



Prepared Testimony of

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on

“Calculated Risk: Assessing Non-Traditional Mortgage Products”

before the

Subcommittee on Housing and Transportation

and

Subcommittee on Economic Policy

Committee on Banking, Housing and Urban Affairs

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Good morning Chairman Allard, Chairman Bunning, Ranking Members Schumer and Reed, and Members of the Subcommittees, I am George Hanzimanolis, CRMS, President-Elect of the National Association of Mortgage Brokers (“NAMB”). Thank you for inviting NAMB to testify today on nontraditional mortgage products. In particular, we appreciate the opportunity to address the need to: (1) evaluate the risks presented by nontraditional mortgage products to the housing industry, (2) educate consumers to the risks, as well as benefits, posed by these products, and (3) reform the current disclosure scheme to make the information imparted about nontraditional mortgage products more meaningful to consumers.

NAMB is the only trade association exclusively devoted to representing the mortgage brokerage industry and speaks on behalf of more than 25,000 members in 50 states and the

District of Columbia. Our members are independent, small business men and women that adhere to a strict code of ethics and best lending practices when taking consumers through the loan process. We typically maintain business relationships with various lenders to provide consumers with numerous financing options. These partnerships allow our members to offer consumers the most competitive mortgage products available.

Today, we believe that 85 to 90% of loans are “brokered” loans, which includes mortgage brokers, correspondent lenders, and any lender that does not service the loan for a period longer than three months.<sup>1</sup> As the principal conduit for bringing an array of innovative loan products developed by both federally- and state-regulated lenders directly to the consumers, NAMB has a vested interest in addressing the issues raised by the growing nontraditional mortgage segment of the market.

We commend the Subcommittees for holding this important hearing to address risk management and consumer protection practices with respect to the growing market of nontraditional mortgage products. We appreciate the salient concerns raised by this topic, such as risk layering and borrower knowledge, and welcome the opportunity to discuss and comment on these issues.

Earlier this year, NAMB also took the opportunity to submit comments and recommendations to the Federal Banking Agencies,<sup>2</sup> as well as the Conference of State Bank Supervisors (“CSBS”) and the American Association of Residential Mortgage Regulators (“AARMR”) on the Interagency Guidance on Nontraditional Mortgage Products released in December 2005 (“Proposed Guidance”). In our letter, we expressed support for those elements in the Proposed Guidance that address consumer knowledge of nontraditional mortgage products and cautioned against efforts that would eliminate viable loan products or unduly restrict innovation. We look forward to working with the Federal Banking Agencies, CSBS and AARMR to address the safety and soundness issues presented and to implement policy decisions that will aid in consumer education and knowledge about the risks and benefits posed by these products.

NAMB believes that to effectively address the issues posed by the nontraditional mortgage market, we must have a joint effort from all three components of the marketplace—the industry, the consumer, and the government.

First, NAMB believes all mortgage originators should be knowledgeable about the benefits and risks posed by the nontraditional mortgage products they offer. Second, consumers should possess the necessary financial knowledge to carefully evaluate the risks and rewards of these products. Financial literacy is the tool that consumers need to make an informed decision as to whether a particular product—traditional or nontraditional—meets their needs. Third, disclosures should impart information that is meaningful and that does not otherwise

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<sup>1</sup> Most lenders fund loans with the intent to resell to the secondary market within three months or less and in many cases, within a few days.

<sup>2</sup> “Federal Banking Agencies” include the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System.

mislead or deceive the consumer. To facilitate meaningful comparison shopping, all distribution channels must provide the same disclosures in the same manner. Last, a comprehensive approach to the issues raised by nontraditional mortgage products requires that we include not only originators in the discussion, but also those who fund, service and collect on mortgage loans. Origination is one step in the process of how a consumer obtains and secures financing to achieve and maintain homeownership.

## **I. The Knowledgeable and Ethical Originator**

We have witnessed a great growth in our mortgage finance industry—expanding product choice and distribution channels, adding robust competition and great pricing options. Innovations in mortgage financing have increased the number and type of loan products available to consumers dramatically. Nowhere has this been more apparent than in the nontraditional mortgage segment of the market.

