



One- to Four-Family Residential Real Estate Lending

Summary: This Regulatory Bulletin transmits revised Examination Handbook Section 212, One- to Four-Family Residential Real Estate Lending. The Office of Thrift Supervision (OTS) revised this section to include the *Interagency Guidance on Nontraditional Mortgage Product Risks*, issued October 4, 2006; bring OTS guidance into line with that interagency guidance; and implement other revisions. This revised handbook section replaces the existing Examination Handbook Section 212.

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SUMMARY OF CHANGES

OTS is issuing revised Examination Handbook Section 212, One- to Four-Family Residential Real Estate Lending. Change bars in the margin of the section indicate significant revisions. We provide a summary of changes below.

Section 212 One- to Four-Family Residential Real Estate Lending

This section focuses on one- to four-family residential mortgage lending, including first mortgages, second mortgages, and home equity lines of credit. The section addresses the many elements necessary for a successful real estate lending operation and highlights risk and underwriting considerations for specific types of mortgage loan products. We significantly revised Examination Handbook Section 212 to:

- Incorporate the *Interagency Guidance on Nontraditional Mortgage Product Risks*, issued on October 4, 2006, by the OTS and the other bank and credit union regulatory agencies. We revised parts of Section 212 to be consistent with the interagency guidance.
- Revise the guidance that addresses loan qualification expectations for teaser rate, nontraditional, and subprime mortgages to state that associations should qualify borrowers with payments based on the loan's fully indexed amortizing interest rate.

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- Revise the guidance to state that associations should use prudent underwriting standards to qualify borrowers including loans originated for sale to third parties under contract of sale. OTS is concerned that certain standard representations and warranties, such as a guarantee against early payment defaults, could result in repurchases by savings associations for loans that do not meet their own prudent underwriting standards.
- Add additional conditions to qualify low-doc residential loans as prudently underwritten for purposes of meeting the 50 percent capital risk weighting requirements for qualifying residential mortgages.
- Add a discussion of the addendum to *Credit Risk Management Guidance for Home Equity Lending*.
- Revise the guidance on the use of automated underwriting systems and reduced loan documentation.

Program: Adds new Level I procedure no. 3 regarding the types of 1-4 family residential loan programs. Expands on Level II procedure no. 11 regarding negatively amortizing loans. Expands on Level II procedure no. 12 regarding hybrid ARM loans. Adds two new bullets to Level II procedure no. 15 regarding manufactured home financing.

Questionnaire: Adds new questions regarding loan documentation and subprime lending.

Appendix C: Makes minor clarifications throughout the document.

Appendix F: Adds *Interagency Guidance on Nontraditional Mortgage Product Risks* as a new appendix.



—Grovetta Gardineer

**Assistant Managing Director
Examinations and Supervision Policy**

One- to Four-Family Residential Real Estate Lending

The primary business of the thrift industry is residential real estate lending. Section 5(c)(1)(B) of the Home Owner's Loan Act (HOLA) authorizes federal savings associations to invest in loans secured by "residential real estate" — subject to safety and soundness considerations. Residential real estate loans include permanent mortgage loans, construction loans, or other loans secured by single- and multi-family residential dwellings. This Handbook Section focuses on permanent mortgage lending secured by one- to four (1-4) family residential properties. We discuss construction and multifamily loans in [Handbook Section 213](#).

The single-family residential mortgage market is a highly competitive market and one that offers a wide variety of loan products to meet consumer demand. Loan products are, on the one hand, highly standardized as a result of the secondary market, along with innovations in automated underwriting and credit scoring. On the other hand, competition and demand have produced an array of mortgage loan product options for consumers ranging from fixed-rate to variable-rate loans, interest-only loans, negatively amortizing loans, subprime loans, and reverse mortgages. Each of these products brings different underwriting, risk, and portfolio management considerations.

From a credit risk perspective, well-underwritten loans to creditworthy individuals secured by their personal residences are among the safest loans in a savings association's portfolio¹. While annual loan loss rates for prime 1-4 family permanent loans fluctuate over time, they are typically below 20 basis points, which is generally lower than the loss rates for any other class of loans. Portfolios of such loans generally present much less credit risk than commercial real estate loan portfolios because:

- The risk of default is spread over many moderately sized loans rather than a few large loans.
- Savings associations generally use standardized underwriting criteria, which makes overall performance more predictable.
- Default risk is low and diversified. It is generally not dependent on the success of a particular business or industry.

¹ Initially, we will focus our discussion on prime mortgage loans with loan-to-value (LTV) ratios of less than 90 percent or with private mortgage insurance. Subprime mortgage lending and high LTV lending will be discussed later in this section.

- The amount of loss given default is generally lower because the loans are well secured by the borrower's home.

Single-family mortgage loans do entail risks. These risks include interest-rate risk, an increased default risk if underwriting standards are weak or are not followed, and the risk that properties in a particular community or during an economic downturn may experience price declines. Price declines may lead to both higher defaults and greater losses in each default. The risks inherent in a real estate mortgage loan depend on:

- The borrower's creditworthiness (or ability and willingness to pay) over the loan term.
- The loan amount relative to the value of the security property (LTV) over the life of the loan.
- The loan's terms and interest rate over the loan term.

Lenders can mitigate risk by establishing and adhering to sound lending standards and portfolio diversification strategies; maintaining high quality loan servicing and collections departments; regularly assessing portfolio risk and monitoring portfolio performance; and making changes or taking remedial action as necessary.

This Handbook Section has two parts:

- **Real Estate Lending Policies and Operations:** an overview of real estate lending standards, loan portfolio risk management, and other underwriting considerations.
- **Underwriting Considerations for Specific Loan Products:** subprime mortgage lending, adjustable rate mortgages including negatively amortizing loans, interest-only loans, home equity loans, manufactured housing loans, and reverse mortgage loans.

REAL ESTATE LENDING POLICIES AND OPERATIONS

Real Estate Lending Standards

As indicated in [Handbook Section 201](#), one of the first steps in creating a sound lending program is the establishment of safe and sound lending policies and prudent underwriting criteria. On December 31, 1992, OTS, in concert with the other federal banking agencies, adopted the *Real Estate Lending Standards Rule (RELS)*, 12 CFR § 560.100-101. The rule requires each insured depository institution to adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or are made for the purpose of financing the construction of a building or other improvements to real estate. Such policies must be consistent with safe and sound banking practices, appropriate to the size of the institution and the nature and scope of its operations, and reviewed and approved by the board of directors. The rule also requires that the lending policies must establish:

- Loan portfolio diversification standards.
- Prudent underwriting standards, including loan to value (LTV) limits that are clear and measurable.
- Loan administration procedures.
- Documentation, approval, and reporting requirements to monitor compliance with the savings association's lending standards.

In addition, savings associations must monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions. The rule also requires that the real estate lending policies reflect consideration of the *Interagency Guidelines for Real Estate Lending Policies* (Interagency Guidelines). The Interagency Guidelines in Appendix A to § 560.101 state that an institution's written lending policy should contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made. In particular, the institution's policies should address the following:

- Geographic lending areas.
- Loan portfolio diversification strategies.
- Prudent underwriting standards that are clear and measurable.
- Appropriate terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Loan review and approval procedures for loan exceptions.
- Loan administration procedures.
- Monitoring and reporting procedures.
- Appraisal and evaluation program.

The institution should consider both internal and external factors in the formulation of its loan policies.

The institution should consider both internal and external factors in the formulation of its loan policies, including the expertise and size of its lending staff, market conditions, and compliance with real estate related laws and regulations.

Appendix A to this Handbook section contains answers to commonly asked questions about the REELS and Interagency Guidelines. While the Interagency Guidelines apply to all real estate loans, not just 1-4

family residential real estate loans, we incorporate the guidance relevant to single-family mortgage lending in the following discussion.

Underwriting Standards

Prudently underwritten real estate loans should reflect all relevant credit factors including:

- The capacity and creditworthiness of the borrower.
- The value of the security property.
- Borrower equity.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (guarantees, private mortgage insurance, etc.).

The underwriting standards should also address:

- Maximum loan amounts.
- Maximum loan maturities.
- Amortization schedules.
- LTV limits.
- Pricing structures.
- Credit scores.
- Debt-to-income requirements for loans originated, loans purchased and loans sold in the secondary market.
- The use of automated underwriting and credit scoring systems in the underwriting process.

Documentation Standards

OTS expects savings associations to document loans to establish a record of each transaction, demonstrate loan quality, and secure its interest in any collateral pledged for the loan. OTS designed its documentation requirements to be flexible and based on the size and complexity of the savings association's lending operations. Pursuant to 12 CFR § 560.170, each savings association, including its operating subsidiaries and service corporations, should establish and maintain loan documentation practices that:

- Ensure the association can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose of and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate the appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

The purpose of this rule is not to mandate a list of required loan documents, but to ensure that the association maintains the necessary documents to protect its interest in the loan and verify management's determination that each borrower has the willingness and ability to repay their obligations in accordance with the loan's contractual terms. OTS modeled these documentation requirements after the *Interagency Guidelines Establishing Standards for Safety and Soundness*. (See 12 CFR Part 570.)

Typical Documentation

For residential real estate lending, savings associations typically obtain the following documentation:

- A signed loan application.
- A signed and dated promissory note and mortgage (or deed of trust).
- A title insurance policy or opinion of title to evidence the recording of the loan and the lender's security interest in the property.
- An appraisal or evaluation, in accordance with 12 CFR Part 564, evidencing the value of the security property.
- Evidence that the borrower obtained adequate hazard insurance and a certification that the borrower will retain such insurance for the life of the loan.
- A credit report or financial statement evidencing the borrower's other credit obligations and payment history.
- Verification of the source of down payment, and a verification of borrower income and employment.

- Debt-to-income ratio calculation, to document the borrower's ability to repay the loan.
- An underwriting or approval memorandum or form (signed off by the person(s) or committee authorized to approve the loan) that documents the loan's compliance with the savings association's underwriting requirements, rules, and regulations.

Some savings associations may require additional documentation such as bank statements, pay stubs, W-2 forms, and income tax returns.

Documentation for Loans to be Sold

When lenders originate loans for resale, they will typically document loans in accordance with the needs or requirements of the intended purchaser. For example, when a savings association originates loans for sale to Freddie Mac or Fannie Mae, the lender may use the underwriting requirements and documentation required by those organizations. Such underwriting and documentation requirements may be less stringent than what the lender requires for loans it plans to hold in its portfolio. Some lenders use the loan underwriting and documentation requirements of the purchaser when they plan to sell the loans and have a written loan purchase agreement with the purchaser. However, virtually all loan sales have contractual representations and warranties that allow the purchaser to "put back" loans that have any of the following issues or concerns:

- Documentation errors or omissions.
- Involve fraud.
- Become delinquent during the warranty period. The warranty period typically is for 120 days after the sale, however, some sales contracts require longer periods and may be up to 12 months after the sale.²

If an investor's underwriting standards are lenient, and a loan becomes delinquent during the representations and warranty period, the purchaser may require the lender to repurchase the loan. Moreover, many lenders use mortgage brokers to supplement their own originations, so that they may not have as much control over the production process and the information in the loan files. Where information is missing or inaccurate, purchasers may be able to require the lender to repurchase loans long after the sale. This can expose a savings association to much greater credit risk than it would have from its "held for investment" portfolio.

Thus, savings associations should use prudent underwriting and documentation standards even when they intend to sell loans to others.

² Selling a loan with representations and warranties that exceed 120 days from the date of loan purchase results in recourse such that the seller must maintain capital for the entire loan until the representations and warranties expire.

Reduced Loan Documentation

In recent years, some savings associations reduced loan documentation requirements to meet customer demand for such products, expedite loan approval, and reduce administrative costs. Savings associations and examiners have raised questions about whether “low-doc” and “no-doc” loans meet OTS’s documentation requirements.

The following definitions are useful in the discussions of this issue:

Well-documented loans. A well-documented loan has the documentation necessary to: record the loan and secure the lender’s interest in the collateral, support the borrower’s willingness and ability to repay the loan, and establish the sufficiency of the collateral to liquidate the loan, if it should become necessary.

Low-doc loans. A “low-doc” loan has the documentation necessary to record the loan and secure the lender’s interest in the collateral, and the sufficiency of the collateral to liquidate the loan, if necessary. However, it may not have all of the documentation lenders typically require to support the borrower’s ability to repay the loan. For example, a lender may ask borrowers to state their income rather than require full income verification such as payroll statements, W-2’s, or tax returns.

No-doc loans. A “no-doc” loan generally has the documentation necessary to record the loan and the lender’s interest in the collateral, but has no documentation to support the borrower’s willingness and ability to repay the loan or the sufficiency of the collateral to liquidate the loan, if necessary (e.g., no income verification, credit report, or appraisal.)

Regardless of the savings association’s name for such programs, you should focus on the actual documents required and the credit risks involved. OTS has long held that no-doc residential real estate lending, as defined above, is unsafe and unsound. Low-doc lending programs, as defined herein, vary greatly and require careful scrutiny.

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Savings associations that make low-doc loans should demonstrate that such loans are prudently underwritten and meet OTS’s documentation requirements. Well-managed low-doc residential lending programs typically offset the higher risk undertaken by not fully evaluating the borrower’s source of repayment with other mitigating credit factors. For example, if the association does not ask for or verify the borrower’s income, it should use other means to demonstrate the borrower’s willingness and ability to make timely loan payments, such as higher borrower down payments (lower LTV ratios) and higher credit scores. Some lenders may determine ability to repay a mortgage by comparing the applicant’s new mortgage payments with his or her current rent or mortgage payments, or they may ask for two or three months of the applicant’s checking account statements and review the activity.

While there can be much debate over which documents are needed to support the loan decision, the ultimate proof of whether the association’s loans are adequately underwritten lies in the performance of its portfolio relative to similar but well-documented portfolios. If an association offers a low-doc loan

product, it should ensure appropriate risk-based pricing and regular monitoring of loan performance, and limit the volume of production until it has experience with the product and it demonstrates adequate performance.

Supervisory Loan-to-Value Limits

As set forth in the Interagency Guidelines, permanent mortgage or home equity loans on owner-occupied, 1-4 family residential property whose LTV ratio equals or exceeds 90 percent at origination should have appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral. On a case-by-case basis, associations may make loans in excess of supervisory LTV limits based on the support provided by other credit factors and documented in the loan file.

On October 8, 1999, the banking agencies issued *Interagency Guidance on High LTV Residential Real Estate Lending*. (See Appendix D.) High LTV loans are defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied, 1-4 family residential property that equals or exceeds 90 percent of the real estate's appraised value. The exception is a loan that has appropriate credit support such as mortgage insurance, readily marketable collateral, or other acceptable collateral, that reduces the LTV ratio below 90 percent. Through this policy statement, the agencies clarified that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support, should be considered an exception to the Guidelines and included in the association's calculation of loans subject to the 100 percent of capital limitation. (See 12 CFR § 560.101, and Appendices A and D of this section for additional information.)

Exceptions to the General Lending Policy

Lending policies may provide for prudently underwritten loan approvals that are exceptions to its standard lending policies. The board of directors is responsible for establishing standards for review and approval of such exceptions. A written justification that clearly sets forth all the relevant credit factors that support the underwriting decision should support the loan approval. Tracking of the aggregate level of exceptions helps detect shifts in the risk characteristics of the loan portfolio. When viewed individually, underwriting exceptions may not appear to increase risk significantly; however, when aggregated, even well-mitigated exceptions can increase portfolio risk. Management should regularly analyze aggregate exception levels and report them to the board. An excessive volume or a pattern of exceptions may signal an unintended or unwarranted relaxation of the association's underwriting standards.

