NATIONAL ASSOCIATION OF REALTORS®

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HEARING BEFORE THE

SENATE BANKING, HOUSING AND URBAN AFFAIRS'

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

AND THE

SUBCOMMITTEE ON ECONOMIC POLICY

ENTITLED

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®, SEPTEMBER 20, 2006

The National Association of REALTORS® (NAR), is pleased to submit our views to the Senate Banking, Housing and Urban Affairs' Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy for the hearing entitled, "Calculated Risk: Assessing Non-Traditional Mortgage Products."

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association representing more than 1.3 million members and five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

NAR Supports High Standards and Consumer Education

NAR is very concerned that some borrowers are using non-traditional mortgages without fully understanding the risks associated with such products and applauds the subcommittees for examining this important consumer issue. Last year, NAR, in partnership with the Center for Responsible Lending, issued two consumer education brochures, "Specialty Mortgages: What Are the Risks and Advantages?" and "Traditional Mortgages: Understanding Your Options," both of which are attached to this statement. The brochures emphasize how important it is for consumers to make sure they fully understand how traditional and non-traditional mortgages work before deciding which is the right choice. More recently, NAR commented in support of the federal banking agencies' and the National Credit Union Administration's (NCUA) proposed Guidance on Non-traditional Mortgage Products (Guidance) which establishes high standards to protect consumers from unknowingly agreeing to inappropriately expensive products.[1]

Common Types of Non-Traditional Mortgages

In many housing markets, home prices have risen to very high levels, making it harder to afford a home – especially for first-time homebuyers. The traditional fixed-rate mortgage and standard adjustable rate-mortgage may not be the best options for everyone. A growing number of

[1] 70 Federal Register 77249 (December 29, 2005).

homebuyers are deciding to use one of the several new types of non-traditional mortgages that let them “stretch” their income so they can qualify for a larger loan. Some common types of non-traditional mortgages include, but most certainly are not limited to:

- **Interest-Only Mortgages:** When a consumer’s monthly mortgage payment only covers the interest owed on the loan for the first 5 to 10 years of the loan, and nothing is paid to reduce the total amount borrowed. After the interest-only period, the consumer starts paying higher monthly payments that cover both the interest and principle that must be repaid over the remaining term of the loan.
- **Option Payment ARM Mortgages:** When a consumer is given the option to make different types of monthly payments with this mortgage. For example, a consumer may make—
    - A minimum payment that is less than the amount needed to cover the interest and increases the total amount of the loan;
    - An interest-only payment; or
    - Payments calculated to pay off the loan over either 30 years or 15 years.
- **40, 50 and even 60-Year Mortgages:** When a consumer chooses to pay off their loan over 40, 50 or 60 years, instead of the usual 30 years. While this reduces the consumer’s monthly payment and helps them qualify to buy a home, the downside is that the balance of the loan is paid off much more slowly, the consumer pays much more interest and it takes longer for the consumer to build equity in the home.

When a Non-Traditional Mortgage May be Appropriate?

NAR recognizes the important contribution non-traditional mortgages have made to achieving record homeownership and we support responsible lenders making such loans when it is appropriate for consumers in special circumstances. For example, a non-traditional mortgage may be appropriate—

- When a borrower can expect a significant future increase in income, such as (a) at the conclusion of additional education or training, (b) when children start school, (c) when a small business becomes more established, or (d) when periodic car payments, tuition, or other financial responsibilities will no longer be a family obligation;
- If the borrower proposes to renovate the home to increase its value and upon completion of the work to refinance the loan or sell the property;
- If the borrower intends to own the home for a short time;
- If the borrower has assets sufficient to permit the family to supplement its income from savings in order to meet the higher payments for a reasonable period even if the mortgage market at the time the higher payments kick in would make refinancing difficult or infeasible; and
- Even if the borrower's debt-to-income ratio exceeds standards used by automated underwriting systems or other underwriting criteria of the lender, if the borrower has a history of paying rent or mortgage payments that exceed usual ratios.

NAR underscores that, even for borrowers in such circumstances where the lender determines they qualify for a non-traditional mortgage, consumers should very carefully consider both the risks and advantages of both traditional and non-traditional mortgages before making a decision.

What are the Major Risks of Non-Traditional Mortgages?

Payment Shock. One major risk is that the consumer's monthly payment may increase by a large amount, resulting in "payment shock." Even a change of 1 or 2 percent in interest rates can result in a very big jump in the consumer's monthly mortgage payment. For example, if the interest rate on a consumer's mortgage changes from 4 to 6 percent, their monthly payment could increase by as much as 50 percent. So if your payment is currently $1,000 it could jump to $1,500. If a consumer's income has not increased enough, he or she may not be able to afford the new larger monthly mortgage payment. And if that happens, the consumer could lose the home.

Example: How Payment Shock Can Occur

Assume that a consumer buys a home for $300,000, puts 10 percent down, and chooses a 5.75 percent **interest-only adjustable rate mortgage**. The mortgage requires interest-only payments for 5 years. After that, the interest adjusts every year based on rates in effect at that point.

- Initial monthly payment: $1,294.
- Monthly payment after 5 years with no increase in mortgage interest rates (amount increases because payments begin to include principal in addition to interest): $1,699.
- Monthly payment after 5 years with a 3 percent increase in interest rate to 8.75 percent: $2,220.

Higher Debt Over Time. Another risk that comes with non-traditional mortgages involves the consumer's "equity" – the amount a house is worth after subtracting the amount still owed to the lender. Consumers who choose some types of non-traditional mortgages will build equity in their home much more slowly than with traditional loans. In fact, with some non-traditional mortgages, the amount a consumer owes on their home could increase rather than decrease over time.