The growth in nontraditional mortgage products is the market’s solution to two basic dynamics in the marketplace: i) lack of affordable housing, especially in major metropolitan areas and coastal cities; and ii) a lack of affordable financing options.<sup>3</sup> The secondary market, along with innovative banks and lenders, aptly responded to the need for consumers to find affordable financing options so that they could obtain homeownership in high-cost areas. The secondary market broadened the parameters of their risk profiles, and interest-only, adjustable-rate, and pay-option ARMs (*i.e.*, “exotic loans”), which have existed since the early or mid-1980s, increased in availability and popularity. Today, nontraditional mortgage products can be effective financing tools—affording consumers the flexibility to invest, manage their wealth, manage uneven income flows, and lower their monthly payments if necessary.

Unfortunately, this expansion of market and product choice has led also to a corresponding rise in the number of unlicensed and uneducated originators entering into the marketplace. While states are increasing requirements for mortgage brokers, they continue to exempt officers of banks and lenders from important standards. Additionally, government disclosures have not kept pace leading to increased consumer confusion about certain products, especially when working with exempt distribution channels.

Mortgage brokers are governed by a host of federal and state laws and regulations. For example, mortgage brokers must comply with the following federal laws: The Real Estate Settlement Procedures Act (RESPA), The Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), Gramm-Leach-Bliley Act (GLBA), and the Federal Trade Commission Act (FTC Act), as well as fair lending and housing laws. We are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC), and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board (Board), the Internal Revenue Service, and the

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<sup>3</sup> We support increased access to affordable mortgage financing options. This can be accomplished through comprehensive Federal Housing Administration (“FHA”) reform that allows for increased mortgage broker participation in the FHA program.

Department of Labor. These agencies ensure that we comply with the aforementioned federal laws, as well as small business and work-place regulations such as wage, hour and overtime requirements, the do-not-call registry, and can-spam regulations to name a few.

Mortgage brokers are also licensed or registered, and comply with any required pre-licensure and continuing education requirements and criminal background checks, in 49 states, and actively support licensing of all mortgage originators in the last remaining state of Alaska. Not only are our entities licensed, but in approximately half of these states our loan officers must also be licensed or registered. This is not true for the loan officers employed by mortgage bankers and lenders. As small businessmen and women, mortgage brokers comply with numerous state predatory lending and consumer protection laws, regulations and ordinances (*i.e.*, UDAP laws). On the state level, mortgage brokers are subject to oversight, audit and/or investigation by their mortgage regulator, the attorney general, or their state agency, and in some instances all three.

Consumers often do not know the difference between a mortgage broker, mortgage banker, lender or even a depository institution. This is because there is little substantive difference between them—we are all competing distribution channels. For this reason, NAMB has always advocated that *every single mortgage originator* be licensed and required to complete both pre-employment and continuing education requirements. It is imperative that all mortgage originators possess up-to-date knowledge about the risks and benefits of the loan products they offer and relevant laws as the industry continues to evolve. Consumers deserve a knowledgeable originator regardless of the distribution channel chosen.

A. *All Customers Should Benefit From Working With a Knowledgeable Mortgage Originator, Regardless of Distribution Channel or Product Complexity.*

Education must be the cornerstone of any effort to improve customer knowledge of available loan products and prevent abusive lending practices. The key to a consumer understanding a particular loan product, whether traditional or nontraditional, is education—not only for the potential borrower, but also for the mortgage originator that offers the product to the consumer. NAMB wholeheartedly agreed with the Federal Banking Agencies' comment in the Proposed Guidance that “[l]ending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner.” (*See Proposed Guidance, p.35*). NAMB has long advocated for uniform licensure, education (including ethics training) and criminal background checks for each and every individual that handles a 1003 application,<sup>4</sup> *i.e.* every mortgage originator.<sup>5</sup>

All consumers should benefit from receiving timely and useful information about a loan product regardless of which distribution channel they use. Education of each and every mortgage originator helps to accomplish the objective of ensuring that consumers are well-educated to make an informed decision about a particular loan product. In addition, ensuring

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<sup>4</sup> A Form 1003 is a Uniform Residential Loan Application.

