When the American Dream Turns Into a Nightmare: A Suitability Standard Will Soon Govern the Mortgage Industry

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Although the California housing market has cooled from the twenty percent increases of the early 2000s, the price of home continues to be out of reach for most people. Currently, the median price of an existing, single-family detached home in California is more than $500,000. Compare this to the Midwest where the median home price remains in the mid-$100s. Suffice it to say California presents unique challenges to home ownership.

During the last decade, Californians have stretched themselves financially to buy a home. Buyers have turned to non-traditional, "creative" mortgages to boost affordability. The traditional 20-percent-down, fixed-rate, 30-year mortgage just is not an option for Californians hoping for a piece of the American Dream. Lower-interest, adjustable-rate mortgages, or ARMs, have allowed Californians the financial leverage to buy a home they might not otherwise afford. ARMs, though attractive to lower initial monthly payments, carry significant risks in the event of rising interest rates. Coupled with a slowing of real estate appreciation or, worse yet, a market correction, ARMs are disastrous for borrowers.

Just recently, federal banking regulators warned mortgage brokers and lenders to ease up on the use of "creative" mortgage loans to get consumers into a home. They have offered guidance on non-traditional mortgage products that would, among other things, impose a suitability requirement on mortgage brokers and lenders the same as that governing investment advisors and stockbrokers.

When implemented, this guidance will go a long way toward protecting home buyers by requiring more complete disclosure of ARMs and a full assessment of each home buyer's risk profile. Accountability for these loan products is long-overdue in California where loan balances generally are so high even slight fluctuations in market conditions can mean financial ruin.

The ABCs of ARMs

Borrowers who use ARMs make monthly payments of their choosing over a certain period, maybe only for a year, after which the mortgage rate changes. The interest rate fluctuates according to a designated market indicator – such as the weekly average of one-year U.S. Treasury Bills – over the life of the loan. When interest rates rise, the monthly mortgage obligation increases. When interest rates decrease, the mortgage payment decreases.

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Lenders generally charge lower initial interest on ARMs in order to make the initial payments more attractive and affordable. With an ARM, borrowers will qualify for a larger loan because lenders make their credit decision on the basis of current income and the first year's payments. It is a trade-off, where borrowers get a lower rate with an ARM in exchange for assuming more risk.

The three most common ARM products are known as "fully-amortized," "interest-only" and "negative-amortization" loans. A fully-amortized ARM is the most like a traditional loan in that the monthly payments include a pay-down of principal on the loan. After the introductory fixed-rate, or "teaser" period, the monthly payment rises and falls each month based on the prior month's fully-indexed rate, loan balance and remaining loan term.

An interest-only ARM is just what it sounds like. Borrowers pay only the monthly interest on the loan, which also fluctuates each month after the introductory period. Unlike the fully-amortized loan, none of the monthly payment goes toward paying down the principal. In exchange for a lower payment, borrowers gamble the housing market will continue to rise and hope to build equity from appreciation of the property.

A negative-amortization loan carries the most risk. With a "neg-am," you continue to make the minimum payment after the end of the introductory period regardless of rising interest rates. Depending on interest rates at the time, the payment may or may not be enough to pay the interest charged on the loan each month. If interest rates increase, the unpaid interest is added to the principal balance owed on the note, resulting in what is known as negative amortization. If a borrower continues to make the minimum payment, the loan balance will grow. If interest rates rise, it will grow even faster. The increased loan balance makes for an even higher interest expense, escalating the problem and the loan balance over time.

ARMs work well to make home ownership less expensive in the short term. However, the affordability is illusory. As interest rates rise, ARM holders are forced to shell out more and more each month to pay the mortgage. By the time the "teaser" payment ends and the true mortgage obligation kicks-in, borrowers have adjusted their lifestyles based on their mortgage payment and available cash flow, thus compromising their ability to service the loan. The industry has even coined a term for this – "payment shock." Usually, it is not until this point that home owners learn the true risk of their loan.

Real Estate Speculation for the Masses

With ARMs, borrowers' ability to pay the mortgage and the safety of their down-payment equity are at the mercy of market conditions. ARM loans are not similar to real estate speculation – they are exactly like real estate speculation. By purchasing an ARM, home buyers are betting on continued growth in the housing market, stable interest rates, and the U.S. economy as a whole. If the market moves the other way, borrowers can very quickly find themselves owing more than their home is worth. With loan-to-value ratios in California commonly at 95 percent – and in some cases even 100 percent – home owners literally can go upside-down overnight.

Most borrowers do not appreciate the risks associated with ARMs or the speculative nature of the loans. Mortgage brokers and lenders have been quick to understate the risks by citing historically low interest rates and record market appreciation. To be fair, buyers rarely perform their own due diligence when presented with a wholly affordable mortgage payment for a home above their means. The problem is perhaps best illustrated by David Lareah, chief economist with the National Association of Realtors. He points out that "[t]he brochure starts out by saying, 'Here is your monthly payment.' It looks so low, you make an appointment, go to the lender. They have to tell you eventually it's negative am, but by the time they tell you, you are emotionally into it."[2]

Due to competition and the need for loan volume, mortgage brokers sell these loans without regard to risk, creditworthiness or a home buyer's risk tolerance. This is particularly troubling as banks are taking on greater risks with less vigilance on their underwriting requirements. With competition for borrowers increasing and profit margins shrinking, there is a move toward even looser standards.

