

Alternative Mortgages



Managed Risk or Gamble?

by Andrew Olszowy • Federal Reserve Bank of Boston

Recent years have seen an explosion in alternative mortgage products. Although instruments such as *interest-only* loans, *payment-option* adjustable-rate mortgages (ARMs), and *reduced-documentation* (“low doc” or “no doc”) mortgages have existed in various forms for a long time, their widespread use is new. According to the Mortgage Bankers Association, interest-only loans, for example, comprised 23 percent of all U.S. mortgages for the first six months of 2005—up from 17 percent in the prior six months.¹

Consumer Risks

Although there are numerous issues to consider, probably the most significant risks to borrowers with regard to alternative mortgages are the following:

Payment Shock — This occurs primarily in interest-only and option adjustable-rate mortgages (option-ARMs). In an *interest-only* loan, the borrower is required to pay only the interest for a specific period of time (typically three to five years). The rate may fluctuate or may be fixed. After the interest-only period, payments start to include interest *and* principal. In a *payment option-ARM*, the borrower typically can choose from four payment options. These can be a minimum payment based on a “teaser,” or low introductory rate; an interest-only payment based on the fully indexed rate; or a fully amortizing principal and interest rate based on a 15-year or 30-year term. In both loans, after the initial period is completed, the loan is “recast” (requires payments that will begin to amortize or pay down the principal), and the borrower must begin making payments to pay off the loan. That is when payment shock hits. If the borrower had been making only the minimum payment, the fully indexed, fully amortizing payment might be 50 percent higher or even double what the original payment was. If the borrower could afford only the minimum payment in the first place, the financial hit could be disastrous.

Negative Amortization — In option-ARMs and other alternative mortgages, loans can experience *negative amortization*. When the borrower opts to take the very low teaser payment options offered on such loans, the amount is typically not only insufficient to reduce principal but also insufficient to cover the interest portion of the monthly payment. In layman’s terms, the monthly payment is so small that the borrower is actually increasing the amount borrowed every month, because the amount of unpaid interest is added to the principal each month. After the initial period is completed or once the principal hits a trigger amount, the loan recasts. At this point, if the borrower has made only the minimum payments, the loan amount outstanding is often more than the original amount borrowed.

In addition to the risk to consumers, there are risks to lenders, and the rapid growth of alternative products have caught the attention of federal regulators. In late December 2005, regulators released proposed joint guidance to financial institutions on how to manage the risks presented by nontraditional mortgage products.² Are their concerns warranted? When does taking a reasonable risk cross over into gambling?

How Alternative Mortgages Work

People like the flexibility of alternative mortgages, and if borrowers are aware of inherent risks, there are situations in which a nontraditional mortgage makes sense. For example, an interest-only or option-adjustable-rate mortgage might be a reasonable choice for a couple if one spouse is employed and the other has a firm opportunity to go to work in the near term. The initial period of low monthly payments would allow them to support the mortgage on one income until the other spouse’s

income can contribute to the larger monthly payment. However, in too many cases, the benefits of alternative mortgages come at a price.

A typical 30-year fixed mortgage is like a two-wheel bicycle—fairly basic transportation. The rider needs to learn how to balance and must be careful not run into anything. Even if riders run into something, they usually walk away with just a few bruises. An alternative mortgage is more like a sports car. The sports car accomplishes the same objective as a bicycle—transportation—but it is a much more complex device, requiring specific knowledge and the ability to manage multiple tasks simultaneously. If something goes wrong, the stakes are higher.

Similarly, alternative mortgages are fairly sophisticated. The borrower must weigh multiple considerations. What is my current income? Will I have at least this much income as long as I have mortgage payments? Will interest rates go up or down? Can I be certain that housing prices will appreciate? Many

borrowers cannot answer such questions beyond the near future.

The Popularity Puzzle

So given their complexity and long-term uncertainty, why have these products become so widespread? Probably the most significant factor has been the state of the housing market. With homes in certain markets appreciating more than 100 percent over the past five years alone, affording a home has become increasingly difficult.

In such steeply appreciating markets, alternative mortgages and low initial payments have been attractive to buyers. In fact, some financial institutions have been promoting alternative mortgages as “affordability” products, potentially misleading consumers about the products’ potential costs and raising the concern of regulators.

Some borrowers do count on their income to increase as payments increase, but regulators worry that many other borrowers have no exit strategy and are essentially gambling on housing prices continuing to appreciate. They may expect to cash in on the home’s equity and quickly refinance with another interest-only loan or option-ARM.