Loan Administration

The loan administration function is responsible for receiving and recording payments, recording security agreements, retaining loan documentation, and maintaining escrow accounts. Associations should establish procedures to monitor the payment of real estate taxes and insurance and to arrange for interim or blanket hazard insurance policies to cover any lapse in coverage. This becomes more important with seriously delinquent loans because borrowers may have less incentive and ability to make such tax or insurance payments. Loan administration procedures for real estate lending should address:

- Documentation requirements.
- Collateral administration, including the type and frequency of collateral evaluations.
- Loan closing and disbursements; payment processing; and loan payoffs.
- Escrow monitoring and administration.
- Collection procedures and timing, including foreclosure procedures.
- Claims processing.
- Servicing and participation agreements.

Timely collection of delinquent loans is a critical factor in portfolio performance. An association's written policies should provide for enhanced collection efforts as delinquency problems become more serious.

You should look for indications of delinquency problems where staff and management are:

- Unaware of delinquency problems.
- Inaccurately reporting such problems to the board.
- Not taking appropriate action to collect on the loan or foreclose, where appropriate.

Real Estate Appraisal and Evaluation

Experience has shown that the lower the LTV, the lower the likelihood of default and the lower the amount of loss in the event of default. While the sale of collateral is not an acceptable *primary* source of repayment, the borrower's equity in the home is an important factor in borrower motivation and should be integrated into the lending decision. Real property provides protection to the lender should the borrower's circumstances change and he or she is unable to service the debt.

Thus, an adequate system of collateral appraisal or evaluation and review in accordance with 12 CFR Part 564 is an essential element in sound real estate lending. A real estate appraiser should base the market value estimate contained in the real estate appraisal or evaluation on the conveyed interest in real estate on a cash or cash equivalent basis. [Handbook Section 208](#) provides guidance and examination procedures on real estate appraisals and evaluations.

Portfolio Risk Management

Loan Review and Monitoring

A sound real estate lending policy should be augmented by strong and effective internal controls. These controls should emphasize proper segregation and independence of duties between:

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- Loan officers who assist the customer and facilitate the application process.
- Loan administration personnel who disburse funds, collect payments, and provide for the timely receipt, review, and follow-up of all necessary mortgage loan documentation.
- Accounting staff that record loan transactions.
- Loan review and internal audit staff.

To monitor credit quality and compliance with board established policies and procedures, the savings association should implement a system of internal loan review commensurate with its size, risk, and the complexity of its lending and investment activities. Management's inadequate response to problem loans or lending practices can often be traced to an inadequate loan review function, or one that is poorly structured or that is not sufficiently independent of the officers who made the loans. Unfortunately, such weaknesses surface when credit problems emerge that an effective Internal Asset Review (IAR) system could prevent.

The *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)* contains an attachment on loan review systems. Refer to [Appendix A in Handbook Section 261](#) for the ALLL policy statement. The loan review section sets forth guidelines for establishing a prudent internal loan review program that:

- Promptly identifies loans with potential credit weaknesses so that timely corrective action can be taken to minimize losses.
- Assesses relevant trends that may affect collectability.
- Provides information to assess the adequacy of the ALLL.
- Assesses the adequacy of and adherence to internal loan policies.
- Evaluates the activities of lending personnel.
- Provides management and the board of directors with objective, accurate, and timely information on the portfolio's quality.

- Includes all loans, whether originated or purchased.
- Includes sample coverage that is statistically valid and includes periodic reviews of high-dollar, high-risk loans.

The purpose of the internal loan review or IAR is to assess overall asset quality, and identify specific problem assets so that association management may implement corrective action. An effective IAR should enable management to identify weaknesses in the loan portfolio and take appropriate corrective actions when necessary, both with respect to individual loans and any weaknesses in the association's loan policies and procedures.

The guidelines list several important elements to an effective loan review system. These are:

- Qualifications and independence of loan review personnel.
- Frequency, scope, and depth of reviews.
- Management review of findings and follow-up corrective action.
- Report distribution to appropriate staff, management, and the board of directors.

While each of these elements is important to an effective loan review function, one of the most critical elements is independence. Often, the initial loan review function is given to loan officers because they are the most familiar with their loans and can spot weaknesses early. This is acceptable as a first line of review. However, associations should avoid over-reliance on loan officers and their line supervisors for identification of problem loans. Senior management and the board of directors should ensure that loans are also reviewed by individuals who do not have control over the loans they review and are not part of, or influenced by, anyone in the approval process.

Please refer to [Appendix A in Handbook Section 261](#) for a further discussion of an effective internal loan review system.

Management Information Systems

Accurate and timely management information reports are key to a successful lending operation. Management information systems (MIS) reports should enable management and the board of directors to assess the performance of each loan product type (LTV, credit score, originating office, loan officer, geographic location, and profitability); and the performance of the portfolio as a whole. This will enable management to make changes to poorly performing, or unprofitable programs.

MIS reports may include:

- Summary reports showing trends in outstanding loans, new loan volume, delinquencies, and portfolio yield by different product types and LTV.

- Credit scoring distribution reports by portfolio, new volume, delinquency, and losses.
- Past due, nonaccrual, trial balance, and collections reports.
- Extension and renewal reports.
- Reports on the volume and significance of underwriting exceptions.

You should ensure that MIS reports are:

- Used to monitor loan performance or improve the portfolio.
- Timely, accurate and appropriate to the size and complexity of the association's operations.
- Provided to both management and the board.

Automated Underwriting Considerations

Some savings associations use automatic underwriting programs when they plan on selling loans in the secondary mortgage market. Automated underwriting uses historical loan performance, statistical models, and known risk factors to evaluate whether a loan can be sold into the secondary market. The most widely used automated underwriting services are Freddie Mac's Loan Prospector® and Fannie Mae's Desktop Underwriter®.

Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time.

Mortgage lenders use automated underwriting to help them:

- Determine the terms under which the loan can be sold into the secondary market.
- Evaluate the credit, collateral, and capacity of borrowers to make their monthly mortgage payments.
- Identify the appropriate type of loan for the borrower.

Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time. It also helps lenders weigh all the strengths and weaknesses of the loan appropriately, in accordance with historical experience so that worthy borrowers with minor weakness are not unjustly rejected.

When a savings association designs and uses its own automated underwriting program, it should test and validate the program prior to placing it in use and regularly thereafter.

A savings association may use such automated underwriting to facilitate loan analyses and verify that such loans can be sold to the intended investor; however, it must perform its own underwriting to determine if such loans are prudently underwritten and meet OTS and interagency guidelines.

Interest Rate Risk Considerations

In addition to credit risk, mortgage lending, particularly long-term fixed rate loans, expose the savings association to interest rate risk; that is the risk that the savings association's liabilities will reprice faster than its assets as interest rates rise, causing net interest margins and thus earnings to decline. In addition to establishing sound lending policies, the association can mitigate other portfolio risks such as interest rate and market risk, by hedging, by expanding its loan products to include adjustable-rate mortgage (ARM) loans and 15-year mortgages, and by selling some or all of its most interest-rate sensitive mortgages. Moreover, many savings associations sell residential mortgage loans in the secondary market to reduce the interest-rate risk associated with funding long-term, fixed-rate assets with short-term liabilities. This can also provide future fee income if the loans are sold with servicing retained. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Handbook.

Compliance Considerations

As part of a sound lending program, the association must ensure that all loans are made in accordance with federal laws governing credit transactions. OTS regulation 12 CFR § 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of loans originated. Loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B, or OTS Nondiscrimination regulations. The Truth-In-Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are subject to specific restrictions. Loans are also subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community. (See the Compliance Sections of the Examination Handbook for further discussion.)

Capital Considerations

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines a qualifying mortgage loan as a loan that:

- Is fully secured by a first lien on a 1-4 family residential property.
- Is underwritten in accordance with prudent underwriting standards, including standards relating to the ratio of the loan amount to the value of the property (LTV ratio). See Appendix to 12 CFR § 560.101.
- Maintains an appropriate LTV ratio based on the amortized principal balance of the loan.
- Is performing and is not more than 90 days past due.

If a savings association holds both the first and junior liens on a residential property, and no other party holds an intervening lien, the transaction is treated as a single first lien loan for purposes of determining the LTV and appropriate risk weighting under § 567.6(a).

In essence, 1-4 family residential mortgages that are performing, are prudently underwritten, and have loan-to-value ratios at origination of less than 90 percent, or are covered by private mortgage insurance, may qualify for the 50 percent risk weighting. OTS has not specifically defined the term “prudently underwritten” for purposes of determining compliance with 12 CFR § 567.1; however, OTS has long held that to be prudently underwritten, a loan must be made in a safe and sound manner to ensure that the borrower has the ability and willingness to repay the loan in a timely manner.

OTS allows savings associations flexibility in underwriting their loans, based on many factors, including borrower equity or LTV, the borrower’s credit standing (as evidenced by a credit report and credit score), sufficient cash flows to service the debt (as evidenced by an acceptable debt-to-income ratio or other appropriate information), combined with other factors, such as a guarantee from a financially responsible third party, private mortgage insurance, or evidence of other borrower assets that could be used to liquidate the loan.

Low-doc Residential Loans

OTS will consider low-doc residential mortgage loans prudently underwritten for purposes of meeting the 50 percent capital risk weighting requirements for qualifying residential mortgages, provided the following conditions are met:

- The loans otherwise meet the requirements of § 567.1.
- The association adequately documents the value of the security property pursuant to the requirements of 12 CFR Part 564.
- The association adequately documents its analysis of each borrower’s credit history (as evidenced by a credit report or credit score, for example).
- The association obtains borrower income and employment information on the signed application and uses that information to determine the borrower’s ability to repay the loan. (No income, no asset loans do not meet this requirement.)
- The loan possesses other credit strengths, such as high credit score or low LTV that mitigate risks from limited documentation.
- Private mortgage insurance is required for loans with LTVs of 90 percent or more.
- The association performs ongoing risk analysis to monitor performance and risk of low-doc lending and implements adequate and timely corrective action when needed.
- OTS has no major safety and soundness criticisms of the association’s lending program.

To retain the 50 percent risk weighting, the loans should perform as well as well-documented qualifying mortgages, given their risk profile, loss variance, and profitability. Should the performance on a portfolio of low-doc mortgage loans decline to a level that presents safety and soundness concerns, OTS may direct the savings association to risk weight some or all of the low-doc mortgages at 100 percent or higher.

Subprime Mortgage Loans

The interagency policy statement *Expanded Guidance for Subprime Lending Programs* addresses the capital requirements for subprime mortgage loans. (OTS [CEO Memo 137](#), issued February 2, 2001.) The guidance states: “Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an association would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type.” Therefore, if such programs otherwise meet the above requirements, OTS expects associations to hold capital of one and a half to three times the 50 percent risk weighting for qualifying 1-4 family mortgages (or more, depending on the overall risks involved).

UNDERWRITING CONSIDERATIONS FOR SPECIFIC LOAN PRODUCTS

Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies.

Subprime Mortgage Lending

The term *subprime* refers to the credit characteristics of the individual borrower. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.
- Bankruptcy in the last five years.
- Relatively high default probability as evidenced by, for example, a credit bureau score of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default probability likelihood.
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.

With subprime lending programs, financial institutions target subprime borrowers and offer them loans at higher interest rates and loan fees than that offered to prime borrowers, based on the risk of the loan. Since lenders charge a premium for the added risk of default, subprime loans can be more profitable than standard risk loans, provided that the lender has accurately estimated default and loss rates and has adequately priced the loans.

The banking agencies believe that responsible subprime lending can expand credit access for consumers and offer attractive returns. However, the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital. A savings association that is or plans to become engaged in subprime mortgage lending (or the purchase of such loans) must consider the additional risks inherent in this activity. It must determine if these risks are acceptable and can be controlled, given its staff, financial condition, size, and level of capital support. If management and the board decide to enter the subprime lending business, they must establish board-approved policies and procedures, and internal controls to identify, measure, monitor, and control the additional risks.

In March 1999, the OTS, together with the other banking agencies issued *Interagency Guidance on Subprime Lending*, which provides detailed guidance to examiners on subprime lending activities. (See [Appendix A of Handbook Section 217](#).)

On February 2, 2001, the Agencies issued the *Expanded Guidance for Subprime Lending Programs (CEO Memo 137)*. This expanded guidance discusses supervisory expectations for the ALLL regulatory capital, examination review of subprime activities, classification of risk, and documentation for re-aging, renewing, or extending delinquent accounts. This guidance also discusses regulatory expectations for the review and treatment of certain potentially abusive lending practices.

Adjustable Rate Mortgage Loans

Unlike fixed-rate mortgages, where the interest rate does not change over the life of the loan, the interest rate on an adjustable rate mortgage (ARM) is based on the movement of a predetermined index. The rate is usually set as the function of the predetermined index plus an incremental amount established at the initiation of the loan. This incremental amount is commonly referred to as the margin. The combination of the index rate and the margin is referred to as the fully indexed rate. Depending on the type of index the ARM is based on, the interest accrual rate can change monthly (11th District Cost of Funds Index [COFI]) or annually (Constant Maturity Treasury Index [CMTI]). Some ARMs are structured such that there are limits on the amount of the increases and decreases in the interest accrual rate as the result of changes in the underlying rate index. These are called interest rate “caps,” “ceilings,” and “floors.”

For most ARM loans, the borrower’s monthly payment amount is recalculated periodically to assure full amortization of the loan over its remaining life at the current fully indexed interest rate.

Teaser Rates and Interest Rate Buy Downs

One feature commonly associated with some ARM products is the “teaser” or low introductory interest rate. This includes situations where borrowers receive a short-term subsidy or “buy down” on the loan rate from the home seller or lender. Teaser rates are used to attract borrowers to do business with the home seller or lender and help borrowers qualify for the loan. Teaser rates reduce the initial interest accrual and monthly payment while the teaser rate is in effect, usually 12 to 36 months. At the expiration of the teaser-rate term, the borrower’s monthly interest accrual is calculated at the fully indexed rate.

OTS regulations place no specific restrictions on the structure of ARM loans. The adjustable rate mortgage provisions of 12 CFR § 560.35 do not set limitations on periodic and lifetime interest-rate adjustments. Thus, management has the flexibility to develop a buy down program provided it underwrites and structures the program in a safe and sound manner.

Qualifying ARM Borrowers

Loans that have adjustments to higher interest rates may lead to steep increases in payment burdens and subsequent delinquencies if borrowers were originally qualified at low introductory rates, particularly borrowers with initial high debt-to-income payment burdens. It is important that associations assess a borrower’s ability to qualify for the loan by measuring that borrower’s current income against projected amortizing payments that will result from a fully indexed or current market interest rate.

Using the deep teaser rates to qualify a borrower will enable some borrowers to qualify for loans that they would not qualify for under normal circumstances. OTS is concerned about the potential payment shock to borrowers after the teaser rate term expires, particularly when other credit risk factors, such as high LTVs, poor credit histories, high debt-to-income, and low documentation are present. Savings associations should qualify borrowers at an amortizing payment based on the fully indexed or market mortgage rate as of the date of commitment.

Pricing of ARMs

The pricing of products and services offered by savings associations should be competitive, provide sufficient yield to cover the operating expenses, funding costs, expected losses, and a reasonable risk adjusted return on invested funds. The pricing of products and services should foster safe and sound lending.

Some lenders may incorrectly price ARMs because of a lack of understanding of the “options” or risks associated with ARMs. Lenders should price “promotional” mortgage loans, such as adjustable “teaser” rate mortgages, to yield a sufficient return over the life of the loan. Mortgage documents should state precisely which index is used and when the rate may be adjusted.

Some lenders may incorrectly price ARMs because of a lack of understanding of the “options” or risks associated with ARMs.