<sup>5</sup> The basic requirements of education, continuing education, ethics training, written exams, and criminal background checks can be found in NAMB's ongoing work and commitment on the Model State Statute Initiative (MSSI) that NAMB began in 2002.

that all distribution channels provide the same disclosures helps to eliminate confusion and facilitate meaningful comparison shopping. To better illustrate the need to educate all mortgage originators, as opposed to just one subset, it is useful to understand that the actions of any originator can be divided into two categories: unintentional acts that can result in harm to a borrower and intentional acts that have similar results.

*B. Education of All Mortgage Originators.*

1. Educated Mortgage Originators Are Less Likely to Commit Unintentional Acts That Can Harm a Borrower.

Unintentional acts include those mistakes made by a mortgage originator that result from lack of knowledge about a loan product, the mortgage process or relevant laws and regulations. These are mistakes that *any* mortgage originator can make, even those employed by banks and other non-depository entities.

NAMB believes that the best solution to unintentional mistakes on the part of mortgage originators is a national, minimum requirement of pre-licensure education and continuing education. Pre-licensure and continuing education requirements are effective measures in protecting consumers throughout the mortgage origination process. To ensure the existence of a minimal level of expertise, all mortgage originators should receive pre-licensure education. Mortgage originators should not only understand the features of the loan products they sell and be able to communicate such information to a borrower, but also have sufficient knowledge of the laws and regulations that govern the loan origination industry. To maintain this competency and enhance the expertise of the industry, all mortgage originators should also be required to comply with continuing education requirements. Pre-licensure and continuing education courses should also include studies on State laws, federal statutes, and ethics.

NAMB is committed to ensuring that all originators are knowledgeable about the range of loan products available in the marketplace and understand the features, risks and benefits of the loan types that they offer. This is why NAMB encourages states to adopt minimum standards relating to pre-licensure and continuing education requirements. In addition, as part of NAMB's commitment to mortgage origination education, we have taken steps to add to our already extensive array of available education courses, a course focused solely on nontraditional mortgage products. NAMB believes that Congress should support uniform education standards for all mortgage originators that offer these nontraditional mortgage products.

2. Criminal Background Checks of Every Mortgage Originator, in Addition to Education Requirements, Will Weed Out the Bad Actors That Commit Intentional Acts.

Intentional acts are certainly the most grievous acts committed by mortgage originators against consumers. An example of an intentional act is a mortgage originator using personal financial information provided by the consumer during the mortgage loan process illegally, *i.e.*, falsifying income on a loan application.

While pre-licensure and continuing education requirements further ensure that a consumer works with a knowledgeable originator, the consumer also deserves to know he or she is not working with an individual who has been convicted of a financial crime, such as fraud. If an originator has been convicted of a financial crime, he or she should not be dealing with consumers in their financial matters.

A valuable tool for protecting consumers from such intentional bad acts of mortgage originators is the criminal background check. Criminal background checks create a barrier to entry into the mortgage origination system by those convicted of financial and other crimes. Criminal background checks conducted periodically throughout employment also ensure that an originator who has unfettered access to sensitive financial information of consumers continues to be licensed, educated and ethical. In short, criminal background checks should be required of all mortgage originators and be a barrier to employment, in certain circumstances, to help weed out the bad actors that engage in abusive lending practices. Moreover, criminal background checks ensure that bad actors can not move freely from one segment of the mortgage origination market to another unchecked.

## **II. Financial Literacy and the Consumer**

As stated previously, NAMB believes that consumer education is the cornerstone of any effort geared to address the issues facing the mortgage industry today, especially those posed by the nontraditional mortgage market. No law or regulation should ever require any mortgage originator to supplant the consumer's ability to decide for him or herself what is or is not an appropriate loan product. As the decision-maker, the role of the consumer is to acquire the financial acumen necessary and take advantage of the competitive marketplace, shop, compare, ask questions and expect answers. Financial education and uniform disclosure of information are the tools that will help consumers take these steps and make sound and informed financial decisions.

