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The Mortgage Corner

Fed Regulators Urge Caution on Risky Mortgages

Banks and other mortgage lenders should exercise caution when offering nontraditional mortgage products like interest-only loans and payment-option adjustable-rate mortgages, U.S. regulators said Tuesday.

In a proposal, regulators including the Federal Reserve said banks should assess borrowers' abilities to repay such loans before making them and that banks should recognize these loans warrant "strong risk-management standards." Loans like the ones singled out by regulators allow borrowers to defer payment of principal and, in some cases, interest.

The proposal was written by the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision and the National Credit Union Administration. "While innovations in mortgage lending can benefit some consumers," the joint proposal said, "the agencies are concerned that these practices can present unique risks that institutions must appropriately manage."

Banks should gauge a borrower's ability to repay these kinds of loans, including any balances added through negative amortization, the regulators said. The Fed and others acknowledged this step differs from some institutions' underwriting standards and are specifically seeking comment about the proposal.

Many lenders do not now take into account the maximum amount of principal balance a negative amortization may expand to, for instance, which can be up to 25 percent of the initial principal. Such a mortgage balance could therefore become greater than the value of the property financed, leaving no equity.

In addition, some of the nontraditional loans are "untested in a stressed environment". Banks should put steps in place to manage risk related to those mortgages "as well as appropriate capital and loan loss reserves," the Fed and others said. One proposal would be some kind of income verification requirement, whereas most negatively amortized mortgages today are based on income that is stated by the borrower. Studies have shown that borrowers tend to overstate their income in such cases.

Finally, banks and other lenders should ensure that borrowers know enough about the products to fully understand the loan terms before they buy them. The agencies said these products are being offered to a wider spectrum of borrowers, including some who may not qualify for fixed-rate or other adjustable-rate mortgage (ARM) loans. Those consumers "may not fully understand the associated risks" of the nontraditional mortgages, the Fed and others said.

One such risk is that the margin and index of an ARM—which determines the underlying interest rate—may not be adequately disclosed. Some indexes have more volatility than others and without historical comparison, a borrower may not know that he could be opting for the more volatile index.