One method to determine if lenders are appropriately pricing ARMs is to compare the expected returns on originated ARMs with yields on comparable ARMs in the secondary market. Specifically, you can compare secondary market data to determine whether the points the association receives for originating the ARM compensate it for the discount that the secondary market requires to accept the risks of that ARM. If the required discount is larger than the fees the association receives for originating the ARM, you might conclude the association is not pricing its ARMs appropriately.

Accounting Treatment

Where the buy down payment is in the form of a single, lump sum representing a portion of the interest due during the buy down period, the association should include the payment with other deferred fees and loan costs to determine the net deferred fees for the loan. The association should amortize such net deferred fees over the life of the loan using the interest (level yield) method pursuant to SFAS No. 91. Such accounting is required for any type of loan, whether fixed-rate or adjustable-rate, in connection with making a buy down payment.

Savings associations should take into consideration the existence of any buy down arrangement in determining the value of the property. If the amount of the buy down is reflected through an increase in the property's sale price to a level higher than on an identical property in the local market on which no buy down is offered, then the appraisal should reflect this fact.

Alternative or Nontraditional Mortgage Products (AMP)

Lenders have developed a variety of AMPs designed to reduce interest rate risk, make mortgages more affordable, and avoid the payment fluctuations typically associated with conventional adjustable rate mortgages. On October 4, 2006, the OTS, together with the other bank and credit union regulatory agencies issued *Interagency Guidance on Nontraditional Mortgage Product Risks*.

The Guidance applies to all federally insured depository institutions, their subsidiaries, and affiliates. It also applies to loans purchased from or sold to others. While it specifically applies to nontraditional mortgages, the principles in the guidance apply to all mortgage loans with similar features. See [Appendix F](#) for the full text of the Guidance.

The Guidance defines the alternative mortgage products as:

- “Interest-only” mortgages – a borrower pays no loan principal for the first few years of the loan.
- “Payment option” adjustable-rate mortgages (ARMs) – a borrower has flexible payment options with the potential for negative amortization.

The Guidance instructs institutions to review and analyze several factors when underwriting these types of loans. Additionally, the Guidance sets forth supervisory expectations for institutions that originate or service alternative mortgage loans, including:

- **Portfolio and Risk Management Practices.** Financial institutions should have strong risk management practices, capital levels commensurate with risk, adequate allowances for loan losses, and strong systems and controls for establishing and maintaining relationships with third parties.
- **Loan Terms and Underwriting Standards.** Institutions should establish prudent lending policies and underwriting standards for alternative mortgage products that include consideration of a borrower's repayment capacity.
 - OTS recognizes that an institution's underwriting criteria are based on multiple factors that are jointly considered in the qualification process, and that a range of reasonable tolerances may be developed for each factor.
 - Savings associations should set the initial interest rate or start rate for alternative mortgage products in a manner consistent with prudent risk management practices, since a start rate substantially below the accrual rate for the loan may lead to negative amortization or payment shock.
- **Risk Layering.** Financial institutions that layer multiple product features may increase the potential risks of alternative mortgage products. Institutions should perform adequate underwriting analysis and consider strengthening borrower qualification standards when loan products have several higher risk features or credit risk factors. These may include:
 - Reduced or no documentation, or no customer verification.
 - High LTV's.
 - Borrowers with poor credit histories.
 - Simultaneous second mortgages.
- **Consumer Protection.** Institutions should implement programs and practices designed to ensure that consumers receive clear and balanced information to help them make informed decisions while shopping for and selecting alternative mortgage loans.
 - Providing this information to consumers serves as an important supplement to disclosures required under the Truth in Lending Act, Regulation Z, or other laws.
 - Such information should apprise consumers of, among other things, the potential for negative amortization, whether prepayment penalties apply, and the costs associated with reduced documentation mortgages.

Many savings associations have successfully offered alternative mortgage products for many years. OTS is aware that the experience of these institutions provides insight into successful risk management practices and disclosures. The Guidance provides flexibility in the methods and approaches an institution can incorporate into its underwriting standards to appropriately mitigate risks associated with alternative mortgage products. Accordingly, institutions should strive to incorporate the standards set forth in the Guidance and balance any inherent risks through sound risk management practices, implementation of strong control systems, prudent underwriting, and portfolio monitoring to offset the risks of negative amortization.

Following is a discussion of alternative mortgage product features.

Negative Amortization

Lenders may structure some ARM products such that they negatively amortize under certain interest rate scenarios. With conventional fixed-rate mortgages, the interest accrual rate and annual payment are held constant over the life of the loan, and a portion of each monthly payment reduces the outstanding principal balance of the loan. Some loans have flexible payment features, such as option ARMs, where borrowers have the option of making fully amortizing payments, interest only payments, or a low, minimum payment. The minimum required payment remains constant for a specified period; then the loan recasts so the loan fully amortizes over the remaining loan term. If the borrower only makes the minimum required payment during the option period, any unpaid interest is added to the principal balance, thus increasing the outstanding loan amount. The minimum payment on option ARM loans typically increases 7.5 percent each year during the option period. Option ARM loans also have caps that limit the loan balance increases, because of negative amortization, to 110 percent to 125 percent of the original loan amount.

Negatively amortizing mortgages give borrowers payment flexibility, the option of reduced monthly payments, and if borrowers are qualified at the low, minimum payment, allows them to borrow more than they could otherwise afford. It also allows them to free up monthly income for other purposes.

The disadvantage of negatively amortizing loans is that the monthly payment will increase significantly after the option period expires, the loan is recast, and the amortization period begins. This may place borrowers in danger of default if they cannot afford the higher monthly payments. In addition, there is the risk that the borrower's equity will decrease if they make only the minimum required payments during the option period. This decline in borrower equity will accelerate during periods when interest rates are high.

Another disadvantage is that negatively amortizing loans are less liquid than fully amortizing loans when borrowers make only the minimum required payments.

Savings associations that offer negatively amortizing mortgages should establish identify, measure, monitor and control the risks associated with these loans. Associations should implement sound underwriting criteria and property valuation standards, as well as controls to monitor and manage the additional risks from negatively amortizing lending.

Savings associations should also ensure that the borrowers are able to make the higher required payments after the loans are recast. In general, savings associations should qualify borrowers at an amortizing payment based on the fully indexed or market mortgage rate as of the date of commitment.

Rather than focusing on loan products with negative amortization features, you can better evaluate risk by focusing your attention on loans where borrowers are only making the minimum required payments. Borrowers that chronically make only the minimum payment may be at risk should rates increase or they experience financial difficulties. You should also determine the amount of mortgages in the portfolio that actually negatively amortize as opposed to those where the loan contract merely allows it.

NegAm loans should not be considered high LTV loans (pursuant to 12 CFR §§ 560.100-101) just because of a commitment by the lender to allow the loan balance to negatively amortize to a level that exceeds the supervisory LTV limits. Because the NegAm commitment is conditional and because the borrower may elect to pay a higher payment so that negative amortization does not occur or would be limited, the loan would only become a high LTV loan if the loan balance actually increases to 90 percent or higher of the real estate's value at origination.

See [Appendix C](#) for a more detailed discussion of negatively amortizing loans.

Interest-only Mortgage Loans

Interest-only (I/O) mortgages are becoming increasingly popular. With a typical 30-year fixed-rate mortgage, a portion of the borrower's monthly payment pays the interest accrued each month, and a portion of the payment reduces the principal amount of the loan. Over the term of the loan, the principal balance is repaid in full. In comparison, with an I/O mortgage, the borrower's monthly payments are structured to repay the interest accrued each month, with no portion to reduce the principal. Thus, the loan balance does not decrease during the interest-only period. Most I/O mortgages have an interest-only period and an amortization period. Typically the I/O period is five years, and the amortization period is 25 years. I/O loans often have a 5-year fixed interest rate, which is lower than the interest rate on a typical 30-year fixed-rate mortgage. The loan then has a 25-year adjustable-rate, fully amortizing period.

It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans.

I/O mortgages allow borrowers to reduce their monthly payments, often allowing them to borrow more than they could otherwise afford, or to free up their income for other purposes. The disadvantage of I/O loans is that the monthly payment will inevitably increase significantly after the interest-only period expires and the amortization period begins. This may place borrowers in danger of default if they cannot afford the higher monthly payments.

I/O loans are also less liquid than fully amortizing loans, because the borrower pays no principal for the first five years. This may be an advantage or a disadvantage, depending on the association's liquidity needs and its other investment alternatives.

It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans. The primary factor to consider is the borrower's ability to make higher payments after the expiration of the I/O period.

Qualifying I/O Borrowers

It is important that associations qualify borrowers by measuring current income against projected larger, amortizing payments after the interest rate and the I/O period expires.

As with any lending program, OTS expects savings associations to identify, measure, monitor, and control the risks of their lending activities. Therefore, a prudent strategy may be to limit the association's investment or sell most I/O production until management fully understands and can control the risks involved with this product.

You should review I/O programs and assess whether management is conducting the program in a safe and sound manner, identifying and controlling the risks, and monitoring the performance of the I/O portfolio. Appropriate MIS and performance reporting to management and the board of directors is an essential element in this process.

Home Equity and Second Mortgage Loans

For years, savings associations accommodated homeowners' needs by allowing them to take out second mortgages to make improvements to their homes, finance education, consolidate bills, start a business, or other purposes. Typically, a lender offers second mortgage or home equity loans for shorter terms and higher rates than they offer for their first mortgage loan products. When home equity and second mortgage loans originally were offered in the marketplace, the maximum amount financed would typically be 80 percent of the value of the home, less the amount of the borrower's first mortgage. Savings associations have generally had excellent performance experience with these loans.

Over the past few years, lenders have offered various higher risk home equity products, such as subprime home equity loans and home equity lines of credit up to 100 percent of the value of the home, when combined with the first mortgage. Some lenders (many of them unregulated) offer home equity loans up to 125 percent of the value of the borrower's home. The higher risks associated with this lending is discussed in the *Interagency Guidance on High LTV Residential Real Estate Lending*. (See [Appendix D](#).)

Because of the higher risk associated with subprime and high LTV home equity loans, savings associations should consider the *Credit Risk Management Guidance for Home Equity Lending* issued by the OTS together with the other banking agencies on May 16, 2005. (See [Appendix E](#).) The guidance outlines OTS's expectations for savings associations with home equity lending programs to implement sound risk management practices. Savings associations should also adhere to the Interagency Guidelines and the REELS Rule, as well as other applicable rules and guidelines. The association should determine whether such a program is appropriate taking into account its staff resources, capital levels, and other risk exposures inherent in the association's asset structure. Savings associations should

establish prudent lending standards, credit management, servicing and collections procedures to identify, measure, monitor, and control the risks associated with such lending.

- **Lending Standards.** Savings association lending policies relating to its home lending program should be appropriate given the size and financial condition of the association, the expertise and size of the lending staff, the need to avoid undue concentrations of risk, market conditions, and compliance with real estate laws and regulations. The policy should also clearly state the goals of the association's home lending program.

Some high LTV home equity lenders offset the higher credit risks inherent in low security or unsecured lending by requiring higher credit bureau scores. Lenders may also use other strategies such as setting maximum debt to income ratios that limit a borrower's total monthly debt burden to prudent levels, and establishing maximum loan amounts and length of employment standards. Since these products are often ARMs with no caps, it is also appropriate to consider the guidance on ARM lending in this Handbook Section.

- **Credit Management.** Once loans are on the books, a savings association should perform periodic risk assessments through loan review and portfolio monitoring. Monitoring should include the evaluation of trends in loan volume, delinquencies, nonperforming and classified loans, as well as losses and the adequacy of the ALLL. At a minimum, associations should segregate portfolios by LTV ratio (such as 80 to 89 percent, 90 to 99 percent, and 100 to 109 percent) and analyze them separately. When the first mortgage is with another lender, associations should include the mortgage balance with the other lender in calculating LTV. It is not necessary that an exact first mortgage balance be obtained for this purpose; associations may use the balance of the first mortgage at origination or a reasonable approximation based on expected amortization. If an association approves loans using credit scores, it should track performance by periodic credit score updates. The association should make adjustments to underwriting standards and loan administration and collection procedures when performance does not meet expectations or economic cycles dictate added concern.
- **Servicing and Collections.** Because foreclosure is seldom a cost effective option, lenders that engage in high LTV home equity lending often need to make special efforts to develop and maintain effective servicing and collection procedures. Lenders involved in subprime lending stress that their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary. Associations need to ensure they can absorb the costs associated with a more intensive loan servicing and collection function.
- **Other Strategies to Minimize Risk.** To further minimize risk, associations may want to adopt strategies more pertinent to the unique nature of subprime or high LTV home equity loans. For example, when a borrower uses the loan to consolidate other debts, borrowers may reload on credit card debt after taking out the home equity loan. Lenders might design procedures to prevent this, such as paying off other creditors directly from the loan proceeds and limiting "cash out" funds. Lenders may also monitor subsequent charge account activity by updating

credit bureau reports on a regular basis. When credit report data indicates a decline in the borrower's credit standing, lenders should consider taking action to limit their exposure, such as curtailing further advances on open-end lines of credit.

Addendum to Credit Risk Management Guidance for Home Equity Lending

In September 2006, the federal banking agencies amended the *Credit Risk Management for Home Equity Lending* guidance to provide additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only features. While HELOCs with these features may provide flexibility for consumers, OTS is concerned that consumers may not fully understand the product terms and associated risks. This addendum (See Appendix F) provides guidance addressing the timing and content of communications with consumers obtaining interest-only HELOCs. These consumer protection recommendations are similar to the guidance contained in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (September 2006) for closed-end home purchase, refinance, and home equity mortgage products.

Manufactured Home Financing

Congress designated the term “manufactured housing” to describe homes built to Housing and Urban Development (HUD) building code (HUD code) established in the Manufactured Home Construction and Safety Standards Act of 1976. HUD code pre-empts local building codes. Manufactured homes have a permanent chassis. Modular, panelized, kit and other homes without a permanent chassis are not considered manufactured homes. Modern manufactured homes have evolved from their distant origins as travel trailers or mobile homes, and are almost never moved from their original site. Today, about three-fourths of new unit sales are multi-section homes, and two-thirds are placed on the buyer's land.

In most states, manufactured homes are originally titled as personal property or chattel. To be considered real estate, the home's wheels, axles, and hitch must be removed and the home must be permanently attached to the land. In such cases, personal property title is surrendered and the home converted to real property in accordance with state and local requirements.

Pursuant to section 5(c)(1)(J) of the HOLA, a federal savings association may invest in manufactured home chattel paper³ and interests therein without limitation as to percentage of assets. This authority includes dealer inventory and retail financing.

Additionally, a savings association may invest in manufactured homes secured by a combination of the manufactured home and real estate. If the manufactured home is permanently affixed to a foundation, a savings association may treat a loan secured by a combination of manufactured home and lot on which it sits as a home loan and report it as such on its Thrift Financial Reports. Such loans are subject to the LTV and other requirements of the Interagency Guidelines, at 12 CFR § 560.101.

³ The term “manufactured home chattel paper” means a document evidencing an installment sales contract or a loan or interest in a loan secured by a lien on one or more manufactured homes and equipment installed or to be installed therein.

Lenders engaged in manufactured housing finance must carefully manage the risk of collateral depreciation. Savings associations should establish conservative underwriting standards, prudent LTV limits and amortization schedules, and rigorous appraisal standards for manufactured home lending. Professional appraisers with specific experience in valuing manufactured homes should conduct the appraisals. Fannie Mae and Freddie Mac purchase mortgages secured by manufactured homes, subject to specific underwriting guidelines. Mortgage insurance is available from private mortgage insurers and Federal Housing Administration (FHA) for loans secured by manufactured homes.

Reverse Mortgage Loans

Over two-thirds of this country's senior citizens own their homes. While almost 80 percent of the homes are owned free of any liens or encumbrances, many seniors find themselves in the position of being "house rich but cash poor." In response to this problem, some lenders have developed loan products referred to as reverse mortgage loans.