The risk consequence of ARMs and other interest-sensitive mortgages is just now coming home to roost. With the economic slowdown in the last two years, some owners who negotiated ARMs in 2004 and 2005 are facing interest rate increases that are boosting their monthly payments by as much as 50 percent. On May 10, 2006, the Federal Reserve increased the federal funds rate for the sixteenth time in the last two years. Mortgage delinquencies are at an all-time high. As interest rates continue to rise and the California housing market cools, millions of home owners in highly-leveraged, low-payment loans are staring down the barrel of foreclosure.

Federal Regulatory Agencies Propose a Suitability Standard on Brokers and Lenders Offering Non-Traditional Loans

In December 2005, the federal financial regulatory agencies issued for comment proposed guidance on residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest. Specifically, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Insurance Deposit Corporation (FDIC), the Office of Thrift Supervision, and the National Credit Union Administration have targeted "non-traditional mortgage loans, including 'interest-only mortgages and 'payment option' adjustable rate mortgages."[3] These agencies together regulate virtually all mortgage lenders in the country.

The agencies call to task mortgage brokers and lenders for their liberal use of ARMs. Of concern is the increasing availability of these "creative" mortgages and the volume of borrowers making use of them. The proposed guidance includes restrictions

[2] Kathleen Pender, *The Hazards of Option ARMS*, *San Francisco Chronicle*, June 21, 2005.
[3] Interagency Guidance on Non-Traditional Mortgage Products, p.8.

and limitations on the offering of non-traditional mortgages to home buyers "who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans, and who may not fully understand the associated risks," the regulators said in a statement. The comment period on the guidance closed in March, and currently the agencies are preparing to release their final guidance.

Of the regulators' proposals, none is more controversial that the imposition of a standard of care obligating mortgage brokers and lenders to only offer suitable mortgage products to consumers. Essentially, it imposes an affirmative duty on the part of mortgage brokers and lenders to assess whether a particular product is suitable for a consumer on a case-by-case basis. More specifically, "[w]hen an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment on the borrower's capacity to repay when loan amortization begins." Particularly applicable to California home buyers, "an institution's qualifying standards should recognize the potential impact of payment shock, and that nontraditional loans often are inappropriate for borrowers with high loan-to-value (LTV) ratios." This legal duty matches that governing stockbrokers and investment advisors.

The agencies' guidance is long-overdue in the mortgage industry. The conflict of interest in the mortgage industry is at least equal that in the heavily regulated securities industry. Without question, ARMs and other non-traditional loans are the profit centers for mortgage brokers and lenders because they necessitate short-term refinancing. In a good economy, borrowers refinance in order to lower their mortgage cost because appreciation increases their loan-to-value ratio. In a bad economy, borrowers refinance to avoid payment shock and, in many cases, foreclosure. In this regard, ARM sales are a lot like built-in annuities for mortgage brokers and lenders because they act as a pipeline source of continuing, fee-heavy business.

Also, in California, a majority of mortgage brokers do business with only a real estate broker's license. The license that allows the listing and sale of real property (the traditional activities associated with a real estate broker license) is the same license that allows the solicitation of borrowers and the negotiation of loans. Put simply, the motivation of mortgage brokers and lenders is misaligned with the interests of their customers.

Historically, borrowers have had no recourse against their mortgage broker or lender for steering them unwittingly into real estate speculation. For the most part, courts have treated mortgage brokers as sales people with disclosure obligations, but have put full responsibility on home owners for their mortgage decisions. When implemented, the agencies' guidance will at long last impose accountability for the non-traditional, high-risk mortgage products brokers and lenders push on unsophisticated home buyers.

PROTECT YOURSELF FROM PREDATORY BROKERS AND LENDERS

Unfortunately, home buyers in California need creative, highly-leverage financing to afford a home. Whether because of negligence or misconduct by brokers and lenders, or home buyers' own failure to investigate the loan before purchase, millions of

California home owners have unknowingly put their family home at the mercy of economic tides. The good news is even with ARMs many of these risks are avoidable.

Shop Around for the Best Deal

- Interest rates and fees vary among lenders. They are negotiable. Compare the interest rates and the total costs of loans offered by several lenders.

- Ask brokers and lenders for referrals to see if other customers have found themselves in unsuitable loans.

- Don't take the first loan you are qualify for.

Run From the Predators

- Be wary of lenders who solicit your business by e-mail or telephone solicitations.

- If it is too good to be true, e.g., guaranteed loan approval regardless of credit history, it is.

- Be wary of post-close promises like a guaranteed, lower-rate refinancing in the future.

Watch Out For Hidden Terms

- Early pay-off penalties make a refinancing very, very expensive. When you have to refinance to avoid foreclosure, you are at the mercy of these terms. Plan for the worst.

- Avoid "balloon" payments—some loans keep monthly payments down by requiring a big payment at the end of the loan term.

- Plan against “payment shock” – make sure the monthly payments after interest-rate increases are well within your monthly budget.

Use Your Rights

- Ask your broker and lender to explain every term. They have a legal obligation to tell you the cost of the loan, the annual percentage rate, the monthly payments and how long you have to pay back the loan.

- Have all fees and points explained to you before applying for a loan.

Question, Question, Question

- Project the worst-case scenario for interest rates and the housing market, and have your broker and lender explain to you their effect on the mortgage they are selling you.

- Question your appraisal. Many times brokers and lenders influence your appraisal to over-value the home to qualify you for the loan. At the time of sale or refinance, this will spell disaster.