Consumer Protection Issues

NAR believes that lenders should be required to explain to consumers considering a non-traditional mortgage how they work and the unique risks associated with the loan. We strongly support the federal banking agencies and the NCUA's proposed Guidance, which in addition to establishing underwriting standards for non-traditional loans, would require lenders to:

- Explain the risks as well as the benefits in a clear and timely way;
- Alert borrowers about payment shock, negative amortization, prepayment penalties, and any pricing differences for "low doc" loans; and
- Issue monthly statements that explain the impact of various choices, when the borrower has an option about how much to pay.

Payment Shock. In our comment letter on the proposed Guidance, NAR advocated that the section on the subject of Payment Shock,[2] be strengthened to make it clear that lenders should disclose to consumers, *up front*, an example of the impact of typical non-traditional mortgages. For example, consumers should see how the payment would change for a typical mortgage amount (such as $100,000 or $200,000) if they pay only interest or, for payment option ARMs, pay less than needed to amortize the loan for the first years of the mortgage. In particular, NAR recommended that the example in the promotional materials section of the draft Guidance should state that product descriptions "should" – not "could" as proposed – specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical, worst-case example.

To promote compliance and clear and concise disclosures, NAR encourages Congress to recommend that the banking agencies and the NCUA develop model disclosure forms. Model forms would be particularly helpful for consumers who are shopping for loans and comparing the extremely complex terms for non-traditional mortgages. Even though variation among these products would require tailoring the model to the particular product, having a uniform base document would make a significant contribution to promoting consumer understanding.

Prepayment Penalties. While not unique to non-traditional mortgages, the issue of prepayment penalties is frequently raised in discussions on this subject matter, including the federal banking agencies' and NCUA's Guidance. Specifically, the proposed Guidance states that lenders should inform consumers if a prepayment penalty is a feature of the mortgage and the amount of the penalty. Lenders typically justify prepayment penalties as a trade-off for a lower rate. NAR has advocated to the federal banking agencies that the Guidance state that lenders should specify the benefit the borrower is receiving in exchange for accepting a prepayment penalty to give the applicant enough information to decide whether to select a mortgage with a prepayment penalty.

Bait and Switch. Families seeking non-traditional mortgages may face an especially high risk of "bait and switch" tactics that some lenders use to, in practical effect, force a family to take a higher cost mortgage loan at closing. One way to help deter this unscrupulous behavior by some

[2] See page 77256, center column.

lenders would be to establish policies that give borrowers the option and sufficient time to obtain a new loan, without penalty, if the lender changes the terms of the loan within a reasonable number of days before closing, with a refund of any fees or other charges already collected by the lender. We ask Congress to urge the federal banking agencies and the NCUA to include this concept in their proposed Guidance, which would be a significant step and signal to lenders and their affiliates that bait and switch tactics are unacceptable.

Steering. Another way to strengthen consumer protections would be to adopt policies to minimize steering of applicants that would qualify for a traditional prime mortgage to a non-traditional mortgage or even to a subprime mortgage instead. One approach would be to require lenders to initially process every application as an application for a conventional prime mortgage. Since underwriting is now computerized, this should add very little cost or time to the process. Borrowers approved for a conventional prime mortgages would still have the option of electing a non-traditional prime mortgage. Those who do not qualify for a conventional prime mortgage could then consider other options.

Negative Amortization Mortgages: The last issue we would like to address is negative amortization, which is a frequent feature of option payment ARM mortgages but can also be found in the traditional mortgage market. Negative amortization occurs when a consumer's monthly payment is less than the amount of interest owed on the loan. The unpaid interest is added to the loan's principal amount, causing the total amount owed to increase each month instead of getting smaller. NAR recognizes that loans giving consumers the ability to pay less than the fully amortizing monthly mortgage payment can help increase the affordability of homeownership. However, we also maintain that, more often than not, the risk associated with such loans that do not fully amortize at the end of the term or that must provide for a large increase in monthly payments outweighs the reward. For example, if the interest rate on an option ARM loan is steadily increasing, the negative amortization is increasing the total principal amount of the loan, and the house appreciation is slowing or is even declining, the homeowner's equity will most likely *decrease rather than increase.*

NAR maintains that Congress should prohibit lenders from making high-cost Home Ownership and Equity Protection Act (HOEPA) loans that negatively amortize. For loans that fall outside the scope of HOEPA, NAR encourages Congress to ask the federal banking regulators to consider whether the downside (negative amortization) of the option payment ARM mortgages is in fact helpful to the consumer in the long run. Regardless, lenders should be required to explain in detail to consumers agreeing to an option payment ARM that if the monthly mortgage payment is not made for the fully amortizing amount, the consumer's monthly payment and the total amount owed on the loan will increase.

Conclusion

When shopping for a mortgage, consumers have more choices than ever before. Non-traditional mortgages can help make homeownership more affordable for homebuyers in special circumstances. NAR hopes that any action the federal banking agencies, the NCUA and Congress may take in the area of non-traditional mortgages does not have the unintended consequences of driving this type of lending to extinction as it provides for an important source of home financing in unique situations. Nevertheless, NAR is encouraged by the federal banking agencies' and NCUA's effort to establish standards for how lenders (insured banks, thrifts, and credit unions) should underwrite, manage, and inform consumers about non-traditional mortgages, including interest-only and payment option adjustable rate mortgages. NAR stands ready to work with Congress on this important issue and is happy to make available to your constituents our consumer education brochures on non-traditional and traditional mortgages. The non-traditional mortgage brochure is also available in Spanish. Thank you.