Regardless of how knowledgeable a mortgage originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a loan product that can match his or her financial needs. Borrowers must possess the financial literacy tools to properly evaluate the risks and benefits of nontraditional mortgage products that have been highlighted and communicated by the educated mortgage originator. For this reason, NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school

level so that consumers are educated about the financial decisions they make and retain their decision-making ability.

NAMB has always been a staunch supporter and advocate for consumer financial literacy. Our firm belief that an educated borrower is significantly less likely to fall victim to any abusive lending practice is demonstrated by our active involvement in various consumer education efforts. For example, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently being managed by NAMB state affiliates in California, Florida and Texas. NAMB partnered with United Guaranty in 2003 to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low-to-moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more.

NAMB appreciates the call by the Federal Banking Agencies, the consumer groups, and the industry as a whole to focus on the use of disclosures to inform the borrower, and in fact, is in favor of a constructive and useful disclosure scheme which we discuss in further detail below. But a consumer that is not well-versed in financial literacy will never be able to fully reap the benefits of a disclosure no matter how well-constructed.

We recommend Congress to put forth measures and explore those avenues that outreach to borrowers and provide meaningful education to them in a timely fashion rather than just at the time of application or at the closing table. Possessing a fundamental understanding of the mortgage lending marketplace and the loan product types available will empower borrowers to comparison shop, ask meaningful questions and make financial decisions that advance their personal life objectives. Again, NAMB strongly believes that because financial education is the key to choosing the right loan product and protecting oneself against fraud, the consumer education process should begin at a young age.

### **III. Revamp and Consumer-Test Disclosures**

NAMB wholeheartedly supports the concept of clear and consistent communication with the consumer from the shopping stage through consummation, and afterwards throughout the life of the loan (*i.e.*, monthly statements). We believe that disclosures can aid in the effort to alert potential borrowers of not only the benefits, but also the risks presented by nontraditional mortgage products. Therefore, NAMB supports the use of a uniform, industry-wide required brochure on nontraditional mortgage products that is provided to the potential borrower at the shopping stage upon inquiry about a particular loan product or no later than at the time of application.

Before we discuss the need for uniform and consistent disclosures, we wish to emphasize a few critical points.

First, any disclosure, whether new or existing, can only *aid* in the effort to inform consumers on the risks and benefits of nontraditional mortgage products. As stated above, NAMB firmly

believes that an ill informed mortgage originator can not communicate, and a borrower not well-versed in financial literacy can not understand, complex information provided in any disclosure format, whether simple or not. A disclosure by itself is insufficient to accomplish the stated objective of ensuring that a borrower is aware of the risks and benefits of the nontraditional mortgage product. This is because the inherent complexities of such products require explanations that will be too overwhelming and detailed in a written context. For this reason, education of loan officers, in addition to consumers, must operate in tandem with any mandatory disclosure scheme. Once the mortgage originator and the borrower possess the financial literacy tools necessary to understand the information imparted throughout the loan origination process, the disclosure becomes an invaluable communication tool.

Second, for disclosures to be meaningful to consumers they must be uniform, consistent and well-tested. Regardless of the distribution channel chosen, each consumer should receive the same disclosures in the same format for any particular loan product type or transaction, giving meaning to the ability to “comparison shop.”

There are numerous market players in the industry today. A consumer can get a loan from a “mortgage banker type”, a “mortgage lender type”, a “mortgage broker type”, a “credit union type”, a “banker type”, a “homebuilder type”, a “real estate agent type”, an “internet type”, and the list goes on. Because these market participants compete directly with one another, consumers are best served when all disclosures are the same regardless of the originator “type.”<sup>6</sup> Regrettably for consumers, this is not true today,<sup>7</sup> and recent proposed disclosures created nothing but consumer confusion.<sup>8</sup>

Last, NAMB believes that any disclosure requirement should refrain from being unduly burdensome on industry and should strive to complement, rather than be redundant, of information already provided to the consumer today. Simultaneously, NAMB agrees with the

