NON TRADITIONAL MORTGAGES

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Interagency Guidelines

- In October 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) issued final **Interagency Guidance on Nontraditional Mortgage Product Risks.**

- The guidance was developed to clarify how institutions can offer "nontraditional" mortgage products in a safe and sound manner—and with clear explanations so that borrowers can fully understand their loan terms.

- The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

- Nontraditional mortgages are also referred to as "alternative" or "exotic" mortgages and allow borrowers to defer payment of principal and, sometimes, interest. Many programs give borrowers a wide choice of amortization options and include interest-only loans and "payment option"' adjustable-rate mortgages, known as "Option ARMs."

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Reduced Documentation

- Nontraditional mortgages generally have fewer written verifications and two well known types are called SISA's (Stated Income-Stated Asset) or SIVA's (Stated Income-Verified Asset).

- Actual requirements can vary based on loan characteristics, such as CLTV%, loan seasoning, property type, loan purpose, occupancy, co-borrower occupancy and citizenship.

- Credit scores and debt ratios are primary factors that generally affect both pricing and documentation parameters.

- Verbal employment verification is completed by loan processors on all stated-income loans.

- Lenders utilizing Automated Underwriting (AU) such as Fannie Mae's Desktop Underwriter, ® or Freddie Mac's Loan Prospector® call for verbal confirmation prior to funding and underwriters are expected to perform a ***"salary reasonableness test***" on borrower income.

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Risk Layering

- Lenders that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk.
- When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity.
- Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements.
- Risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

Introductory Rates

- Lenders may offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products.
- Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience payment shock
- Borrowers may also experience negative amortization or an earlier-than-scheduled recasting of monthly payments.

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Interest-Only Mortgages

- Traditional mortgages require that each month the borrower pays pay back some of the money borrowed (the principal) plus the interest on that money. The principal owed on the mortgage decreases over the term of the loan.

- In contrast, an I-O payment plan allows borrowers to pay only the interest for a specified number of years. After that, both the principal and the interest are repaid.

- Most mortgages that offer an I-O payment plan have adjustable interest rates, which means that the interest rate and monthly payment will change over the term of the loan. The changes may be as often as once a month or as seldom as every 3 to 5 years, depending on the terms of the loan.

  For example, a 5/1 ARM has a fixed interest rate for the first 5 years; after that, the rate can change once a year (the "1" in 5/1) during the rest of the loan.

- The I-O payment period is typically between 3 and 10 years. After that, the monthly payment will increase, even if interest rates stay the same, because both principal as well as the interest are repaid.

  For example, if a borrower takes out a 30-year mortgage loan with a 5-year I-O payment period, they will pay only interest for 5 years and then both principal and interest over the next 25 years. Payments increase after year 5 when the principal is included.

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Pay Option Mortgages

- A payment-option ARM is an adjustable-rate mortgage that allows borrowers to choose among several payment options each month. The options typically include:
  - **a traditional payment of principal and interest** (which reduces the amount owed on the mortgage). These payments may be based on a set loan term, such as a 15-, 30-, or 40-year payment schedule.
  - **an interest-only payment** (which does not change the amount owed on the mortgage).
  - **a minimum (or limited) payment** (which may be less than the amount of interest due that month and may not pay down any principal). If this option is selected, the amount of any interest not paid will be added to the principal of the loan, increasing the amount owed and increasing the interest to be paid.
- The interest rate on a payment-option ARM is typically very low for the first 1 to 3 months (2%, for example). After that, the rate usually rises to a rate closer to that of other mortgage loans. Monthly payments during the first year are based on the initial low rate, meaning that if the borrower only makes the minimum payment, it may not cover the interest due.
- The unpaid interest is added to the amount owed on the mortgage, resulting in a higher balance. This is known as *negative amortization.* Also, as interest rates go up, payments are likely to go up.