However, if the real estate market slows or takes a significant downturn, refinancing may not be possible. Even worse, if the loan had been experiencing negative amortization, an increased loan amount coupled with a softening real estate market could mean the borrower owes more on the house than it is worth—a scenario that is making regulators anxious. (See the exhibit “Consumer Risks.”)

What Lies Ahead?

The quickly appreciating real estate market has created an unprecedented boom in alternative mortgages. However, no one can anticipate the effect of a significant downturn, as such a volume of these products has never been stress-tested in the marketplace. A downturn could hurt both consumers and financial institutions holding a sizable portfolio of such loans.

Comments in late 2005 from the Comptroller of the Currency John Dugan and then-Federal Reserve Chairman Alan Greenspan highlighted regulators' increasing concern. Dugan stated that option-ARMs are increasingly becoming "the primary way to afford the large mortgages necessary to buy homes in many housing markets." He also expressed concern that the use of alternative mortgages to "penetrate the subprime market cannot be far behind."

Greenspan hinted that the proliferation of alternative mortgages may be creating a Catch-22 situation in housing markets by "adding to the pressures in the marketplace." As he explained, "Some households may be employing these instruments to purchase a home that would otherwise be unaffordable." Rather than choose a more affordable home or wait for the market to cool, some borrowers do appear to be using alternative mortgages to purchase homes they cannot afford. That may be contributing to what Greenspan called "froth" in the housing market by artificially maintaining inflated prices.

Adding to regulators' apprehensions is a practice called *layering*. Layering occurs when a financial institution combines several alternative or exotic features in one loan product. For instance, an option-ARM may also have a low-doc feature: The lender doesn't demand the usual documentation and, instead of verifying applicants' income, accepts what applicants "state" is their income.

Layering obviously results in increased risk to both parties. The typical lender compensates by raising the loan's interest rate. But if the consumer has an interest-only loan or option-ARM, that can actually lead to worse payment shock down the road—and an increased likelihood of default.

Be Cautious

So what do regulators suggest? Basically, proceed with caution. In December 2005 federal regulators released proposed guidance suggesting

that financial institutions should follow prudent lending practices with alternative mortgage products. Regulators said that lenders should consider the borrower's ability to repay the debt, should not rely on credit scores as substitutes for verifying applicants' income, and should emphasize the borrower's ability to repay the debt more than they emphasize the value of the collateral. Also, if lenders intend to layer the risks rather than simply increase the interest rate, they should look for higher credit scores, lower loan-to-value and debt-to-income, and other mitigating factors. That may appear to be simply sound loan underwriting. But regulators recognize that the competition in alternative products may be putting new pressure on lenders.

Regulators also strongly encourage lenders to educate consumers with easy-to-understand product information, promotional material, and discussions. They need to address the pros and cons so that consumers can see if an alternative mortgage is the correct fit.

And what should consumers be doing? If the lender is not providing easy-to-understand product information, they should be asking questions:

- **Payment Shock** — When does the introductory rate expire? When do payments begin to pay down the loan? How are payments calculated? Can the lender give a maximum hypothetical example of what the payment might be?
- **Negative Amortization** — Can negative amortization occur? When is it possible under the terms of the loan? Can the lender provide a sample payment schedule to show the effect of negative amortization?
- **Prepayment Penalties** — Is there a prepayment penalty on the mortgage? How much is it in plain terms, and how is it incurred?
- **Reduced Documentation** — Is there a price difference between a low-doc loan and a standard loan?

What is it?

Alternative mortgages are subject to consumer protection laws and regulations. Most notably, the Truth in Lending Act implemented through Regulation Z requires that certain disclosures be provided for an advertisement, for an application, and for changes in interest rates. Section 5 of the Federal Trade Commission Act makes it illegal for lending institutions to employ any unfair or deceptive acts or practices. Thus lending institutions should review their procedures with regard to alternative mortgages to ensure they are following regulations.

Similarly, consumers should ask questions to be sure they understand all the finer points and potential consequences of alternative mortgages. And because the disclosures under Regulation Z are triggered only at application, both the consumer and the lender should make a point of having an informative dialogue before then.

Although alternative mortgages can be a useful tool allowing flexibility to both the consumer and the lender, the increased risk does require that both parties proceed prudently. Neither consumers nor lenders should gamble that housing markets will continue to appreciate rapidly. If all involved parties proceed carefully and cautiously, potential problems can be avoided.

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Endnotes

¹ See <http://www.mortgagebankers.org/news/2005/pr1025d.html>.

² For the Federal Financial Institutions Examination Council's proposed guidance on alternative mortgage products, see <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/default.htm>.