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<sup>6</sup> It has been argued previously that because mortgage lenders hold their loans in portfolio, they absorb a higher level of risk and therefore, function differently than mortgage brokers who do not fund their originated loans. As a result, mortgage lenders assert that they should not be subject to the same requirements placed on mortgage brokers. Some twenty plus years ago—prior to the advent of the secondary market that we have today in America—this may have been true. But today, the line between mortgage brokers and mortgage lenders has been blurred. Today, mortgage lenders operate functionally in the same manner as mortgage brokers—they present an array of available loan products to the consumer, close the loan and then, almost instantaneously sell the loan to the secondary market. No practical difference exists in the services that many mortgage lenders provide to consumers or in the level of risk retained as compared to mortgage brokers. In fact, industry statistics show that over 85% of residential mortgage loans are originated by a mortgage broker or a lender acting as a mortgage broker for an investor.

<sup>7</sup> For example, today, only mortgage brokers disclose on the good faith estimate (“GFE”) that they earn indirect compensation when a loan closes. The truth is that ALL originator types – brokers, bankers, lenders, credit unions, etc.—receive direct compensation, indirect compensation or a combination of both. However, with all these other originator types, the back-end compensation that they all earn is not disclosed. Again, to make comparison shopping meaningful, all channels must provide the same disclosures.

<sup>8</sup> The well-documented 2004 study by the Federal Trade Commission on a proposed GFE released by HUD in 2002 clearly demonstrated that many consumers would choose a higher cost loan from a direct lender over a mortgage broker loan because they were confused by the format of the disclosure which emphasized solely broker’s indirect compensation. See The Effect of Mortgage Brokers Compensation Disclosures on Consumers and Competition: A Controlled Experiment, The Federal Trade Commission, Bureau of Economics Staff Report (Feb. 2004), at <http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf>.

Federal Banking Agencies' suggestion in their Proposed Guidance that the disclosure should provide the consumer with enough information to "prudently consider the costs, terms, features, and risks of these mortgages in their product selection decisions." (*See Proposed Guidance, p.31*).

A. *A Simple, Plain Language Brochure on Nontraditional Mortgage Products That Consolidates Information Will Be A Meaningful and Useful Information Source to the Consumer.*

With these principles in mind, NAMB respectfully makes the following two suggestions with respect to disclosing information to borrowers about nontraditional mortgage products: (1) update the Consumer Handbook on Adjustable Rate Mortgages ("CHARM Booklet") to include information about nontraditional mortgage products,<sup>9</sup> and (2) coordinate the update of the CHARM booklet with HUD so that it can also update the HUD-required booklet entitled "Buying Your Home: Settlement Costs and Helpful Information" ("Special Information Booklet") to include a discussion on the recent innovations and new loan products types that have developed in the mortgage industry, such as interest-only and pay option ARMs.

1. Create a New and Revised CHARM Booklet and Special Information Booklet That Includes Information About the Features, Risks and Benefits of Nontraditional Mortgage Products.

The Board and the Office of Thrift Supervision ("OTS"), at the behest of the House Committee on Banking, Finance and Urban Affairs over twenty years ago, developed what is commonly referred to as the CHARM Booklet. This booklet fully explains an adjustable rate mortgage ("ARM")—its definition, features, risks and benefits. The booklet also provides ways that a consumer can lessen his or her exposure to the risk presented by an ARM. The booklet advises the consumer to "ask for all the information the lender has on the loan you are considering" and to "understand [the] index rates, margins, caps, and other ARM features like negative amortization." Significantly, this booklet *already* addresses many of the topics the Federal Banking Agencies list in the Proposed Guidance and recommend that regulated entities focus upon throughout their communications with borrowers, such as payment shock, negative amortization, and prepayment penalties. Although not a one-page form, the CHARM booklet is invaluable because it provides consumers with a one-stop source for ARM information, advises consumers on the inherent risks of ARMs, and recommends specific steps consumers can take to ensure that they choose the loan product that match their financial needs.