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Pay Option Mortgages

- **Payment changes -** Many payment-option ARMs limit, or cap, the amount the monthly minimum payment may increase from year to year. For example, if the loan has a payment cap of 7.5%, the monthly payment won't increase more than 7.5% from one year to the next (for example, from $1,000 to $1,075), even if interest rates rise more than 7.5%. Any interest not paid because of the payment cap will be added to the balance of the loan.

- Payment-option ARMs have a built-in recalculation period, usually every 5 years. At this point, the payment will be recalculated (also known as *recast*) based on the remaining term of the loan. If the borrower has a 30-year loan, at the end of year 5, the payment will be recalculated for the remaining 25 years. The payment cap does not apply to this adjustment. If the loan balance has increased, or if interest rates have risen faster than the payments, monthly payments could go up a lot.

- **Ending the option payments -** Lenders end the option payments if the amount of principal owed grows beyond a set limit, say 110% or 125% of the original mortgage amount. For example, if the borrower made minimum payments on a $180,000 mortgage and had negative amortization, the balance grew to $225,000 (125% of $180,000), the option payments would end. The loan would be recalculated and the borrower would pay back principal and interest based on the remaining term of the loan.

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Risks of Interest-Only Mortgages & Option ARMs

- **Rising monthly payments and payment shock.** It is risky to focus only on the ability to make I-O or minimum payments, because eventually the borrower must repay all of the interest and some of the principal each month. When that happens, the payment could increase a lot, leading to payment shock. In the worksheet example, the monthly minimum payment on the option-ARM payment rises from $630 in the first year to $1,308 in year 6, assuming the interest rate stays at 6.4%. The monthly payment could go up to $2,419 if interest rates reach the overall interest rate cap.

- **Negative amortization.** If the borrower has a payment-option ARM and makes only minimum payments that do not include all of the interest due, the unpaid interest is added to the principal on your mortgage, and they will owe more than they originally borrowed. If the loan balance grows to the contract limit, the monthly payments would go up. For example, if a $180,000 loan grew to $225,000 (125% of 180,000), the payments would be recalculated.

- **Prepayment penalties.** Some mortgages, including I-O mortgages and payment-option ARMs, have prepayment penalties. So if the borrower refinances their loan during the prepayment penalty period, they could owe additional fees or a penalty. In the Mortgage Shopping Worksheet example, the penalty is 3% in the first year, 2% in the second year, and 1% in the third year. In this case, they could owe $3,600 if they refinanced in year 2. Most mortgages let borrowers make extra, additional principal payments with their monthly payment. This is not considered "prepayment," and there usually is no penalty for these extra amounts.

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When I-O or Option ARMs are Not Appropriate

- Interest-only or option-ARM minimum payments may be risky if the borrower will not be able to afford the higher monthly payments in the future.
- For example, suppose they are in the market for a home and can afford a monthly payment of about $1,100. Depending on the interest rate, with a traditional 30-year, fixed-rate mortgage, they might expect to get a $180,000 mortgage.
- The lender or broker could offer them an I-O mortgage payment of $1,100 monthly that might enable them to get a $215,000 mortgage--and, therefore, a more expensive house. However, keep in mind that the payments could go up because of interest rate increases when the I-O period ends, or when the loan is recalculated.
- The $1,100 monthly payment could jump to $1,340 or more.
- If the borrower cannot reasonably expect to make this larger payment when the time comes, they might want to think about a different type of loan.

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Important Target Dates

- **Introductory period.** Many option ARMs have a 1-month or 3-month introductory period at the beginning of the loan. During this period, lenders use a lower interest rate to calculate payments. For some I-O mortgage payment loans, this introductory period lasts 1, 3, or 5 years.

- **Interest rate adjustment period.** Most payment-option ARMs have interest rates that adjust monthly after the introductory period. Borrowers could find that the interest owed increases even though their minimum payment stays the same each month, adding to negative amortization. Typical interest rate adjustment periods for an I-O mortgage are monthly, every 6 months, or once a year.