Reverse mortgage loans are a form of credit extension secured by first mortgages on single-family residences. As the term implies, reverse mortgage loans are the reverse of traditional mortgage loans. Instead of borrowing a lump sum and repaying it over time, borrowers receive loan proceeds either in the form of a line of credit (typically about 30 percent to 40 percent of the property's value, which they can draw on when they need it) or in regular monthly advances. The advances may either be for a specified number of months ("term" loans) or may be paid as long as the borrower lives in the home ("tenure" loans). Regardless of the advance feature of the loan (term, tenure, or line of credit), reverse mortgage loans do not have fixed maturity dates. They mature when the borrower either dies or moves. If there are two borrowers, the loan matures when the survivor dies or moves. At that time, lenders are repaid out of the proceeds from the sale of the home, and the lender's recovery from the borrower or the estate will be limited to the proceeds from the sale of the home. As with conventional mortgage loans, the lender accrues interest on the outstanding balance until the loan is repaid.

For a typical mortgage loan, the loan amount is based on a percentage of the appraised value or sales price, and is repaid by the borrower(s) through monthly payments over a fixed loan term, so that the loan amount in relation to the property's value typically decreases over time. Reverse mortgages, on the other hand, start out with a low LTV ratio that typically increases over time as the lender makes advances to the borrower(s) and interest accrues on the unpaid balance.

The amount of the monthly payments or advances the borrower(s) receive for either term or tenure reverse mortgage loans depends on the estimated loan maturity, the interest rate, and the value of the home. Lenders use mortality and relocation tables to estimate the loan maturity. For tenure loans, the number of months to maturity equates to the number of payments the lender will have to make to the borrower(s). For example, under the FHA reverse mortgage program, a 65-year-old woman, with \$100,000 in home equity, might receive \$234 per month for life. An 85-year-old woman with \$100,000 in home equity might receive \$604 per month. The reason for the increase in payment amounts to the 85-year old borrower is that the number of payments the lender expects to pay is much lower than for the 65-year old borrower.

Other factors that affect monthly payments are the expected appreciation or depreciation of the home and whether the borrower receives an up-front advance in addition to monthly payments. The FHA program uses very conservative life expectancy assumptions in its payment model, so monthly payments are often lower than with private programs that use standard life insurance mortality tables.

Reverse mortgage loans are attractive from a consumer standpoint in that they enable borrowers to use the equity in their homes to produce monthly cash income while they remain in their homes. OTS encourages associations to engage in lending programs that meet identified community credit needs, provided the association conducts them in a safe and sound manner. While reverse mortgage loans may be responsive to a particular community's credit needs, their structure presents several challenges to lenders, including:

- The management of risks associated with changes in the value and condition of the property over the life of the loan.
- The uncertainty over the loan term, the number of payments that will be made to the borrower.
- The general lack of experience among many lenders with reverse mortgage products.

Therefore, it is incumbent on management and the board of directors to carefully assess all risks associated with any proposed reverse mortgage-lending program and determine to what degree the association can offset or tolerate such risks.

Furthermore, as with all new lending programs, savings associations should limit their reverse mortgage investments until they gain sufficient experience in dealing with the unusual characteristics of the product. As reverse mortgage loans are secured by real estate, they are subject to the REELS regulation and Interagency Guidelines discussed in this section.

[Appendix B](#) contains a more detailed discussion of the risks associated with reverse mortgage loans, as well as accounting and other policy issues.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(5)(c)(1) Loans or Investments without Percentage of Assets Limitations

§ 1464(5)(c)(2) Loans or Investments Limited to a Percentage of Assets or Capital

Code of Federal Regulations (12 CFR)

Part 528	Nondiscrimination Requirements
Part 535	Prohibited Consumer Credit Policies
Part 560	Lending and Investment
560.100-101	Real Estate Lending Standards
§ 560.170	Establishment and Maintenance of Records
§ 563.43	Loans by Savings Associations to Their Executive Officers, Directors and Principal Shareholders
Part 564	Appraisals
§ 567.1	Qualifying Mortgage Loan
§ 567.6	Risk-based Capital Credit Risk-weight Categories
Part 570	Safety and Soundness Standards
§ 590.3	Operations (Preemption)
§ 590.4	Consumer Protection Rules for Federally Related Loans, Mortgages, Credit Sales and Advances Secured by First Liens on Residential Manufactured Housing Loans

Office of Thrift Supervision Guidance

CEO Memos

CEO 103	Uniform Retail Credit and Account Management Policy
CEO 137	Expanded Guidance for Subprime Lending Programs
CEO 222	Credit Risk Management Guidance for Home Equity Lending
CEO 244	Interagency Guidance on Nontraditional Mortgage Product Risks

Regulatory and Thrift Bulletins

RB 3b	Policy Statement on Growth for Federal Savings Associations
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
TB 55a	Interagency Appraisal and Evaluation Guidelines
TB 72a	Interagency Guidance on High Loan-to-Value Residential Real Estate Lending

Handbook Sections

Section 208	Appraisals
Section 217	Consumer Lending, Appendix A, Interagency Guidance on Subprime Lending
Section 261	Adequacy of Valuation Allowances, Appendix A, Effective Internal Asset Review Systems
Section 410	Financial Reports and Records
Section 1100	Compliance Examination Oversight Program
Section 1200	Fair Lending
Section 1300	Consumer Loans and Regulations
Section 1400	Compliance Laws and Regulations

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 34	Capitalization of Interest Cost
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
No. 91	Specifies GAAP Accounting for Loan Fees
No. 133	Accounting for Derivatives

Other References

Fannie Mae and Freddie Mac Underwriting Guidelines

FHA Underwriting Guidelines

One- to Four-Family Residential Real Estate Lending Program

EXAMINATION OBJECTIVES

To evaluate the one- to four- (1-4) family residential loan portfolio for credit quality and risk.

To determine if a savings association's lending policies regarding real estate lending activities are adequate, in conformance with the Real Estate Lending Standards (RELS), and appropriate to the size and complexity of the association's lending operations.

To assess management's and lending personnel's conformance with established policies and guidelines, and compliance with applicable laws and regulations.

To determine if a savings association's risk management practices and internal controls regarding residential real estate lending activities are adequate.

To initiate corrective action as appropriate.

EXAMINATION PROCEDURES

You should conduct the following examination procedures in conjunction with the [Examination Handbook, Section 201, Overview](#) procedures to bring together a review of the entire lending function(s) of an association. Where a savings association has multiple loan departments (e.g., segregated by lending type(s)) the examiner team will use the aggregate findings to arrive at an overall assessment of the lending function and the credit risk and quality of the entire loan portfolio. As such, the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality should avoid duplication of efforts by ensuring an exchange of information and results from each examiner responsible for the different asset quality sections.

LEVEL I

WKP. REF.

This section expands on the general lending discussion in [Section 201](#) to address additional policy guidelines specific to 1-4 family residential mortgage lending.

1. Review Section 201 Level I findings to determine whether the loan policies and procedures include guidance related to the types of 1-4 family residential lending programs the association offers, and whether the portfolio risk management practices and internal controls adequately address these programs.

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Prepared By:	
Reviewed By:	
Docket #:	

One- to Four-Family Residential Real Estate Lending Program

WKP. REF.

2. Verify that the lending policies and practices are consistent with the REELS (12 CFR §§ 560.100-101) and the Interagency Guidelines for Real Estate Lending Policies, the Interagency Guidance on High LTV Residential Real Estate Lending (Interagency LTV Guidance) ([Appendix D to this Handbook Section](#)), and the Interagency Guidance on Nontraditional Mortgage Product Risks ([CEO Memorandum 244](#)). Verify that the lending policies and procedures are appropriate for the nature and risk of the real estate lending activities conducted.

 3. Determine the types of 1-4 family residential loan programs and note whether and to what extent the association makes nontraditional, hybrid, or subprime mortgages. Identify any new lending activities, programs, or strategies to evaluate as part of this review.
 - Determine whether the association’s lending programs incorporate risk layering features such as high LTV lending, simultaneous second mortgages, or limited documentation.

 4. Review loan portfolio performance for the various mortgage products offered. Ensure that the association has properly stratified loans by various risk elements.
 - Identify any performance concerns and determine whether additional review is needed to assess such concerns.

 5. Review the audit reports and preceding report of examination and all lending related exceptions noted, and determine if management took appropriate corrective action.
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One- to Four-Family Residential Real Estate Lending Program

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6. In conjunction with the board and management report reviews in Examination [Handbook Sections 260, 310, and 330](#), ascertain if any problems or concerns regarding real estate lending were noted.

7. Review MIS reports related to 1-4 family residential lending to identify potential areas of concern and to assess the adequacy of reporting to the board of directors and management on the performance of the real estate portfolio (trends, delinquencies, exceptions, losses, collections, etc.).

8. Verify that the association is properly classifying past due 1-4 family mortgages and home equity loans in accordance with the Uniform Retail Credit and Account Management Policy.

9. Participate in the Level I review of [Section 208](#) or discuss findings with the EIC to ensure that the association's appraisal practices are sound and do not otherwise impact the risk of the association's lending operations.

10. Coordinate with examiners reviewing compliance management to ensure that the association adequately covers the 1-4 family residential lending within the scope of the compliance management oversight, and that there are no material violations of consumer lending laws or deficiencies in the compliance management function that could impact the risk profile of the real estate loan portfolio.

11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures. Where you determine that the association has sound underwriting policies and practices, and strong internal controls and risk management practices, you might limit your review to higher risk lending activities (e.g., subprime lending), areas with identified

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performance concerns, or newer lending activities or programs (e.g., interest-only loan programs) where the association's track record is limited.

12. Based on your Level I review, determine the need for sampling of homogeneous assets.
-

LEVEL II

One- to Four-Family Residential Lending

1. Determine whether the association has established procedures to verify borrower provided information (such as sending out verification of deposit letters and verification of income letters).
-
2. Determine whether the association has established adequate procedures to perfect its interest in the security property.
-
3. Verify that the association adequately prices mortgage loans to provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit.
-
4. If applicable, determine whether the association has appropriate controls, oversight, and underwriting policies and procedures to address low-doc loan programs.
-

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5. For FHA-insured and VA-guaranteed loans:
- Determine that a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by test checking a representative sample of such loans.
 - Determine that required delinquency reports are being submitted.
-

Adjustable Rate Mortgages

6. Verify that the points the association receives for originating the ARM loans compensate the association for the discount that the secondary market would demand to accept the risks of that ARM product.
-

7. Determine which index (Treasury bill rate quoted on a discount basis or on the constant-maturity yield rate) the association uses for adjustable rate mortgages (including interest-only mortgages). Verify that association's mortgage documents state precisely which index is used.
-

8. For discounted, Hybrid, or "teaser" ARMs:
- Determine if the association's current pricing structure or policy is sufficient to cover the association's operation expenses, funding costs, and risk premium. If not, determine the soundness of management's strategy. Note if any of the following conditions are present:
 - Deeply discounted ARMs, even in periods of stable or falling interest rates, may not reach profitability until at least two or three repricings occur.
 - Any interest-rate movement above the yearly interest-rate cap must be absorbed by the association.
 - Refinancing existing ARMs at lower rates offered on new ARMs reduces the opportunity to recoup initial losses in subsequent repricings.

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- Determine if the association's lending policies and procedures and underwriting guidelines adequately address the increased default risk by qualifying borrowers at the fully indexed rate.
-

9. Verify that the association properly accounts for interest rate buy downs according to SFAS No. 91.

Home Equity Lending

10. If the association originates home equity loans, verify that the association:

- Adheres to the guidance set forth in the Interagency LTV Guidance regarding high LTV loans.
 - Has adequate underwriting procedures.
 - Has an adequate servicing and collection department and staffing.
 - Has adequate monitoring and reporting systems.
-

Negative Amortization and Interest Only Loans

11. If applicable, determine whether the association has underwriting policies and procedures that adequately address loans with the potential for negative amortization, including limits on the amount of negative amortization allowed on a loan compared with its current market value.

- Determine that the underwriting for such loans conforms with OTS guidance in this section as well as the Interagency Guidance for Nontraditional Mortgage Product Risks.
 - Assess the level of such loans with chronic negative amortization.
-

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12. Determine if the association (and brokers, if applicable) provide borrowers with adequate information concerning the payment options, negative amortization if only the minimum payments are made, and reset provisions of loans with negative amortization features.
-

Subprime Mortgage Lending

13. If the association is engaging in subprime mortgage lending, verify that the association:
- Segregates its subprime loans to manage risks and monitor performance.
 - Follows the Interagency Subprime Lending Guidance and the Expanded Subprime Lending Guidance.
 - Has sufficient staff training and resources to manage any additional collection burden.
 - Has sufficient ALLL and capital to cover the additional risks inherent in its subprime lending operation.
-
14. If the association makes hybrid 2-28 or 3-27 ARM loans, verify that underwriting standards require borrowers to qualify at the fully indexed rate, and not the start or “teaser” interest rate.
-
15. As appropriate, conduct additional subprime lending examination procedures detailed in [Appendix B of Handbook Section 217](#).
-
16. Select a sample of subprime loans for review and analyses. **Sampling is mandatory for associations with subprime lending programs.**
-

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Reverse Mortgage Loans

17. Determine if the association engages in reverse mortgage lending. If so, verify that the association:
- Calculates the risk-based capital requirement separately for each reverse mortgage loan.
 - Assesses each borrower's life expectancy for each reverse mortgage loan.
 - Performs a sensitivity analysis on the reverse mortgage loan program's profitability for:
 - A range of alternative mortality rates.
 - A variety of possible appreciation and depreciation scenarios.
-

18. Determine whether the association structures reverse mortgage loan contracts to withhold the appreciation portion of payment until appreciation actually occurs.
-

Manufactured Home Financing

19. Determine whether the association engages in manufactured home financing. If so, determine whether the association:
- Is originating residential real estate loans secured by permanently affixed manufactured homes; or investing in retail manufactured home chattel paper that is insured or guaranteed.
 - Has adequate underwriting standards, policies and procedures specific to manufactured home financing.
 - Has staff with expertise in this area.
 - Has adequate loan administrative and collections for this lending activity.
 - Has adequate ALLL.
 - Uses professional appraisers experienced in manufactured home valuation.