In its comments to the Federal Banking Agencies, NAMB urged the Board to update this CHARM booklet to include the recommended information relating to the features, risks and benefits of nontraditional mortgage products, such as the interest-only, pay option ARMs, and negative amortization loans. (*See Proposed Guidance pp.31-33*). NAMB specifically suggested that the updated booklet include the following information pertaining to such

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<sup>9</sup> NAMB is pleased to learn that the Federal Reserve Board ("Board") has moved forward in updating the CHARM booklet. NAMB has agreed to participate, as part of an industry working group, in the review and update of the CHARM booklet.

nontraditional mortgage products: (1) a brief definition of the loan product type, including some basic FAQs; (2) a delineation of the material risks presented by the loan product type; (3) a simple, brief discussion on who can benefit and therefore, should consider, this type of loan product; (4) a list of questions that a consumer should ask his or her mortgage originator before choosing this type of loan product; (5) clear examples of several nontraditional loan product types that present a “worst case scenario” and fully demonstrate how interest rates and monthly payments may change throughout the life of the loan; and (6) a sample monthly billing statement that reflects a payment schedule for the selected loan product under the “worst case scenario.” Also, to ensure that a consumer has received all the required information for the selected loan product, NAMB suggests that both the mortgage originator and the borrower be required to initial the section that details the “worst case scenario” for the selected loan product type.

Again, NAMB believes that all consumers should benefit from any proposed construct that is designed to educate, inform and assist in the selection of a loan product, regardless of distribution channel. The CHARM booklet is already a universal requirement of every lender, whether federally or state-regulated, and therefore, it is a well-suited medium to provide uniform information about nontraditional mortgage products to every consumer, regardless of distribution channel. In this spirit, NAMB also believes that the Federal Banking Agencies should consult and endeavor to work with HUD to update the Special Information Booklet to reflect the new loan products types that have developed in the mortgage industry. The Special Information Booklet should contain information similar to that which would be included in the updated CHARM Booklet.

2. Consumer Test the New and Revised CHARM Booklet and Special Information Booklet to Ensure Its Utility and Effectiveness as an Information Source for Consumers.

NAMB also strongly recommends consumer testing of any proposed or revised disclosure, such as the updated CHARM booklet, to better glean the utility and effectiveness of such a disclosure format. As stated by Julie L. Williams, Former Acting Comptroller of the Currency, in a speech before Women in Housing and Finance and The Exchequer Club, “There’s a critical element that’s been missing from our consumer disclosure rulemaking processes—testing *how consumers interpret* particular disclosures and how to make disclosures *usable* to them.”<sup>10</sup> Only consumer input can shed light on whether the information provided is too dense, too complex, insufficient or in need of further explanation. Without consumer testing, a new and revised booklet will be just another paper added to a pile of disclosures that is already largely ignored by consumers.

During the consumer testing phase, the entity responsible for oversight should also be required to consider whether the proposed or revised disclosure: (1) presents information in a “user friendly format”; (2) provides the borrower with sufficient information without being overwhelming, and (3) deters the consumer from reading it in the first place by using complex

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<sup>10</sup> See Remarks by Julie L. Williams, Acting Comptroller of the Currency Before Women in Housing and Finance and The Exchequer Club, Washington D.C. (January 12, 2005).

“legalese.” Consumer testing can also provide insight as to whether the current disclosure regime is in need of an update and how technology can be used to improve the disclosure process.

3. Consult with a Task Force That Represents The Current Mortgage Marketplace and Obtain Both Industry and Consumer Input When Revising the CHARM Booklet and the Special Information Booklet.

Over twenty years ago, the Board and OTS created the CHARM booklet in consultation with input from a number of different industry and consumer organizations. NAMB urged in its letter to the Federal Banking Agencies that the Board should again consult with industry and seek input on any proposed update to the CHARM booklet, or other proposed disclosure schematic. The mortgage industry has evolved significantly since that time and the mortgage broker is now a principal fixture in the loan origination process. Mortgage brokers offer an array of loan products that may meet the financial needs of consumers and inform homebuyers throughout the home buying process. As the segment of the mortgage industry that originates the majority of mortgage loans, NAMB respectfully requested that it be an integral part of any task force that may be assembled for purposes of advising on the update of the CHARM booklet and Special Information Booklet, as well as other matters relating to educating borrowers or mortgage originators about nontraditional mortgage products. NAMB was pleased to be invited by the Board to be part of an industry working group that will review and comment on an updated CHARM booklet. NAMB looks forward to working with the Board, as well as with other entities, that endeavor to re-examine and re-evaluate their disclosure scheme in an effort to make it more meaningful and useful to the consumer.

