GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS
Highlights

On October 4, 2006, federal financial institution regulatory agencies published final guidance on nontraditional mortgage product risks. On November 14, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued parallel guidance to cover state-licensed mortgage entities not subject to the federal interagency guidance as a means of promoting consistent regulation in the mortgage market.

The following practices are deserving of increased scrutiny due to higher than normal risk, to both the lender and to the borrower:

- Collateral-Dependent Loans
- Risk Layering
- Reduced Documentation
- Simultaneous Second-Lien Loans
- Introductory Interest Rates
- Lending to Subprime Borrowers
- Non-Owner-Occupied Investor Loans

The guidance is applicable to non-traditional, alternative or exotic mortgage loans, including “interest-only” mortgages and “payment-option” adjustable rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

Special attention should be given to “interest-only” mortgages where a borrower pays no loan principal for the first few years of the loan, and “payment option” adjustable rate mortgages where a borrower has flexible payment options, as both types of mortgages have an increased potential for negative amortization.

Often, non-traditional mortgage loans are underwritten with less stringent income and asset verification requirements and are increasingly combined with simultaneous second-lien loans. Such risk-layering, combined with broader marketing of nontraditional mortgage loans, exposes providers to increase risk relative to traditional mortgage loans.

Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as “payment shock,” this is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization.

Providers are advised to analyze a borrower’s repayment capacity to evaluate the borrower’s ability to repay the debt by final maturity at the fully-indexed rate. This analysis should not be based on an over-reliance of credit scores as a substitute for income verification in the underwriting process.

Lenders should clearly disclose the risks that borrowers may assume. In addition to apprising consumers of the benefits of nontraditional mortgage products, providers should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations.

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