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- Sells manufactured home chattel paper without recourse.
-

Sampling

20. If concerns are noted in reviews, select for review a sample of 1-4 family mortgages. You should base this decision on the performance of those portfolios, whether the association offers new loan programs, and the adequacy of the association's lending policies, practices, oversight, and controls. Focus transactional testing on the higher risk areas. Use transactional testing to provide reasonable confidence that the conclusions regarding 1-4 family residential lending are valid.
-

CONCLUSIONS

1. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.
-
2. Ensure that your review meets the objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
-

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Real Estate Mortgage Lending Questionnaire

Yes No

GENERAL QUESTIONNAIRE

Real Estate Loan Policies

1. Has the board of directors adopted written real estate loan policies that define:
 - Geographic lending areas? Yes No
 - Acceptable types of properties? Yes No
 - Lending authority of committees and individual officers? Yes No
 - Minimum financial information required for borrowers of specific types of mortgage loans? Yes No
 - Minimum appraisal standards for real estate mortgage loans? Yes No
 - Maximum advance as a percentage of appraised value or purchase price? Yes No
 - Limits on the amount of negative amortization allowed on a mortgage compared with its current market value? Yes No
 - Maximum loan maturities? Yes No
 - Sound review standards for real estate loan applications that require the underwriting analysis/decision be documented? Yes No
 - Minimum standards for loan documentation? Yes No
 - Limitations on the number or amount of loans involving any individual borrower or contractor? Yes No
 - Limitations on the number, type, or amount of loans purchased or sold by the institution? Yes No
 - Minimum standards for qualification of borrowers for various loan products (ARMs, Teaser Rate, etc.)? Yes No
2. Are loan underwriting standards reviewed at least annually to determine if they are compatible with changing market conditions? Yes No
3. Does the institution have written collection policies and procedures that are approved by the board of directors? Yes No

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Real Estate Mortgage Lending Questionnaire

Yes No

4. Does the institution have a written schedule of fees, rates, terms, and collateral requirements for all new loan? Yes No

Appraisal Practices

1. Has the board of directors:
- Adopted an appraisal policy? Yes No
 - Developed written hiring policies for appraisers? Yes No
 - Developed a review system for appraisers? Yes No
2. Has the board of directors adopted a current approved appraiser list and are appraisers approved before they are used? Yes No
3. Are current agreements of sale, option, or listing information made available to appraisers? Yes No
4. Are appraiser's fees based upon a set fee and not the granting of the loan or the appraised value of the property? Yes No
5. If staff appraisers are used, does the institution periodically have test appraisals made by independent appraisers in order to check the accuracy of appraisal reports? Yes No
6. If appraisers who are not employees of the institution are used, does the institution adequately investigate their report quality, reputation, and qualifications? Yes No
7. Do loan approval and appraisal functions maintain adequate independence internally? Yes No
8. Does the institution not use borrower-supplied appraisal reports? Yes No
9. Are appraisal review personnel identified and given specific guidelines to determine the adequacy of the appraisal? Yes No
10. Are appraisers paid the same amount whether or not the loan is granted? Yes No

Collateral

1. Does the institution have a sound policy of cross-collateralizing security properties for major borrowers? Yes No
2. Are loan advances supported by written evidence or reinspection of property? Yes No

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Real Estate Mortgage Lending

Questionnaire

- | | Yes | No |
|--|--------------------------|--------------------------|
| 3. If supplemental collateral is held on loans, is it secured and a record of its status maintained? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Is written acknowledgment obtained from the borrower for the pledging of savings accounts or the assignment of life insurance policies? | <input type="checkbox"/> | <input type="checkbox"/> |

Loan Documentation

- | | | |
|--|--------------------------|--------------------------|
| 1. Do the institution's loan documentation policies and procedures comply with 12 CFR § 560.170? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Does the institution verify each applicant's income, employment, and financial condition prior to loan commitment? | | |
| 3. Are procedures in effect to ensure compliance with the requirements of government agencies insuring or guaranteeing the loans? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Has a system for maintaining adequate loan document files been established including: | | |
| • A check sheet to assure that required documents are received and on file? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Inspection performed by internal loan review personnel? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are procedures in effect to protect loan documents from theft, damage, or inappropriate release? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Are collateral releases executed only after required payments have been cleared? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Are lien releases approved reviewed by an officer or officers based on the size of the loan? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are all real estate loan commitments issued in written form? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the institution's loan commitment or legal lending limit? | <input type="checkbox"/> | <input type="checkbox"/> |

Loan Interest and Commitment Fees

- | | | |
|---|--------------------------|--------------------------|
| 1. Is the preparation of interest earned or loan fees subsidiary journals reviewed by personnel who do not issue checks or handle cash? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are interest and fee computations made and tested by persons who do not also issue checks/drafts or handle cash? | <input type="checkbox"/> | <input type="checkbox"/> |

Real Estate Mortgage Lending Questionnaire

	Yes	No
3. Does the institution properly account for deferred and earned loan fees?	<input type="checkbox"/>	<input type="checkbox"/>
Recordkeeping		
1. Is the preparation and posting of subsidiary loan records performed or reviewed by persons who do not also issue official checks/drafts or handle cash?	<input type="checkbox"/>	<input type="checkbox"/>
2. Are the subsidiary loan records reconciled daily with the appropriate general ledger accounts and are reconciling items investigated by persons who do not also issue official checks/drafts or handle cash?	<input type="checkbox"/>	<input type="checkbox"/>
3. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling loan subsidiary records to general ledger accounts and are they handled by persons who do not also issue official checks/drafts or handle cash?	<input type="checkbox"/>	<input type="checkbox"/>
4. Are detailed statements of account balances and activity mailed to mortgagors at least annually?	<input type="checkbox"/>	<input type="checkbox"/>
5. Are inquiries about loan balances received and investigated by persons who do not also handle cash?	<input type="checkbox"/>	<input type="checkbox"/>
6. Are documents supporting recorded credit adjustments checked or tested by persons who do not also handle cash?	<input type="checkbox"/>	<input type="checkbox"/>
7. Is a daily record maintained summarizing loans made, payments received, and interest collected to support applicable general ledger accounts?	<input type="checkbox"/>	<input type="checkbox"/>
8. Are note and liability ledger trial balances prepared and reconciled to controlling accounts by employees who do not process or record loan transactions?	<input type="checkbox"/>	<input type="checkbox"/>
9. Are records and files for serviced loans segregated and identifiable?	<input type="checkbox"/>	<input type="checkbox"/>
10. Is an overdue accounts report generated on a timely basis?	<input type="checkbox"/>	<input type="checkbox"/>
11. Are loan officers prohibited from processing loan payments?	<input type="checkbox"/>	<input type="checkbox"/>
12. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?	<input type="checkbox"/>	<input type="checkbox"/>
13. Are advance loan payments adequately controlled if they are not immediately credited to the loan account?	<input type="checkbox"/>	<input type="checkbox"/>

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Real Estate Mortgage Lending

Questionnaire

Yes No

Insurance and Escrow

- | | | | |
|----|---|--------------------------|--------------------------|
| 1. | Does the institution require escrows for taxes and insurance, and include such payments when qualifying borrowers? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. | Does the institution have a mortgage blanket hazard insurance policy? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. | Is there an effective, formalized system for determining whether insurance premiums are current on collateral properties? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. | Does the institution require that insurance policies include a loss payable clause to the institution? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. | Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursements? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. | If advance deposits for taxes and insurance are not required, does the institution have an effective system for determining whether taxes and insurance have been paid? | <input type="checkbox"/> | <input type="checkbox"/> |

Subprime Lending

- | | | | |
|----|---|--------------------------|--------------------------|
| 1. | Does the institution have a subprime lending program? | <input type="checkbox"/> | <input type="checkbox"/> |
| | If so: | | |
| | • Does the institution track performance of subprime loans based on product type, combined LTV, credit score, documentation, and originating officer/office, or broker? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Does the institution use the same underwriting standards for sold or held-for-sale loans as it does for its portfolio loans? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Does the institution sell loans without any form of implicit or explicit recourse? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Are representations and warranties standard and limited to 120 days? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Where repurchase obligations are significant, does the institution maintain adequate reserve accounts for such contingencies? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Has the institution had to repurchase a significant amount of sold loans? | <input type="checkbox"/> | <input type="checkbox"/> |

Questions and Answers on Real Estate Lending Standards (RELS)
Regulation and Guidelines

1. **What is the private mortgage insurance (PMI) requirement for owner-occupied, one-to four- (1-4) family residential and home equity mortgage loans?**

Owner-occupied, 1-4 family residential and home equity mortgage loans of 90 percent LTV ratio or greater have “appropriate” PMI or readily marketable collateral. There is no requirement to have PMI coverage that would bring the effective LTV ratio down to 80 percent. If an association makes a 95 percent LTV loan and requires PMI that insures losses down below 90 percent, the loan would not be considered a high LTV loan for purposes of the real estate lending standards policy.

2. **Can a savings association originate 100 percent LTV ratio loans without PMI?**

A savings association can originate 100 percent LTV home mortgage loans without PMI, though they would be included in the “Loans in excess of the supervisory LTV limits” category, which must be reported to the board of directors and limited, in aggregate, to 100 percent of capital. While examiners would not take exception to a moderate amount of such loans, they may criticize the association if the loans are underwritten in an unsafe and unsound manner.

3. **What is the loan category for a loan to purchase a developed residential lot where the roads and sewers, etc., are in place, but there are no immediate plans to build a home?**

The association should treat the loan as a land development loan. Although the purpose of the loan is not to develop the lots, the end product is the same. OTS expects savings associations that make higher-risk loans to do so at lower LTV ratios. Those with lower risk, such as loans to purchase finished lots, could be made at the maximum LTV ratio.

4. **Do uninsured deposits that are in excess of the FDIC insurance limit (currently \$100,000) count as “financial instruments” for “readily marketable collateral?”**

Yes.

5. **How would the maximum supervisory LTV ratio limit be calculated for loans fully cross-collateralized by two or more properties or secured by a collateral pool of two or more properties?**

For cross-collateralized loans, the maximum loan that the association can make within the supervisory LTV ratio limits is based on the following formula: [(Value of each property X appropriate maximum LTV ratio) less any senior liens].

6. **What is the loan category of a loan to construct a single-family home, where the borrower has a take-out commitment (made by either the same lender or a different lender) for permanent financing when completed?**

A construction-permanent loan secured by a single-family residence to the owner-occupant is treated as a permanent mortgage loan for purposes of categorizing the loan in the supervisory LTV ratio limits. In other words, if the LTV ratio equals or exceeds 90 percent, the loan should have credit enhancement in the form of PMI or readily marketable collateral. A construction loan by one lender with the permanent take-out by a second lender is treated as a 1-4 family construction loan (with an 85 percent supervisory LTV ratio limit) until construction is complete and the permanent lender refinances the loan. If the permanent lender is a closely held affiliate of the construction lender, then the loan can be treated as a permanent loan. Of course, as in all construction loans, a lender should always maintain appropriate disbursement controls during the construction period.

7. **Are unsecured loans (with loan proceeds used to purchase or improve real estate) subject to the rule?**

Yes. In drafting the statutory language that required the banking agencies to draft regulations requiring federally insured depository institutions to issue regulations on real estate lending standards, Congress was concerned that, without a requirement to include unsecured loans used to finance real estate transactions, some institutions would be tempted to make unsecured loans to avoid having to comply with the rule.

8. **Are loans underwritten as “unsecured” loans where the lender takes a security interest in real estate at borrower’s request (i.e., for tax purposes) subject to the RELS rule?**

Yes. The “abundance of caution” exception only applies when a loan is otherwise well collateralized, such as a loan to purchase an automobile that is collateralized by the vehicle, and the underwriting criteria and loan terms were more indicative of an auto loan.

9. **How should associations categorize, for supervisory LTV ratio limit purposes, mortgage loans that are not principal residences?**

Unless such residences meet the Internal Revenue Service (IRS) test of residency, the loans are considered improved property loans (85 percent LTV ratio limit) since they are not

owner-occupied, 1-4 family residences. (The definition of owner-occupied requires that the home be the borrower's principal residence.) If the loan is made with an LTV ratio higher than 85 percent, it is placed in the larger 100 percent of capital "bucket" (which does not have a principal residence requirement).

Loans that meet the IRS test of residency are treated as owner-occupied, 1-4 family residences.

10. How should loans under the FHA Title I program be treated?

Similar to the OTS capital rule treatment of such loans, FHA Title I program loans are not considered guaranteed loans, so if the association makes loans with LTV ratios of 90 percent or higher without PMI, they would go in the loans in excess of the supervisory limits "bucket."

11. Does the REELS rule cover manufactured homes?

The rule applies to real estate loans. Loans secured by "manufactured homes" that are not affixed to real property are not real estate loans and the REELS rule does not apply to them. Other "similar" personal property – mobile homes, RVs, etc. – are chattel and are not considered home loans under the rule. If a mobile home and a lot secure the loan, the security property is categorized as chattel and land, and the lot loan would be subject to the REELS rule. If a manufactured loan is permanently attached to the property, it is a home loan and covered by the rule.

12. How should loans guaranteed by the Federal government or state governments be treated for purposes of the supervisory LTV ratio limit if the guarantee is less than the loan amount?

All loans, or portion of loans, guaranteed by the U.S. Government or its agencies, and all loans backed by the full faith and credit of a state government, are excluded from the supervisory LTV ratio limit guidelines. Consequently, any portion of a loan that is so guaranteed should not be categorized as a high LTV loan.

13. Do we include non-owner-occupied, 1-4 family loans in the 100 percent of capital exception bucket?

Yes. Non-owner-occupied 1-4 family loans are subject to the 85 percent LTV ratio for improved property loans; such loans with LTV ratios greater than 85 percent are placed in the 100 percent exception bucket.

14. **Are loans in excess of the supervisory LTV limit secured by developed lots for 1-4 family residential homes placed in the 100 percent of capital exception bucket?**

Yes. All loans related to 1-4 family residential properties go into the 100 percent exception bucket. For developed lots, the lots should be in a 1-4 family residential subdivision and properly zoned to be treated as 1-4 family residential properties.

15. **Should home improvement loans be treated like permanent mortgages or construction loans?**

Yes, home improvement loans should be treated like permanent mortgages for purposes of determining the maximum supervisory LTV.

16. **If an association has a firm take-out commitment on a construction loan, can it be treated as an excluded transaction under the fourth exclusion (loans to be sold)?**

No, because the borrower has not met the conditions of the ultimate lender (complete construction, obtain an occupancy permit, etc.).

17. **How do you determine the supervisory LTV ratio limits for multi-stage projects?**

The maximum LTV ratio for multi-stage projects is ultimately limited by the LTV ratio applicable to the final stage of the loan. Associations should establish, as part of their loan administration policies, procedures on loan disbursements, based on the value of the project less the cost to complete it less a completion reserve, during the entire construction process. In general, prudent loan disbursement means that funding of the initial acquisition of raw land should not exceed 65 percent of the cost of the land and funding the development stage should not exceed 75 percent of the costs of development, etc.

18. **For cross-collateralized loans, we calculate the maximum LTV ratio based on a weighted average method. If one loan in the pool is over the LTV ratio limits, what goes into the high LTV ratio “bucket?”**

If the weighted-average LTV ratio of the pool is over the maximum supervisory LTV ratio, the whole pool goes into the bucket. If the weighted-average LTV ratio is less than the supervisory maximum, nothing goes into the bucket, even if one loan is above the maximum supervisory LTV ratio. This is in recognition that with cross-collateralization, the association has “excess LTV ratio cushion” in one loan to “cover” another loan’s lack of LTV ratio cushion. Conversely, if the entire excess cushion is used, then the whole pool presents a higher degree of risk. This will give associations an incentive to structure pools to exclude any loans that might cause the pool to be put in the bucket, but that is acceptable. We can review any individual loan for safety and soundness, and associations should only be making prudent loans.

19. **If a bank makes a loan to a borrower to purchase a property and make improvements that will enhance the value over the original cost, on what value should the LTV be based?**

In general, the LTV should be based on the original cost plus the improvements, however, use the fair market value (per the appraisal or evaluation) as completed after the improvements are made.

RISKS AND POLICY ISSUES ASSOCIATED WITH REVERSE MORTGAGE LOANS

Accounting for Reverse Mortgages

The accounting for reverse mortgages, including the recognition of interest and fee income, should be in accordance with instructions provided by the staff of the Securities and Exchange Commission (SEC), in an October 1992 paper, “Accounting for Pools of Uninsured Residential Reverse Mortgage Contracts.” In general, the SEC instructions require the grouping of individual reverse mortgages into pools, and then adjusting the carrying value of, and recognizing income on the pools based on the retrospective yield. The retrospective yield is the effective yield from inception of the mortgages, which reflects both actual cash flows to date and expected future cash flows.

The SEC instructions require that estimates of future cash flows incorporate actuarial projections of mortgage terminations, including assumptions about life expectancy, prepayments, and borrower relocation, and projections of collateral values. At each reporting date, the analysis of actual cash flows to date and expected future cash flows is to be updated, and the retrospective yield is to be recomputed. The carrying value of each pool of reverse mortgage loans represents the recorded investment in the loans, adjusted on a cumulative basis for income recognized based on the retrospective yield. Considering the complex accounting issues involved with reverse mortgage lending, savings associations are cautioned against engaging in such programs unless their accounting staffs have the knowledge and experience to deal with such issues.