*B. Enforcement of Existing Laws Is Needed to Effectively Eliminate Deceptive or Misleading Marketing Practices and Communications With Consumers.*

With respect to the need to increase borrower knowledge and awareness of nontraditional mortgage products, we have conveyed the importance of education for the mortgage originator and the consumer. We have also commented on the need for an improved, updated disclosure schematic that is useful and consumer-tested to advance consumer awareness as it relates to nontraditional mortgage products. We would be remiss, however, if we failed to mention that one of the most powerful tools in the arsenal of consumer protection is enforcement of existing laws.

NAMB shares the Federal Banking Agencies concern that “marketing and promotional practices. . . [may] emphasize potential benefits without also effectively providing complete information about material risks.” (See Proposed Guidance, p.29). Likewise, we agree that communications with consumers, which would include promotional and marketing materials in addition to monthly statements, should fairly reflect the loan’s products terms and payment structures. NAMB strongly believes that there should be increased enforcement of existing laws that target deceptive or illegal marketing and promotional practices, such as Section 5 of the FTC Act.

As the primary federal law that prohibits unfair or deceptive acts or practices and unfair methods of competition in or affecting commerce, the FTC Act is an invaluable consumer protection statute.<sup>11</sup> The FTC Act, which the FTC and the Federal Banking Agencies have the authority to enforce,<sup>12</sup> can be used to address “unethical” or otherwise “bad” business practices, such as deceptive marketing, that may not necessarily fall directly under the purview of a specific banking or consumer finance law. Many states also have “mini-FTC Acts” that operate in a fashion similar to the federal law and which are enforceable by the state attorney general. NAMB strongly encourages Congress to allocate resources to, and urge the increase use of, these consumer protection laws to ensure that marketing and promotional materials used to promote nontraditional mortgage products, as well as communications with consumers, are clear, balanced and not otherwise deceptive or misleading.

#### **IV. Safety and Soundness Matters Relating to Nontraditional Mortgage Products**

Mortgage brokers bring an array of loan products directly to the consumer. Mortgage brokers also focus on providing assistance to the consumer throughout the home financing process so that the consumer can find and then choose a loan product that meets their financial needs. Clearly, the business operations of the mortgage brokerage industry are not centered on product development, underwriting, or risk management of loan products. Still, as stated previously, the mortgage origination industry is inter-dependent in nature. For this reason, NAMB takes this opportunity to comment briefly on safety and soundness matters relating to nontraditional mortgage products.

##### *A. Maintain an Innovative and Free Marketplace.*

First and foremost, NAMB encourages Congress to maintain the benefits of innovation, an expansive range of financing options, and low cost of credit that can be provided only by an open and free mortgage marketplace. Overly strict, prescriptive laws and regulations that attempt, either directly or indirectly, to control product innovation and availability in the marketplace could result in unintended consequences. Many innovative loans products, such as the interest-only ARM or the 40-year mortgage, have contributed to the greater availability of diverse loan products and enhanced consumer choice, which has directly resulted in increased competition and more affordable credit.

Second, NAMB believes that innovation and technological advancement in the mortgage marketplace has occurred because the market has been free to identify market needs and develop loan products to satisfy that need. Government regulation of this innovative spirit, whether in the area of pricing, compensation, or in product development, will only result in firm boundaries that will prevent the marketplace from adequately responding to consumer needs in the future.

##### *B. Do Not Eliminate Viable Loan Products That Serve a Real Customer Need.*

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<sup>11</sup> 15 U.S.C. § 41 *et seq.*

<sup>12</sup> On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks, by Julie L. Williams and Michael S. Blysmas, *The Business Lawyer*, Vol. 58 (May 2003).

