



The Need for the Non-Traditional Mortgage

The steep rise in delinquencies and foreclosures has prompted consumer-advocacy groups, plaintiffs' attorneys and mortgage industry regulators to restrict or eliminate non-traditional mortgage products, which are largely blamed for the residential real estate meltdown. But not everyone believes that these products should be regulated into extinction.

"Much like a chainsaw is a good tool in trained hands and a dangerous tool in a child's hands, all loan products are potentially good if they are in the right hands," says Paul Wylie, founder and former chief executive officer of Metrocities Mortgage LLC, Sherman Oaks, California. "Non-traditional loans have a risk and a potential reward, and for some knowledgeable borrowers, the risk is worth the reward," he says.

Wylie, for instance, has two London interbank offered rate-based (LIBOR-based) loans and two pay-option adjustable-rate mortgage (ARM) loans with interest rates that have fluctuated between 3 percent and 8 percent over the past 20 years. Based on the interest rates at the time these loans originated, Wylie would have paid 6.75 percent to 7.75 percent interest had he secured traditional 30-year, fixed-rate mortgage (FRM) loans instead.

A month-to-month comparison of the fixed-rate financing option versus the variable rate loans he secured shows that he would have paid less during some months with traditional loans, but a range of 0.5 percent to 1.5 percent extra overall. Applied to each of his four loans, this would have amounted to tens of thousands of dollars in extra interest payments had he gone with fixed-rate mortgages instead of the variable-rate loans he chose.

Comfortable weathering the storms and paying more during periods of higher short-term interest rates, Wylie has benefitted from his non-traditional loans. But not everyone shares his economic profile. A borrower with a fixed budget might be unable to afford fluctuating interest payments, and a short-term increase in monthly payments could break the bank for such a borrower.

In other words, explains Wylie, "There is no such thing as a bad loan. Different people have different needs at different times, which is why offering a variety of loan products and options is important. The paradigm should allow for the closest possible alignment of interests between borrowers and lenders."

But the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR), both based in Washington, D.C., have encouraged state mortgage regulators to impose the federal banking regulators' Interagency Guidance on Nontraditional Mortgage Products on mortgage lenders. The guidance imposes additional dis-

closures on top of those that already exist, which typically run well over 100 pages. In California, the new disclosures are particularly burdensome, requiring that borrowers be provided with disclosures specific to their loan.

Under the new California regulations (California's adopted version of the interagency guidance), the lender must provide a borrower with a complete analysis of how the loan compares with the following:

- A similar 30-year, fixed-rate, fully amortizing loan;

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- A loan that is interest-only for the first five years and that fully amortizes over the remaining 25 years;

- A fully amortizing 5/1 ARM;

- An interest-only, fixed-rate loan for the first five years that becomes an ARM; and

- An adjustable-rate loan that amortizes over the full term.

For each of these scenarios, the lenders must calculate and disclose the following:

- The minimum monthly payment for the first five years;

- The monthly payment in the sixth year with no change in rate;

- The monthly payment in the sixth year with a 2 percent increase in rate;

- The minimum monthly payment;

- The monthly payment in the sixth year with a 5 percent increase in rate;

- The borrower's remaining loan balance after the first five years of payments; and

- Whether the original loan balance has been reduced during the first five years (and, if so, the amount by which it has been reduced).

And for each possible permutation, the lender must also calculate the difference between the minimum payment and the borrower's gross monthly income.



According to the Conference of State Bank Supervisors, as of July 7, 2008, 45 states plus the District of Columbia have adopted the Interagency Guidance on Nontraditional Mortgage Products in some form. These regulations affect all non-traditional loans, broadly defined to include interest-only mortgage loans, pay-option ARMs, subprime ARM products, reduced-documentation loans (e.g., low-doc/no-doc, stated-asset/stated-income) and simultaneous second-lien loans.

In laymen's terms, "non-traditional" has come to mean any mortgage loan product that is not a 30-year or 15-year fixed-rate, fully amortizing loan with full documentation and a 10 percent to 20 percent borrower down payment. A borrower considering anything other than a 30-year, full-documentation, fully amortizing loan will now be provided with additional disclosures that may or may not have anything to do with the borrower's actual circumstances.

All this extra work and the confusion it causes the borrower mean the lender might be reticent to recommend these loans, especially when explaining the current disclosures can take hours and hours.

But when considering whether these loans are the right loans, the question is this: Who is best to determine suitability—the borrower, the lender or the government?

Wylie believes that certain borrowers are sophisticated enough to make their own choices, without having a government body or regulatory agency restricting their options and

creating barriers to access. The current guidelines should be replaced with the concept of "accredited investors," he says. Accredited investors are those who do not require traditional protections under the federal securities laws due to their sophisticated financial knowledge. Currently, the SEC regulations define accredited investors to include individuals with a net worth in excess of \$1 million or with income in excess of \$200,000 for the preceding two years and expected current year. (Assets held jointly with a spouse are combined when determining net worth, but raise the bar from \$200,000 to \$300,000.)

The same classification should be established for residential loans, says Wylie.

"This concept defines high-risk investments and qualified investors, and it requires that investors certify their qualifications," he says. "It simply standardizes what a high-risk investment is and who can make it."

The "accredited investor" concept would allow qualified borrowers to choose interest-only loans, pay-option ARMs, short-term hybrid ARMs, one-month LIBOR ARMs and loans with prepayment penalties.

Devin House is a California-licensed attorney based in Los Angeles, with more than 20 years of experience assisting banks, lenders and mortgage companies practically comply with consumer-protection-based laws and regulations. He can be reached at devin.house@me.com.



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