# Disclosure Requirements and the Sub-prime Meltdown

**Jack Guttentag**

**At the time of this writing (early April, 2007), the 60-day delinquency rate in the sub-prime segment of the home mortgage market of the US was 15% and rising. Sub-prime loans are the riskiest, associated with some combination of poor credit history, little or no down payment, and inadequate documentation of income and assets.**

**Had there been no mandatory disclosures in this market, in my opinion the delinquency rate today would be…15% and rising. For one thing, many of the sub-prime borrowers who are now in trouble knew exactly what they were doing and could not have been persuaded by any disclosures to do anything differently.**

**Such borrowers include many who took 100% loans in order to buy the most expensive house possible in an expectation of continued price appreciation. They went for a quick score and lost. With prices no longer appreciating, these borrowers have negative equity and little incentive to continue making the payments.**

**There is another group of sub-prime borrowers, also heavily represented in the default statistics, who did <u>not</u> fully understand what they were doing and might have been helped by mandatory disclosures. But they weren't because the existing disclosures were hopelessly inadequate.**

**This group took on adjustable rate mortgages (ARMs) with high-risk features. These ARMs include 2/28s with large margins, where the initial rate is fixed for 2 years and then reset to equal the current value of an index plus a margin. The borrower who cannot refinance after 2 years gets hit with a large rate and payment increase, and if they can refinance, they usually are hit with a large prepayment penalty.**

**An even more toxic mortgage is the option ARM, on which a minimum initial payment is calculated based on the rate in month one, and holds for a year, increasing by a maximum of 7.5% per year. The rate, however, jumps to the index plus margin in month 2, with the result that the minimum payment doesn't cover the interest and the balance grows. At some point, either at a scheduled payment recast after 5 years, or upon hitting a maximum loan balance, the borrower faces a payment increase that can be shockingly large.**

**None of the existing disclosures help borrowers distinguish these toxic ARMs from their more benign cousins. For example, the initial rate which holds for 2 years on a 2/28 and for one month on an option ARM, is a required disclosure. But the margin, which affects the rate for the remaining 28 years and 359 months, respectively, is not a required disclosure.**

**After most of the damage had been done, in late 2006, an inter-agency group of Federal regulators recommended that lenders voluntarily develop their own disclosures about these instruments. This was an implied recognition that revision of the official disclosures, which would have to run the political gauntlet, would take years, with no guarantee of a successful outcome. The agencies provided some suggested formats but implementation by lenders was left voluntary.**

**While the suggested formats are actually quite good, even widespread adoption will have little effect. One reason is that the new disclosures will be piled atop an already excessive volume of existing disclosures. Most borrowers ignore disclosures because too many hit them at one time, much of it is useless garbage, and few borrowers can extract the useful nuggets from the garbage. So all get short shrift, which would also be the fate of the new disclosures.**

**Unless, that is, there is someone directly involved in the process who tells the borrower "Read this one before you sign on, it is truly important." Unfortunately, the loan officers and mortgage brokers with whom borrowers deal have a financial incentive to do just the opposite. *They sell these ARMs.* Expecting them to promote disclosures that will raise questions and perhaps thwart a deal is like expecting an automobile salesman to call attention to low gas mileage or poor collision performance.**

**Given the way in which mortgages are sold, a new disclosure added to the morass of existing disclosures can be effective only if it hits mortgage shoppers between the eyes, and cannot be swept aside by loan officers and mortgage brokers. To that end, I proposed the following very simple rule:**

***Whenever a shopper is quoted a monthly payment, he must also be shown the highest monthly payment possible on that loan, and the month it would be reached, assuming the borrower always makes the minimum payment allowed.***

**But lenders will never adopt such a rule voluntarily, so don't expect to see it.**

*The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. His articles on disclosure will be found at* **http://www.mtgprofessor.com**