As noted previously, nontraditional mortgage products such as interest-only loans, pay option ARMs, and negative amortization ARMs have been in existence, in some form, for decades. These products have presented consumers with a range of financing options to allow for flexible payment schedules and the ability to manage wealth. Because of their long-term existence, the market already has seasoned experience dealing with the risks presented by these types of loan products. Therefore, it would seem that the current concern by many is with the increased use of these products by the “average borrower,” and the ability to combine these products with features that present several layers of risk.

NAMB shares the concern over the increased use of nontraditional mortgage products, such as interest-only and pay option ARMs that are, at times, being underwritten with either reduced documentation requirements or no documentation requirements (*i.e.*, risk-layering). However, we remind Congress that, as distribution channels, mortgage originators deliver these “exotic” loan products to the consumer. Indeed, these product types, and their availability to the average consumer, operate in direct relation to the risk tolerances first established by the secondary mortgage market investors. Credit scores and automated underwriting systems have moved the decision of whether or not a consumer is approved for a nontraditional mortgage loan away from the “point of sale” upstream to the point where the decision to invest in that particular “risk profile” is first made by private investors. Again, as mentioned previously, to resolve the concerns raised by the nontraditional mortgage loan segment of the market, we must include all the players and address all components in the process. Origination represents only one function of the mortgage financing market, which also includes time of funding, servicing and collection. This means we must add those who provide the liquidity, those who service and those who collect on mortgage loans to the conversation and include all the same to any proposed solution.

NAMB cautions against measures that could result in purposeful elimination of viable loan products that have served in the past, and continue to serve today, a real customer need. Nontraditional mortgage products offer consumers flexibility in managing their assets, as well as flexibility in managing uneven income streams or temporary periods of financial difficulty. For borrowers residing in high-cost areas, nontraditional mortgage products are often the only means available to obtain homeownership. The bottom line is that unwarranted tightening of underwriting guidelines could hurt the robust housing industry and deny deserving consumers the chance at homeownership.

All loan products present some degree of risk. Rather than taking measures designed to eliminate risk, care should be taken to understand and empower both lenders and consumers to manage the risk. NAMB believes that if a lender—federal or state-regulated—desires to offer a specific, or range of, nontraditional mortgage products, then they should not be prohibited simply out of fear of a raising interest rate environment or a falling real estate valuation market, *i.e.*, theoretical risk. As long as the lender maintains sufficient capital and loss reserves to adequately mitigate risks, then the offering of innovative, “exotic” loan products should be left to the business decisions of the lenders’ executives and management.

Accountability and enforcement will be much more effective mechanisms in controlling the risk associated with nontraditional mortgage products than prescriptive laws, regulations or guidance which may do nothing more than hamper innovation and limit consumer choice. Caution should be exercised in applying any law, regulation or guidance to theoretical risk *versus* actual risk. Likewise, we should refrain from restricting access to these products and stifling innovation of future loan products and keep instead the principles of balance and flexibility as central tenets to any law, regulation or guidance that addresses underwriting or risk management.

### **Summary and Conclusion**

NAMB believes that consumers should be: (1) educated about various loan products to better appreciate the range of choice available; (2) provided with information that highlights not only the benefits but also the risks presented by nontraditional mortgage products; and (3) not be misled or deceived by advertisements that promote nontraditional mortgage products.

NAMB also believes that education of every mortgage originator, in addition to consumer financial literacy, must work concomitantly with any uniform, industry-wide mandated disclosure on nontraditional mortgage products to achieve the objective of a well-informed consumer. A brochure, even one that is revised and consumer-tested, is by itself insufficient to alert a consumer to all the features, risks and benefits of any nontraditional mortgage product. A mortgage originator well-versed in the complexities of the loan product type can, and should, convey the more detailed aspects of the loan to the consumer directly. This requires, of course, that every mortgage originator be well-educated on the nontraditional mortgage products that they offer. With respect to safety and soundness issues relating to underwriting guidelines and risk management practices for nontraditional mortgage products, NAMB urges flexibility and balance as the central tenets of any proposed law, regulation or guidance.

Again, thank you for the opportunity to appear before this joint subcommittee today to discuss this timely issue. I am happy to answer any questions that you may have.