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Highlights

Highlights of GAO-06-1021, a report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

ALTERNATIVE MORTGAGE PRODUCTS

Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved

Why GAO Did This Study

Alternative mortgage products (AMPs) can make homes more affordable by allowing borrowers to defer repayment of principal or part of the interest for the first few years of the mortgage. Recent growth in AMP lending has heightened the importance of borrowers' understanding and lenders' management of AMP risks. This report discusses the (1) recent trends in the AMP market, (2) potential AMP risks for borrowers and lenders, (3) extent to which mortgage disclosures discuss AMP risks, and (4) federal and selected state regulatory response to AMP risks.
To address these objectives, GAO used regulatory and industry data to analyze changes in AMP monthly payments; reviewed available studies; and interviewed relevant federal and state regulators and mortgage industry groups, and consumer groups.

What GAO Recommends

As the Federal Reserve Board reviews existing disclosure standards, GAO recommends that it considers revising federal requirements for mortgage disclosures to improve the clarity and comprehensiveness of AMP disclosures. In response, the Federal Reserve noted that it will conduct consumer testing to determine appropriate content and formats and will use design consultants to develop model disclosure forms intended to better communicate information.

www.gao.gov/cgi-bin/getrpt?GAO-06-1021.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

From 2003 through 2005, AMP originations, comprising mostly interest-only and payment-option adjustable-rate mortgages, grew from less than 10 percent of residential mortgage originations to about 30 percent. They were highly concentrated on the East and West Coasts, especially in California. Federally and state-regulated banks and independent mortgage lenders and brokers market AMPs, which have been used for years as a financial management tool by wealthy and financially sophisticated borrowers. In recent years, however, AMPs have been marketed as an "affordability" product to allow borrowers to purchase homes they otherwise might not be able to afford with a conventional fixed-rate mortgage.

Because AMP borrowers can defer repayment of principal, and sometimes part of the interest, for several years, they may eventually face payment increases large enough to be described as "payment shock." Mortgage statistics show that lenders offered AMPs to less creditworthy and less wealthy borrowers than in the past. Some of these recent borrowers may have more difficulty refinancing or selling their homes to avoid higher monthly payments, particularly if interest rates have risen or if the equity in their homes fell because they were making only minimum monthly payments or home values did not increase. As a result, delinquencies and defaults could rise. Officials from the federal banking regulators stated that most banks appeared to be managing their credit risk by diversifying their portfolios or through loan sales or securitizations. However, because the monthly payments for most AMPs originated between 2003 and 2005 have not reset to cover both interest and principal, it is too soon to tell to what extent payment shocks would result in increased delinquencies or foreclosures for borrowers and in losses for banks and other lenders.

Regulators and others are concerned that borrowers may not be well-informed about the risks of AMPs, due to their complexity and because promotional materials by some lenders and brokers do not provide balanced information on AMPs benefits and risks. Although lenders and certain brokers are required to provide borrowers with written disclosures at loan application and closing, federal standards on these disclosures do not currently require specific information on AMPs that could better help borrowers understand key terms and risks.

In December 2005, federal banking regulators issued draft interagency guidance on AMP lending that discussed prudent underwriting, portfolio and risk management, and consumer disclosure practices. Some lenders commented that the recommendations were too prescriptive and could limit consumer choices of mortgages. Consumer advocates expressed concerns about the enforceability of these recommendations because they are presented in guidance and not in regulation. State regulators GAO contacted generally relied on existing regulatory structure of licensing and examining independent mortgage lenders and brokers to oversee AMP lending.