeowner financial education on the specific features and terms for both the first and the second mortgage, as well as projected payments in different rate scenarios demonstrating reasonable and manageable payment adjustments.

III. Other Good Ideas

- The overarching goal is to move consumers from sub-prime borrowing to become a prime borrower. Every participant in the mortgage process should be held accountable in making this happen. By establishing compensation based on the demonstrated performance in making loan payments, the originators or brokers and servicing representatives would be encouraged to follow best practices.

- Therefore, the Committee recommends that these incentives should be implemented by: 1) withholding a portion of originator sales commission until payment performance has occurred, 2) a reduction in GSE guarantee fees for loans where the borrower has received certified financial education, 3) a reduction in fees/rate for borrowers who have received certified financial education, and 4) GSE/investor compensation to servicers for financial education and servicer prompting of borrowers to make payments to help establish good payment practices.

- Financial education should be done face-to-face, over the telephone, and financial education resources and contacts should be listed and provided at all points of the mortgage process and in all mortgage materials.

Action Item:

That the President's Advisory Council on Financial Literacy endorses this proposal.

(For more details on this proposal please see Appendix B)