Classification of Reverse Mortgage Loans

Savings associations should classify reverse mortgage loans in accordance with the OTS Classification of Assets regulation 12 CFR § 560.160 and OTS bulletins and policy statements. The OTS regulation directs federal savings associations to classify assets based on well-defined weaknesses. Assets are classified Substandard, Doubtful, or Loss based on the degree and likelihood that the association would sustain a loss on the assets.

Unlike standard mortgage loans, reverse mortgage loans are repaid from the proceeds of the sale of collateral, not monthly borrower payments. As such, reverse mortgage loans that are not insured by an agency of the federal government should be classified based on the ability of the collateral to support the loan. A loan should be adversely classified if the recorded investment in the loan (including accumulated advances to borrowers, accrued fees, accrued interest, deferred net fees, and any unamortized purchase premium or discount¹) exceeds the estimated net proceeds from the sale of the

¹ The contra account resulting from the application of the retrospective yield approach, if determined on a pool basis, should not be deducted in arriving at the recorded investment. (Specific valuation allowances, however, can be deducted from the loan balance in arriving at the recorded investment.) This is because the classification decision is made on a loan-by-loan basis. Also, because this contra account is not available to absorb losses in the association’s entire portfolio, it cannot be included in the association’s allowance for loan and lease losses (ALLL) for purposes of the risk-based capital regulation.

security property, based on the most current value of the property (based on an appraisal or evaluation). Disposition costs, such as real estate commissions, attorney's fees, settlement costs, etc., reduce the amount realized from the sale of the property. Therefore, unless an association can show that its disposition costs will likely be less than 10 percent, it should classify loans with a loan-to-value (LTV) ratio (based on the current appraised value of the property) greater than 90 percent as no less severe than Substandard.² It should be noted that loan amounts greater than the expected net disposition value of the property should be netted from the loan by additions to the retrospective yield contra account. Therefore, classifying such amounts Loss is not necessary.

Risk-Based Capital Rule Treatment

Reverse mortgages are treated as follows under the risk-based capital rule:

On-balance-sheet amounts are treated like other mortgage loans. Reverse mortgage loans that meet the requirements for "qualifying mortgage loans" (including LTV ratio and performance requirements) are risk-weighted at 50 percent. Once the loan no longer qualifies as a "qualifying mortgage loan" (such as when the LTV ratio is 90 percent or higher), the loan should be risk-weighted at 100 percent. (The LTV ratio, for the capital rule purposes, is computed using the recorded investment in the loan as the numerator and the original property value as the denominator.)

The off-balance-sheet commitment amount is first converted to an on-balance-sheet credit equivalent amount and then risk-weighted in the same fashion as the on-balance-sheet asset. Savings associations should use the 50 percent credit conversion factor for the off-balance-sheet commitment. (The 50 percent credit conversion factor assumes that the commitment is not cancelable by the association. Unconditionally cancelable commitments do not have to be included in the calculation of risk-weighted assets.) The amount of the off-balance-sheet commitment is determined by multiplying the number of remaining payments³ by the amount of the advance to be paid each period. The off-balance-sheet commitment amount must be recalculated annually. For line of credit loans, which contain a cap on the dollar amount to be provided to the borrower, the off-balance-sheet commitment is the undisbursed line of credit amount.

Although pool accounting may be used to determine an association's yield on its reverse mortgage investment, the risk-based capital requirement must be calculated separately for each loan.

² Because reverse mortgage loans are accounted for using the retrospective yield method, which requires a contra account for uncollectible amounts, it is not necessary that uncollectible amounts be classified Loss. An ALLL is not automatically required on reverse mortgage loans classified Substandard. However, general allowances should be established for reverse mortgage loans if the association is likely to experience losses on the disposition of the security property that are not reflected in the recorded investment. The level of any required ALLL on reverse mortgage loans should be based on the association's historical net loss experience for reverse mortgage loans, adjusted for current conditions and trends.

³ For tenure loans, the number of remaining payments is usually equal to the estimated number of remaining months of a borrower's life, based on a third-party, independent actuarial table.

Mortality/Relocation Estimates

In order to estimate how long a savings association will have to make payments under the tenure reverse mortgage loan contracts, it must assess each borrower's life expectancy. Such estimates are generally made using mortality rates, published by the U.S. Bureau of the Census, or actuarial tables available from life insurance companies.⁴ It is important that an association use current actuarial tables from a reliable and independent source (preferably from a major life insurance company or some other entity that has proven expertise and reliability). Also, consideration should be given to whether national mortality norms can be expected to hold for the association's particular area and mix of borrowers. There is the risk that a particular population will not behave as predicted by national mortality and relocation norms. Persons who apply for reverse mortgages may not be representative of the general population, so there is the potential for the mortality rates of an association's borrowers to deviate significantly from published tables. Therefore, an association should perform a sensitivity analysis on the effect a range of alternative mortality rates would have on the program's profitability.

Some reverse mortgage lenders use both mortality and relocation rates to estimate when the reverse mortgage contract will terminate. Typically, a reverse mortgage loan is expected to terminate when the borrower either moves or dies. Since senior citizens often relocate before they die, the use of relocation rates allow for contract term estimates to be shorter and allow lenders to justify larger payments to the borrower. Federal savings associations are urged to use caution when adopting relocation rates for the general elderly population, because reverse mortgage borrowers may alter their relocation patterns in light of the fact that they will continue to receive monthly payments from the lender as long as they remain in their homes.

Appraisals and the Requirement for Reappraisals

As with other real estate loans, the provisions of 12 CFR Part 564 establish when an appraisal or evaluation is required for a reverse mortgage loan. There are no specific requirements for reappraisals or reevaluations after a loan is made; however, as with other types of real estate loans, the association should periodically assess the value of the collateral supporting its loans. This is particularly important for reverse mortgage loans because the loan balance increases over time and the collateral is the primary source of repayment.

As stated in Thrift Bulletin 55, Real Estate Appraisal and Evaluation Guidelines, the useful life of an appraisal or evaluation will vary depending on the property and the market place. Management should determine if there have been material changes to the appraisal's or evaluation's underlying assumptions that affect the original estimate of value. Factors that could cause material changes in property values include:

- Passage of time.

⁴ Insurance companies use actuarial tables (also referred to as annuity tables) to determine the monthly amount they can profitably pay to a purchaser of their annuity products. Actuarial tables differ from mortality tables in that they have built-in assumptions that annuitants will die at a slower rate (generally 65 percent to 85 percent) than indicated by mortality tables. This assumption serves two purposes: (1) it protects the insurance company in the event that annuitants live longer than projected by mortality tables, and (2) it allows the insurance company to build a profit into the annuity product.

- Market volatility.
- Availability of financing.
- The inventory of unsold homes in the marketplace.
- New improvements to, or lack of maintenance on the security property or surrounding properties.
- Zoning changes.
- Changes in the local economy.

If the useful life of an appraisal or evaluation becomes suspect, management should determine whether there is a need for a reappraisal or reevaluation. Where property values have changed significantly from when the loan was originated, a new appraisal or evaluation may be warranted.

This is particularly important if property values have declined or if the loan balance of an individual loan approaches the anticipated market value of the security property. A significant change in property value will result in a corresponding increase or decrease in the estimated net collateral proceeds at contract termination and, therefore, an adjustment to the association's effective yield on the loan.

Property Appreciation Assumptions

Reverse mortgage loan programs often assume that the security property will appreciate over the life of the loan. Integrating property appreciation assumptions into the loan contract allows lenders to offer higher payments to borrowers because the lender would ostensibly receive more funds from the sale of the property when the borrower dies or relocates. While appreciation assumptions may seem reasonable and supported by historical experience, in some markets the anticipated appreciation may not materialize, and, in other markets, properties that have experienced high appreciation rates over the past decade could experience substantial depreciation in the future.

Savings associations should analyze the characteristics and profitability of their reverse mortgage loans under a variety of appreciation and depreciation scenarios, including a "worst case" scenario of property depreciation such as those experienced in parts of California and Boston in the early 1990s. When estimating cash flows for accounting purposes, associations should adjust any appreciation or depreciation assumptions periodically during the life of the loan.

Finally, association management is encouraged to take a very conservative stance toward property appreciation and depreciation assumptions. It may be useful to structure contracts to withhold the appreciation portion of the payment until appreciation actually occurs. The benefit of this structure is that, if appreciation actually occurs, the association could justify higher payments to borrowers later in the contract, which, in effect, would provide borrowers with a hedge against inflation.

Interest-Rate Risk

Interest-rate risk is potentially high for fixed-rate reverse mortgage loans. Because of their negative amortization feature, fixed-rate reverse mortgage loans could have substantially greater interest-rate sensitivity than standard 30-year fixed-rate mortgage loans. The Thrift Financial Report's Consolidated Maturity and Rate Schedule (Schedule CMR) does not have a separate category for reverse mortgages, so they must be reported as they are on Schedule SC. For purposes of Schedule CMR, the savings association should report the outstanding balance of reverse mortgages similar to the manner in which it reports other home mortgage loans, that is, the current outstanding balance (not the estimated future disbursements). The weighted average maturity should be based on the expected life of the loan, given mortality calculations.

Because Schedule CMR may not reflect the interest-rate sensitivity of reverse mortgages, savings associations that plan a significant investment in reverse mortgage loans should conduct an interest-rate sensitivity analysis. Such investment may require associations to undertake an internal interest-rate risk analysis required by Thrift Bulletin 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Activities.

Taxes and Insurance

To protect the collateral value of the security property, savings associations should ensure that real estate taxes are paid and that adequate hazard insurance is maintained. This becomes critically important as the borrower's equity diminishes, because they may have less incentive to pay real estate taxes. Savings associations are advised to monitor the payment of real estate taxes and insurance and to hold blanket hazard insurance policies to cover any lapse in coverage.

Property Maintenance

Adequate maintenance of the security property is critical to a reverse mortgage program. Although most reverse mortgage loan documents obligate borrowers to keep their property in good repair and otherwise maintain the value of the property, the borrowers may have little incentive or ability to do so. While typical reverse mortgage loan documents grant the lender the authority to make needed repairs and add the costs to the loan balance, such additions to the loan balance only increase the risks that there will be insufficient value in the home upon sale to cover the amount due. While the lender could conceivably declare default if the borrower fails to maintain the property, public relations considerations may preclude such action. Also, there are costs associated with property inspections to ensure that the borrower properly maintains the property. Therefore, lenders should consider the effect of deferred maintenance (or lender funded repairs) on the value of their investment.

Legal Requirements and Legal Risks

While reverse mortgage loans have been available for some time, the product is not in widespread use. Therefore, federal savings associations may not be thoroughly familiar with the statutory and regulatory requirements that will apply if they offer a reverse mortgage program. In addition, the contractual rights and obligations of borrowers and lenders in these transactions will differ significantly from those under, for example, purchase-money mortgage loan contracts. For these reasons, a savings association that

offers, or intends to offer, a reverse mortgage program should consult its legal counsel to ensure that the program complies with applicable requirements and that any legal risks associated with these loans are adequately addressed. In this regard, the association should, at a minimum, consider the following laws and statutes:

Basic Authority

Federal savings associations have express authority, under the Home Owners' Loan Act (HOLA) and OTS regulations, to originate or purchase reverse mortgages, notwithstanding any contrary state laws. By virtue of the Alternative Mortgage Transaction Parity Act ("Parity Act"), 12 USC §§ 3801 et seq., state savings associations are also authorized to originate and purchase reverse mortgages even when state law purports to prohibit reverse mortgages, unless the state in question expressly "opted out" of the Parity Act within the three year period beginning on October 15, 1982, and ending on October 14, 1985. In "opt out" states, state law governs the permissibility of reverse mortgages for state savings associations. Federal savings associations are not subject to state law even in states that have exercised their "opt out" option.

Notwithstanding the foregoing, a special rule applies in the state of Texas. The HOLA provides deference to the specific provision in the Texas constitution that prohibits most non-purchase money liens against homesteads.

State Usury Laws

Some reverse mortgage loans have an annual premium feature designed to offset the risks that some borrowers may live longer than the mortality tables predict. If the annual loan fee is significant, the earlier the borrower repays the loan, the higher the effective cost of financing. For example, OTS is aware of some private programs that include an annual loan fee based on the value of the home, not the loan balance. A program with a 5 percent annual loan fee and a 10.5 percent interest rate would result in an effective interest rate of greater than 20 percent should the loan repay within the first 6 years.⁵ Therefore, savings associations should determine whether state usury laws apply. Although federal law generally pre-empts the application of state usury laws to mortgage loans (including reverse mortgage loans) that are secured by first liens on residences, 12 USC § 1735f-7a, states were permitted to "opt out" of this pre-emption provision within the three year period beginning on April 1, 1980, and ending on March 31, 1983. Maximum interest rates in "opt out" states will either be governed by state law or the federal Most Favored Lender provision. 12 USC § 1463(g).

Disclosure Laws

Disclosures made to borrowers about reverse mortgage loans must comply with the Truth in Lending Act (TILA) and with the implementing regulation – Regulation Z – promulgated by the Federal Reserve Board. Lenders must provide reverse mortgage borrowers with full and accurate disclosures including, where appropriate, the loan's annual percentage rate and total finance charges. Borrowers must also be notified of their right to rescind the transaction. Also, savings associations should consider

⁵ The OTS would look unfavorably on such aggressive pricing, which may have a negative effect on the association's CRA rating.

making annual percentage rate and finance charge disclosures under varying scenarios of property appreciation and borrower mortality.

In addition, the Community Development Banking Act amends the TILA to require that lenders make certain new disclosures regarding the projected total cost of a reverse mortgage loan to the borrower.

Contractual Provisions

Circumstances unique to reverse mortgage transactions may affect both the borrower's ability to comply with the terms of the reverse mortgage loan contract and the association's ability to recover possession of the security property at the appropriate time. For example, an elderly borrower receiving a modest fixed income may lack the resources to maintain the security property as called for under the reverse mortgage loan contract. A borrower's heirs may be unaware that he or she has taken out a reverse mortgage and may, upon the borrower's death, challenge the association's right to take possession of the property. While no contractual provision can eliminate the possibility that these problems will arise, foresight and careful drafting of the reverse mortgage loan documents may mitigate the legal risk they present for the association. Savings associations may also reduce their legal risk by ensuring that borrowers understand the practical consequences of the rights and obligations that the reverse mortgage loan contract creates. Savings associations should therefore consider encouraging borrowers to seek independent credit counseling as part of their reverse mortgage programs.

Government Guaranteed Reverse Mortgage Programs

The Department of Housing and Urban Development (HUD), through the Federal Housing Association (FHA), offers a reverse mortgage guarantee program that lenders may participate in. The FHA program is similar to reverse mortgage programs discussed above, except that FHA guarantees payment to the borrower (in the event the lender should become unable to meet its payment obligations to the borrower) and guarantees the lender's investment. Under the program, borrowers pay FHA a mortgage insurance premium (MIP), consisting of an up-front fee of two percent of the maximum claim amount, plus an annual premium of one-half of one percent of the outstanding loan balance. Under the FHA program, the maximum claim amount is the maximum dollar amount that the FHA can insure for a particular geographical area. The MIP, which can be financed, provides a fund to absorb losses in the event that the mortgage balance on some loans exceeds the value of the property at the time the loan becomes due and payable.