- **Payment adjustments.** Most I-O payment mortgages and payment-option ARMs have payments that adjust once a year. In addition, most of the adjustments on payment-option ARMs are limited by a payment cap, usually 7.5%. Keep in mind that payment caps do not apply when the loan is recalculated at the normal recalculation period. Payment caps also do not apply if the balance grows beyond 110% or 125% of the original mortgage amount.

- **Recalculation period.** With a payment-option ARM, the loan will be recalculated, or recast. The recalculation period is usually 5 years, but it can vary depending on the terms of the loan. When the loan is recalculated, the 7.5% payment cap does not apply, so borrowers could see a large change in their monthly payment. After the loan is recalculated, they will still have the option to make a minimum payment. I-O loans are recalculated at the end of the option period (usually 3, 5, or 10 years); after that they will pay back both the principal and interest for the remaining term of the loan.

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Comparison Chart

	Example	Mortgage 1	Mortgage 2
Mortgage amount	$180,000		
Loan description	Payment-option ARM; 1-month introductory rate; 30-year term		
Is this an I-O payment or a payment-option ARM?	Payment-option ARM		
If different payment options are available, what are the options?	1. First year's minimum payment based on initial interest rate 2. Interest-only payment based on rate after adjustment 3. Fully amortizing payment based on 30-year term		
What is the full term of the mortgage?	30 years		
How long is the option period?	The loan will be recalculated (recast) every 5 years. Payment options are available every month except (1) when loan is recast every 5 years, (2) when balance is 125% of original loan, or (3) if you fall more than 60 days behind in your payments.		
What is the initial interest rate?	1.6%		
For a payment-option ARM, how long does the initial interest rate apply?	1 month		
What will the interest rate be after the initial rate?	6.4%		

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Comparison Chart, part 2

	Example	Mortgage 1	Mortgage 2
For a payment-option ARM, how long does the initial interest rate apply?	1 month		
What will the interest rate be after the initial rate?	6.4%		
How often can the interest rate adjust?	Monthly		
What is the periodic interest rate cap?	2% per year		
What is the overall interest rate cap?	6% lifetime cap (maximum interest rate is 12.4%)		
How often will the monthly payments adjust?	Annually		
What is the payment cap?	7.5% per year; does not apply to recalculation every 5th year		
Can this loan have negative amortization?	Yes		
Is there a limit to how much the balance can grow before the loan will be recalculated?	Up to 125% of original amount borrowed (loan will be recalculated if balance grows to $225,000)		
Is there a prepayment penalty if I end this mortgage early by refinancing or selling my home?	Yes		
How much is the penalty?	3% of amount borrowed in 1st year ($5,400), down to 1% of amount borrowed in 3rd year ($1,800); no prepayment penalty after year 3		

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Comparison Chart, part 3

	EXAMPLE	MORTGAGE 1	MORTGAGE 2
What will my monthly payments be for the first year of the loan?	$630		
Does this include taxes and insurance? Homeowner's association fees?	No		
What is the ***most*** *my minimum monthly payment could be after* ***12*** *months?*	$677 (based on 7.5% cap)		
What is the ***most*** *my minimum monthly payment could be after* ***24*** *months?*	$728 (based on 7.5% cap)		
What is the ***most*** *my minimum monthly payment could be after* ***36*** *months?*	$783 (based on 7.5% cap)		
What is the ***most*** *my minimum monthly payment could be after* ***48*** *months?*	$2,491 (based on recalculation of the loan when balance is $225,000)		
What is the ***most*** *my minimum monthly payment could be after* ***60*** *months (5 years)?*	$2,491 (based on recalculation of the loan after 4 years)		
What would my minimum monthly payment be after ***60*** *months (5 years)* ***if the interest rate stays the same?***	$1,308 (based on recalculation of the loan after 5 years)		
What are the fees and charges due at closing on this loan?	See good faith estimate		

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