Consumer Federation of America

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Contact:
Allen Fishbein 202-387-6121
Patrick Woodall 202-387-6121

NEW ANALYSIS OF NON-TRADITIONAL MORTGAGE BORROWERS SHOWS LESS WEALTHY, WEAKER CREDIT THAN INDUSTRY SUGGESTS

African Americans, Latinos More Likely to Receive Negatively Amortizing Mortgages

Washington, D.C. – As Americans struggle to become homeowners, the use of interest only and optional payment mortgages continues to increase. The burden of these "riskier" mortgages is falling on middle and moderate income borrowers with less than stellar credit scores according to new data released today in a study by the Consumer Federation of America. In addition, the analysis also found that African American and Latinos were more likely to receive payment option mortgages than whites and African Americans were more likely to receive interest only mortgages.

"While the lending industry has characterized non-traditional borrowers as financially sophisticated and savvy consumers, the truth is that many are far from affluent and could be betting the house on their mortgage," said Allen Fishbein, Director of Credit and Housing Policy at Consumer Federation of America (CFA). Because home ownership is so critically important in financial security, these Americans are unwittingly putting their entire financial livelihood at risk.

Over the past few years, the number of loan products available to homebuyers has exploded, but there is little understanding by many borrowers about how to compare or even understand the differences between these loan products. The new research findings appear in CFA's newly released study, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*. CFA analyzed certain borrower and loan characteristics of more than 100,000 mortgages originated between January and October 2005. This data offers one of the first opportunities to examine characteristics of non-traditional mortgage borrowers.

Among the key findings:

- **Significant Shares of Non-Traditional Mortgage Borrowers Earn Less Than $70,000 Annually.** More than one third (36.9%) of interest only borrowers earned below $70,000 annually and about one in six (15.6%) earned under $48,000 annually. More than one third (35.0%) of payment option borrowers earned under $70,000 annually and about one in eight (12.1%) earned between under $48,000. ($70,000 was about the median for Atlanta, Philadelphia and Chicago metropolitan areas, according to HUD figures for 2005, and the national median is $44,300.)

- **African Americans and Latinos More Likely to Receive Payment Option Mortgages:** Latinos are **nearly** twice as likely as non-Latinos to receive payment option mortgages. One in fifty (2.1%) non-Latino borrowers received payment option mortgages compared to the 4.0% of Latinos that received payment option mortgages. African Americans were 30.4% more likely than non-African Americans to receive payment option mortgages. 2.2% of non-African Americans received payment option mortgages compared to 2.9% of African Americans.

- **African Americans were more likely than non-African Americans to receive interest-only** loans**.** Nearly one in ten (9.0%) of African Americans received interest-only mortgages, 11.7% higher than the 8.1% of non-African Americans that received interest-only mortgages.

- **Many Non-Traditional Borrowers Have Only Average or Even Weaker Credit Scores.** More than half (53.8%) of payment option borrowers and nearly two-fifths (38.0%) of interest only borrowers have credit scores below 700. More than one fifth (21.4%) and about one in eight (12.1%) interest only borrowers had credit scores below 660.

- **The majority of these two types of non-traditional mortgages are used to purchase homes.** Nearly four out of five (79.0%) interest-only mortgages and nearly three fifths (57.5%) of payment option loans were used to finance the purchase of a home. The high proportion of purchase mortgages in the non-traditional mortgage portfolio tends to support the contention that the increased use of these mortgage products is related to the rapidly escalating cost of housing.

The CFA research highlights that although these borrowers broadly have higher incomes and credit scores than borrowers overall, many have incomes and credit scores considerably below this. Especially considering that many of these loans are made in higher-income areas like Washington, DC and San Jose, where the area median incomes are higher, many of these borrowers are potentially below the median income.

Many borrowers are increasingly relying upon non-traditional mortgages as a means to buy homes they could not otherwise afford. Non-traditional mortgage products typically offer initial lower monthly payments than traditional fixed-rate loans. But when these loan terms reset after a brief period, usually 2 to 5 years, consumers could be vulnerable to payment shocks, making their homes suddenly unaffordable and potentially ruining their finances. A $200,000 home with adjustable rate (ARM) non-traditional mortgage, an interest only ARM payment would rise by 54% and a payment option ARM payment would rise by 123% if the interest rate rose from 5.00% to 6.50%.

"Non-traditional mortgages are more complex than your parents' home loan, and some highly leveraged or unsophisticated consumers could end up learning that the mortgage that helped them buy their home was a ticking time bomb that destroyed their finances for years," said Patrick Woodall, CFA's Senior Researcher.

The report examines the implications of the rapid rise of non-traditional mortgages and how these products pose additional risks for borrowers. Non-traditional mortgage products may benefit certain consumers, but pose more risks than benefits for many others. There are indications that many borrowers do not fully understand that these mortgages expose borrowers to potentially sharp increases in borrowing costs. Federal Regulators recently urged lenders to provide more comprehensive information to borrowers. However, given the array and complexity of many of the new products being offered, improved disclosures may not be enough. The plain fact is that deferred payment mortgage products simply may not be appropriate for all borrowers who receive them and therefore, a threat to homeownership sustainability. Suitability standards that protect borrowers from getting inappropriate mortgage products would be one solution CFA believes is worth considering.

CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education.