The FHA guarantee is structured so that once the balance of a guaranteed loan reaches 98 percent of the maximum claim amount, the lender has the option of assigning the mortgage to FHA, thus eliminating the likelihood of loss to the lender. FHA's loan guarantee is limited to a maximum of the lesser of the appraised value of the house or the maximum dollar amount that the FHA can insure for single-family residences in a geographical area (currently \$67,500 to \$227,550). As mentioned above, the FHA program bases payments on the assumption that a borrower will live to age 100, so monthly payments to a typical FHA program borrower may be lower than payments under programs that use

actuarial life expectancies.⁶ Also, interest rates on the FHA reverse mortgage program are often lower than the rates charged by private programs.

As with other FHA guaranteed loans, the guaranteed portion of these loans is risk-weighted at 20 percent for the risk-based capital rule.

Another positive aspect of the FHA program is that Fannie Mae will purchase an association's reverse mortgage loans made under the FHA program. Because of the federal guarantee, an association's participation in this or similar government guaranteed reverse mortgage loan programs alleviate many of the safety and soundness concerns discussed above.

⁶ The fact that an association's reverse mortgage loan program may have specific features that are very conservative does not ensure that the program as a whole is prudent. Similarly, the fact that the association bases expected loan terms on current actuarial tables, rather than the very conservative mortality assumptions used by the FHA, does not mean that, taken as a whole, the lender's reverse mortgage lending program is imprudent.

NEGATIVELY AMORTIZING MORTGAGES

Introduction

A conventional fixed-rate mortgage holds the interest accrual rate and the payments constant over the life of the loan. A portion of each monthly payment reduces the outstanding principal of the loan. Negative amortization (NegAm) adjustable rate mortgages (ARMs) are structured such that the outstanding principal balance may increase, even though payments are current. Negative amortization occurs when the borrower makes a payment at an interest rate that is lower than the accrual rate; therefore, the monthly payment is insufficient to cover the interest expense, and the difference is added to the principal amount.

If lenders carefully underwrite NegAm loans with prudent loan to value (LTV) percentages and monitor the loans closely, the added credit risk may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns. In addition, the credit performance of NegAm loans is particularly vulnerable in an economic environment of rapidly rising interest rates and stagnant or falling property values.

NegAm Products/Features

Many NegAm loans, also called Option ARM loans, have the following common features:

- Begin with an introductory teaser rate
- Borrower choice of payment amount
- A lagging aggregate interest rate index
- A cap on annual payment increases
- Contain maximum principal accrual limits
- Mandatory recast dates.

Teaser rate. Typically, a savings association originates a NegAm loan with a low introductory “teaser” rate. This may be more than 200 basis points below the fully indexed loan rate. This teaser rate is generally in effect for a period of one to three months. During the teaser rate period, the borrower’s payment rate is the same as the lender’s accrual rate (interest rate). At the expiration of the teaser rate period, the loan’s interest rate immediately rises to the fully indexed rate; however, the minimum required loan payment remains the same until the next payment adjustment. If the borrower only makes the minimum required payment during this period, the loan will typically negatively amortize.

The lender determines the interest rate by adding a margin, stated in the mortgage, to the underlying index rate. This margin over the index varies with competitive pricing pressures, but is usually in the range of 200 to 300 basis points.

Payment amount. Borrowers typically have four payment options available with these loans:

- An amount sufficient to amortize the loan over 30 years.
- An amount sufficient to amortize the loan over 15 years.
- An amount that only covers the monthly accrued interest.
- A minimum payment amount that permits negative amortization.

Index. While the borrower has several payment options, an Option ARM loan's interest rate typically adjusts periodically according to the loan contract. Many contracts allow for interest rate adjustments on a monthly or quarterly basis. Historically, most NegAm interest rates were based on the 11th District Cost of Funds Index (COFI). However, in the last few years, lenders have shifted away from COFI and now use other indexes such as the 12-Month Treasury Average (MTA). Both COFI and MTA have a delayed response to interest rate changes compared with the constant maturity Treasury (CMT) index. This lagged response reduces the potential negative amortization (or payment shock for borrowers wanting to make interest only or amortizing payments). To the extent that an association's liabilities more closely resemble the COFI than the CMT, these indices reduce the association's basis risk from an asset/liability management perspective. However, if the spread between an association's cost of funds and COFI widens for whatever reason, the association may face substantial income compression.

Payment caps. Payment increases or decreases on NegAm loans are typically limited to 7.50 percent per year. If borrowers elect to make only the minimum required payment, and those payments, including the annual 7.5 percent increase, are not sufficient to pay interest accruals, the shortfall is added to the loan balance.

Accrual limits and recast dates. NegAm loans typically recast at the earlier of: (1) every five years, or (2) when the loan balance increases to more than the contractually allowed maximum loan limit, known as the principal accrual limit. This varies by lender and the initial loan-to-value, and typically ranges from 110 percent to 125 percent of the original loan amount. When the loan recasts, the payment will adjust to the amount needed to fully amortize the loan over the remaining 25 years and is not subject to the 7.50 percent annual payment cap. For a \$200,000 loan with a 110 percent accrual limit, the recast would occur if the principal balance increased to \$220,000. If the initial LTV were 80 percent, the LTV would have increased to 88 percent at the recast date (not considering any increase or decrease in property value). Because loan terms are set by contract, and lenders have varying terms, you may also encounter other maximum principal accrual limits.

NegAm Risks

ARM lending involves a transfer of interest rate risk from the lender to the borrower. As a tradeoff, the lender must assume the additional credit risk associated with a borrower's potential inability to service the loan if interest rates rise. NegAm loan products were developed, in part, to help prevent prepayment or default from occurring due to borrowers being unable to meet their monthly payments because of interest rate spikes. While option-ARM loans may mitigate risks associated with payment shock and prepayment from interest-rate increase, payment shock can still be substantial if the loan is structured with a low teaser rate (a minimum payment based on a start rate during the option period that is well below the fully indexed amortizing rate).

The combination of deep teaser rates, aggressively qualifying borrowers at below fully indexed amortizing rates, high principal accrual limits, no verification of borrower income and liquidity, and high LTVs increase the credit risk to the lender.

Underwriting standards. Lenders try to mitigate the option or credit risk associated with NegAm loans with sound underwriting standards, (including credit, verification, and LTV requirements), loan structure, and terms. Please refer to the main body of this section for guidance on underwriting standards.

Payment shock. NegAm borrowers may face recast payment shock, where the loan payment adjusts upward to fully amortize the principle balance over the remaining life of the loan. Even with the protection of interest rate or payment caps, borrowers may not be able to make the higher payments. This is especially true when lenders qualify borrowers at less than the fully-amortizing, fully indexed payment rate, make NegAm loans to subprime borrowers, or have inadequate underwriting controls.

Capitalized interest. Lenders may record negative amortization as income in the form of capitalized interest. The lender does not actually receive the negative amortization amount as a payment from the borrower. Under generally accepted accounting principles (GAAP) the lender may capitalize (add to the loan balance) the accrued but unpaid interest amount and recognizes it as income as long as the capitalized interest is considered collectible. The collectibility of the interest depends on the borrower's ability and willingness to repay to full principal and interest, which is influenced by the borrower's ability to service the debt and the size of the loan relative to the property value. When borrowers consistently make only the minimum required payments on option ARM mortgages, the increasing capitalized interest balance may indicate increasing credit risk, as it might indicate declining borrower equity and the borrower's inability to make fully amortizing payments. A high level of capitalized interest may also create cash flow or liquidity concerns for the lender.

Credit risk. LTVs can increase over time (if property values decline or the borrower chooses to make only the minimum required payments), which increases the credit risk to the association. Recast requirements are designed to prevent runaway LTVs. If property values do not appreciate and interest rates rise, all lenders may be adversely affected, but NegAm lenders face greater exposure because of escalating LTVs. Additionally, the reported earnings sometimes mask credit risk in a NegAm portfolio, where the association is accruing income at a higher rate than the borrower is paying on the loan. Traditional credit quality monitoring reports of point-in-time delinquency and default data may lag as

indicators of asset quality problems because borrowers facing payment problems can opt to reduce their monthly payments without causing the loan to go delinquent or disrupting the income accrual on the loan. Therefore, a strong indicator of potential credit risk is the number of an institution's option-ARN loans that actually negatively amortize.

NegAm Compliance Requirements

Promotion of NegAm loans must comply with OTS and other federal regulatory requirements. Section 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of NegAm loans originated. NegAm loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B or OTS Nondiscrimination regulations. The Truth in Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to NegAm loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are prohibited from having negative amortization features. Moreover, NegAm loans are subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community.

NegAm Risk Management

Not all NegAm loan portfolios are structured the same or have higher credit risk. If lenders carefully underwrite NegAm loans with prudent LTVs and monitor the loans closely, the added credit risk they face may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns.

Lenders engaged in a NegAm lending program should monitor the quality of the NegAm portfolios closely. Specifically, lenders should track and monitor all loans with the NegAm option and quantify the borrowers' preferences regarding NegAm loan payments. The choice of making the fully amortizing versus the minimum payment is a borrower option, the exercise of which is a revealing indicator of a borrower's ability to service the loan. Additionally, lenders should:

- **Use appropriate underwriting standards.** Underwriting standards for NegAm loans should meet the real estate lending standards set forth in 12 CFR §560.101. Poor underwriting can create loans where the potential risk from negative amortization is excessive.
- **Identify the percentage of borrowers utilizing negative amortization and the associated capitalized interest.** Because capitalized interest may have accumulated over several years, lenders should report balances by loan vintage. If capitalized interest is substantial, its impact on the association's income levels should be analyzed to evaluate the quality of earnings. Excess capitalized interest may also create possible cash flow or liquidity concerns.

- **Track NegAm loan performance by program and origination year.** Point-in-time delinquency reports for NegAm loans can be misleading and mask immediate problems not reflected in delinquency rates. NegAm delinquency rates are generally only meaningful when combined with an analysis of borrower utilization and capitalized interest levels. If NegAm utilization and capitalized interest levels are increasing, future credit problems may arise.
- **Track performance by credit scores.** If warranted, segment the portfolio into different credit score groups to better track performance and risk exposure. Tracking portfolio performance using an average credit score may mask portfolio risk.
- **Monitor the impact of its use of NegAm loans on its record of meeting the credit needs of its community, including low- and moderate-income markets.** While many NegAm loan programs offer expanded credit opportunities to communities, a few may have the effect of significantly eroding borrowers' equity and thus adversely affecting the communities.

Qualifying for the 50 Percent Risk-Based Capital Treatment

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines qualifying mortgage loans as one- to four-family residential first mortgage loans that are performing, are prudently underwritten, and have LTV ratios at origination of 90 percent or less, or are covered by private mortgage insurance. To qualify for a 50 percent risk weighting, NegAm loans should meet the above requirements. Should a portfolio of NegAm mortgages present safety and soundness concerns, OTS may direct the association to risk weight some or all of the NegAm mortgages and any future production at 100 percent or more.

Examination of NegAm Lenders

You should carefully analyze NegAm lending programs and determine if the association has appropriate underwriting controls and standards as described throughout this Handbook Section and Appendix. As with all loan types, you should evaluate the level of credit risk in the association's portfolio and ensure that loan loss reserves and capital are sufficient to support the level of risk.

**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision**

October 8, 1999

INTERAGENCY GUIDANCE ON HIGH LTV RESIDENTIAL
REAL ESTATE LENDING

PURPOSE

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are jointly issuing this statement to address some of the inherent risks of high loan-to-value (LTV) residential real estate lending. This statement clarifies that the real estate lending standards jointly adopted by the agencies in 1992 apply to these transactions.¹ This statement also outlines other controls the agencies expect institutions to have in place when engaged in this type of lending.

Background and Scope

Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 required the agencies to adopt uniform regulations prescribing real estate lending standards. The agencies' regulations and the appended Guidelines require institutions to adopt and maintain comprehensive, written real estate lending policies. The Guidelines describe the criteria, specific factors, and supervisory LTV limits that institutions should consider when establishing their real estate lending policies.

For the purpose of applying the Guidelines to high LTV residential real estate loans, a high LTV residential real estate loan is defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied 1- to 4-family residential property that equals or exceeds 90 percent of the real estate's appraised value, unless the loan has appropriate credit support. Appropriate

¹ The agencies adopted uniform rules on real estate lending and issued the *Interagency Guidelines for Real Estate Lending Policies* (Guidelines), dated December 1992. See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS).

credit support may include mortgage insurance, readily marketable collateral or other acceptable collateral that reduces the LTV ratio below 90 percent.²

Insured depository institutions have traditionally avoided originating residential real estate loans in amounts exceeding 80 percent of the appraised value of the underlying property unless the amount above 80 percent was supported by private mortgage insurance, a government guarantee or other credit support. However, this trend is changing. Consumers are increasingly using the equity in their homes to refinance and consolidate other debts or finance purchases. By doing so, they can generally obtain favorable repayment terms, lower interest rates, and tax advantages relative to other forms of consumer debt, such as unsecured credit cards. These and other factors have stimulated strong consumer demand for these loans.

Credit Risks Associated with High LTV Loans

High LTV lending can be profitable when risks are effectively managed and loans are priced based on risk. High LTV lending poses higher risk for lenders than traditional mortgage lending. A summary of the primary credit risks associated with this type of lending follows:

- **Increased Default Risk and Losses.** Recent studies indicate that the frequency of default and the severity of losses on high LTV loans far surpass those associated with traditional mortgages and home equity loans.³ The higher frequency of default may indicate weaknesses in credit risk selection and/or credit underwriting practices, while the increased severity of loss results from deficient collateral protection. In addition, the performance of high LTV borrowers has not been tested during an economic downturn when defaults and losses may increase.
- **Inadequate Collateral.** High LTV loans are typically secured by junior liens on owner-occupied single-family residences where the combined loans frequently exceed the market value of the home, sometimes by as much as 25 to 50 percent. When such a loan defaults and the combined LTV exceeds 90 percent, it is unlikely that the net sales proceeds will be sufficient to repay the outstanding debt because of foreclosure, repair, and selling expenses. Therefore, high LTV lenders are exposed to a significant amount of loss in the event of default.
- **Longer Term/Longer Exposure.** High LTV loans generally have long maturities (up to 30 years). The lender's funds are therefore at risk for the many years it takes the loan to amortize and the borrower to accumulate equity. This leaves lenders vulnerable to future adverse events beyond their control, such as the death, divorce, sickness or job loss of a borrower. Finally, high LTV loans are often underwritten using credit-scoring models. The predictive value of these models is less reliable beyond a two-year horizon and across different economic cycles.

² Examples of readily marketable collateral and other acceptable collateral are contained in the Guidelines.

³ Moody's Investor Service. "Moody's Home Equity Index Update, Special Report," pp 2, 6 - 8, dated October 2, 1998; "Home Equity Index Update: 3Q98," pp 7-8, dated January 22, 1999; and 1Q99, pp 1-2, 9, dated May 21, 1999; OTS Research and Analysis, "National Mortgage Default Rates and the Vintage Effect," May 19, 1997, p 5.

- **Limited Default Remedies.** Traditional mortgage servicing and collection procedures are not as effective when engaging in high LTV lending because the sale of collateral and customer refinancing are generally eliminated as ways to collect these loans. A delinquent borrower with little or no equity in a property may not have the incentive to work with the lender to bring the loan current to avoid foreclosure. The borrower also may not have the ability to fund closing costs to sell the property as an alternative source of repayment. Therefore, high LTV lenders must intervene early to reduce the risk of default and loss.

Effective Risk Management Programs

Institutions involved in high LTV lending should implement risk management programs that identify, measure, monitor, and control the inherent risks. At a minimum, an institution's program should reflect the existing Guidelines for real estate lending, as well as the other risk management issues discussed within this statement. The following represents a partial summary of the Guidelines. Institutions should refer to the Guidelines for additional guidance on loan portfolio management considerations, underwriting standards, and credit administration.

Loan-to-Value Limits

The Guidelines direct institutions to develop their own internal LTV limits for real estate loans, subject to the supervisory LTV limits. The Guidelines permit institutions to grant or purchase loans with LTV ratios in excess of the supervisory LTV limits provided that such exceptions are supported by documentation maintained in the permanent credit file that clearly sets forth the relevant credit factors justifying the underwriting decisions. These credit factors may include a debt-to-income ratio or credit score. The Guidelines further specify that all loans in excess of the supervisory LTV limits should be identified in the institution's records and should not exceed 100 percent of the institution's total capital.⁴

The Guidelines state that first lien mortgages or home equity loans on owner-occupied, 1- to- 4- family residential property loans whose LTV ratios equal or exceed 90 percent should have appropriate credit support, such as mortgage insurance, readily marketable collateral, or other acceptable collateral. Through this policy statement, the agencies clarify that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support, should be considered an exception to the Guidelines and included in the institution's calculation of loans subject to the 100 percent of capital limit.

CALCULATING THE LOAN-TO-VALUE RATIO

For the purpose of determining the loans subject to the 100 percent of capital limitation, institutions should include loans that are secured by the same property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should

⁴ Moreover, within the aggregate limit, total LTV exceptions for all commercial, agricultural, multifamily, or other non-1- to 4-family residential properties should not exceed 30 percent of total capital.

include the recourse obligation of any loan in excess of the supervisory LTV limits that is sold with recourse.

The LTV ratio for a single loan and property is calculated by dividing the total (committed) loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. The following guidance is provided for those situations involving multiple loans and more than one lender. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.
- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the Guidelines and may be excluded from the institution's 100 percent of capital limitation.

Transactions Excluded from Supervisory Guidelines

The Guidelines describe nine lending situations that are excluded from the supervisory LTV limits, reporting requirements, and aggregate capital limitations. The agencies have received numerous questions from bankers and examiners regarding two of these excluded transactions. These are:

- **Abundance of Caution.** The Guidelines indicate that any loan for which a lien on or interest in real property is taken as additional collateral through an abundance of caution may be excluded from the supervisory LTV and capital limits. The Guidelines specifically state that "abundance of caution" exists when an institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral. Because real estate is typically the only form of collateral on a high LTV loan, the abundance of caution exclusion would not apply to these transactions.

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- **Loans Sold Promptly, Without Recourse, to a Financially Responsible Third Party.** The Guidelines state that loans that are to be sold promptly after origination, without recourse, to a financially responsible third party may be excluded from supervisory LTV limits. The agencies have received several inquiries requesting a definition of the word “promptly.”

This exclusion provides flexibility to institutions engaged in mortgage banking operations. Institutions engaged in mortgage banking normally sell or securitize their high LTV loans within 90 days of origination. Accordingly, the agencies will generally find that when a lender sells a newly originated loan within 90 days it has demonstrated its intent to sell the loan “promptly” after origination. Conversely, when a lender holds a loan for more than 90 days, the agencies believe that the intent to sell “promptly” has not been demonstrated. Such loans will be included among the loans subject to the overall capital limit. The agencies may also determine that this exclusion is not available for institutions that have consistently demonstrated significant weaknesses in their mortgage banking operations.

BOARD REPORTING AND SUPERVISORY OVERSIGHT

All exceptions to the Guidelines should be identified in the institution’s records, and the aggregate amount, along with performance experience of the portfolio, should be reported to the board at least quarterly. Examiners will review board or committee minutes to verify adherence to this standard.

An institution will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, its regulatory agency will determine if it has a supervisory concern and take action accordingly. Such action may include directing the institution to reduce its loans in excess of the supervisory LTV limits to an appropriate level, raise additional capital, or submit a plan to achieve compliance. The agencies will consider, among other things, the institution’s capital level and overall risk profile, as well as the adequacy of its controls and operations, when determining whether these or other actions are necessary.

OTHER RISK MANAGEMENT ISSUES

Loan Review and Monitoring. Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, institutions should segment their high LTV loan portfolio by their vintage (age) and analyze the portfolios’ performance for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. Institutions should monitor the ongoing performance of their high LTV loans by periodically re-scoring accounts, or by periodically obtaining updated credit bureau reports or financial information on their borrowers.

On February 10, 1999, the Federal Financial Institutions Examination Council (FFIEC) issued the *Uniform Retail Credit Classification and Account Management Policy*. That FFIEC policy statement established

the minimum uniform classification standards for retail credit. Institutions involved in high LTV lending should adopt the standards contained in this policy as part of their loan review program.

Sales of High LTV Loans. When institutions securitize and sell high LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high LTV loans must implement procedures to control the risks inherent in that activity. Institutions should enter into written counterparty agreements that specify the duties and responsibilities of each party and include a regular schedule for loan sales.

Institutions should also develop a contingency plan that designates back-up purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, institutions should also establish maximum commitment limits for the amount of pipeline and warehoused loans, as well as designate alternate funding sources.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for the subsequent quarterly revaluations.

Compliance Risk. Institutions that originate or purchase high LTV loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory “steering” of borrowers to high LTV products for reasons other than the borrower’s creditworthiness. Such practices could, for example, violate the Fair Housing Act, Equal Credit Opportunity Act, the Truth in Lending Act (including its special rules and restrictions under the Home Ownership and Equity Protection Act for loans with high rates or closing costs), or the Real Estate Settlement Procedures Act. An adequate compliance management program must identify, monitor, and control the consumer compliance risks associated with high LTV lending.

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Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration**

May 17, 2005

CREDIT RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

PURPOSE

In response to the exceptionally strong growth in home equity lending over the past few years, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (collectively, the agencies) are issuing this guidance to promote sound risk management practices at financial institutions with home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). The agencies have found that, in many cases, institutions' credit risk management practices for home equity lending have not kept pace with the product's rapid growth and easing of underwriting standards.

Overview

The rise in home values coupled with low interest rates and favorable tax treatment has made home equity loans and lines attractive to consumers. To date, delinquency and loss rates for home equity loans and lines have been low, due at least in part to the modest repayment requirements and relaxed structures that are characteristic of much of this lending. The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that financial institutions may not be fully recognizing the risk embedded in these portfolios. Specific product, risk management, and underwriting risk factors and trends that have attracted scrutiny are:

- Interest-only features that require no amortization of principal for a protracted period;
- Limited or no documentation of a borrower's assets, employment, and income (known as "low doc" or "no doc" lending);
- Higher loan-to-value (LTV) and debt-to-income (DTI) ratios;

- Lower credit risk scores for underwriting home equity loans;
- Greater use of automated valuation models (AVMs) and other collateral evaluation tools for the development of appraisals and evaluations; and
- An increase in the number of transactions generated through a loan broker or other third party.

Like most other lending, home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral valuation management, individual account and portfolio management, and servicing.

Financial institutions should ensure that risk management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for financial institutions that project or have already experienced significant growth or concentrations, particularly in higher risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party generated loans. This guidance describes sound credit risk management systems for:

- Product Development and Marketing
- Origination and Underwriting
- Third-Party Originations
- Collateral Valuation Management
- Account Management
- Portfolio Management
- Operations, Servicing, and Collections
- Secondary Market Activities
- Portfolio Classifications, Allowance for Loan and Lease Losses (ALLL), and Capital

Credit Risk Management Systems

Product Development and Marketing

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the

institution's internal policies and applicable laws and regulations¹ and to evaluate the credit, interest rate, operational, compliance, reputation, and legal risks. In particular, risk management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, financial institutions should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, refer to the "Third-Party Originations" Section.) Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

Origination and Underwriting

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the agencies' regulations on real estate lending standards,² prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.³ Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.⁴ Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

¹ Applicable laws include Federal Trade Commission Act; Equal Credit Opportunity Act (ECOA); Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); Fair Housing Act; Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

² In 1992, the agencies adopted uniform rules on real estate lending standards and issued the "Interagency Guidelines for Real Estate Lending Policies." See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC) and 12 CFR 560.100-101 (OTS).

³ The OCC also addressed national banks' need to assess a borrower's repayment capacity in 12 CFR 34.3(b). This safety and soundness-derived anti-predatory lending standard states that national banks should not make consumer real estate loans based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. See also Regulation Z (Truth in Lending – 12 CFR 226.34(a)(4)).

⁴ "Interagency Guidelines Establishing Standards for Safety and Soundness" also call for documenting source of repayment and assessing ability of the borrower to repay the debt in a timely manner. See 12 CFR 30, Appendix A, II.C.2 (OCC); 12 CFR 208, Appendix D-1 (FRB); 12 CFR Part 364, Appendix A (FDIC); and 12 CFR Part 570, Appendix A (OTS).

HELOCs generally do not have interest rate caps that limit rate increases.⁵ Rising interest rates could subject a borrower to significant payment increases, particularly in a low interest rate environment. Therefore, underwriting standards for interest-only and variable rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

Third-Party Originations

Financial institutions often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, an institution should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

Brokers are firms or individuals, acting on behalf of either the financial institution or the borrower, who match the borrower's needs with institutions' mortgage origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the financial institution and the broker. For control purposes, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

Correspondents are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Financial institutions commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating financial institution should have systems and controls to provide assurance that the correspondent is appropriately managed, financially sound, and provides mortgages that meet the institution's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality control unit or function in the delegating financial institution should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio performance management activities.

Both brokers and correspondents are compensated based upon mortgage origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, financial institutions should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the institution should have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees

⁵ While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 CFR 226.30(b).

contrary to RESPA prohibitions.⁶ Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the institution should take appropriate action against the third party, which could include terminating its relationship with the third party.

Collateral Valuation Management

Competition, cost pressures, and advancements in technology have prompted financial institutions to streamline their appraisal and evaluation processes. These changes, coupled with institutions underwriting to higher LTVs, have heightened the importance of strong collateral valuation management policies, procedures, and processes.

Financial institutions should have appropriate collateral valuation policies and procedures that ensure compliance with the agencies' appraisal regulations⁷ and the "Interagency Appraisal and Evaluation Guidelines" (guidelines).⁸ In addition, the institution should:

- Establish criteria for determining the appropriate valuation methodology for a particular transaction based on the risk in the transaction and loan portfolio. For example, higher risk transactions or non-homogeneous property types should be supported by more thorough valuations. The institution should also set criteria for determining the extent to which an inspection of the collateral is necessary.
- Ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation.
- Implement policies and controls to preclude "value shopping." Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the institution should adhere to a policy for selecting the most reliable method, rather than the highest value.
- Require sufficient documentation to support the collateral valuation in the appraisal/evaluation.

⁶ In addition, a financial institution that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the institution can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

⁷ 12 CFR 34, subpart C (OCC); 12 CFR 208 subpart E and 12 CFR 225 subpart G (FRB); 12 CFR 323 (FDIC); 12 CFR Part 564 (OTS); and 12 CFR 722 (NCUA).

⁸ Comptroller's Handbook for *Commercial Real Estate and Construction Lending*; SR letter 94-55 (FRB); FDIC (Financial Institution Letter (FIL-74-94), dated November 11, 1994; Thrift Bulletin 55a (OTS); and LTCU 03-CU-17 (NCUA).

AVMs –When AVMs are used to support evaluations or appraisals, the financial institution should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. As part of the validation process, the institution should document the validation’s analysis, assumptions, and conclusions.⁹ The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a “confidence score” which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Financial institutions that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Institutions should also establish the confidence levels that are appropriate for the risk in a given transaction or group of transactions.

When tax assessment valuations are used as a basis for the collateral valuation, the financial institution should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property’s market value as part of the validation process.

Account Management

Since HELOCs often have long-term, interest-only payment features, financial institutions should have risk management techniques that identify higher risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, an institution should have risk management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account management practices for large portfolios or portfolios with high-risk characteristics include:

- Periodically refreshing credit risk scores on all customers;
- Using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- Periodically assessing utilization rates;
- Periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
- Monitoring home values by geographic area; and

⁹ National banks should refer to OCC Bulletin 2000-16, “Risk Modeling – Model Validation.”

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- Obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.¹⁰

Where appropriate, financial institutions should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.¹¹ In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances, and (2) as a result of this change, the institution has a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A financial institution's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

Portfolio Management

Financial institutions should implement an effective portfolio credit risk management process for their home equity portfolios that includes:

Policies - The agencies' real estate lending standards regulations require that an institution's real estate lending policies be consistent with safe and sound banking practices and that an institution's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the institution's

¹⁰ Under the agencies' risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the institution conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See Appendix A to 12 CFR 3, Section 3(b)(4)(ii) for OCC; 12 CFR 208, Appendix A, III.D.4 and 12 CFR 225, Appendix A, III.D.4 for FRB; Appendix A to 12 CFR 325, II(D)(4) (FDIC); and 12 CFR 567.6 (OTS).

¹¹ Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 CFR 226.5b(f)(3)(vi)(A) – (F).

overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

Portfolio objectives and risk diversification - Effective portfolio management should clearly communicate portfolio objectives such as growth targets, utilization, rate of return hurdles, and default and loss expectations. For institutions with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the institution should analyze the situation sufficiently to enable the institution's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, an institution should analyze the portfolio by segment using criteria such as product type, credit risk score, DTI, LTV, property type, geographic area, collateral valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

Management information systems - By maintaining adequate credit MIS, a financial institution can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Financial institutions should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For institutions with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

- Production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type;
- Delinquency and loss distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI);
- Vintage tracking;
- The performance of third-party originators (brokers and correspondents); and
- Market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values.

Policy and underwriting exception systems - Financial institutions should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing

portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

High LTV Monitoring - To clarify the agencies' real estate lending standards regulations and interagency guidelines, the agencies issued "Interagency Guidance on High LTV Residential Real Estate Lending" (HLTV guidance) in October 1999. The HLTV guidance clarified the "Interagency Real Estate Lending Guidelines" and the supervisory loan-to-value limits for loans on one- to four-family residential properties. This statement also outlined controls that the agencies expect financial institutions to have in place when engaging in HLTV lending. In recent examinations, supervisory staff has noted several instances of noncompliance with the supervisory loan-to-value limits of the "Interagency Real Estate Lending Guidelines." Financial institutions should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the institution's board of directors. Specifically, financial institutions are reminded that:

- Loans in excess of the supervisory LTV limits should be identified in the institution's records. The aggregate of high LTV one- to four-family residential loans should not exceed 100 percent of the institution's total capital.¹² Within that limit, high LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.
- In calculating the LTV and determining compliance with the supervisory LTVs, the financial institution should consider all senior liens. All loans secured by the property and held by the institution are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property **equals** or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
- For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the financial institution is legally committed to lend over the life of the loan).
- All real estate secured loans in excess of supervisory LTV limits should be aggregated and reported quarterly to the institution's board of directors.

¹² For purposes of the "Interagency Real Estate Lending Standards Guidelines," high LTV one-to four-family residential property loans include: (i) a loan for raw land zoned for one-to four-family residential use with a LTV ratio greater than 65 percent; (ii) residential land development loan or improved lot loan with a LTV greater than 75 percent; (iii) a residential construction loan with a LTV ratio greater than 85 percent; (iv) a loan on non-owner occupied one-to four-family residential property with a LTV greater than 85 percent; and (v) a permanent mortgage or home equity loan on an owner-occupied residential property with a LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

Over the past few years, new insurance products have been introduced to help financial institutions mitigate the credit risks of HLTV residential loans. Insurance policies that cover a “pool” of loans can be an efficient and effective credit risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The agencies will consider pool insurance as a sufficient credit enhancement to remove the HLTV designation in the following circumstances: 1) the policy is issued by an acceptable mortgage insurance company, 2) it reduces the LTV for each loan to less than 90 percent, and 3) it is effective over the life of each loan in the pool.

Stress testing for portfolios - Financial institutions with home equity concentrations as well as higher risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Institutions should consider stress tests that incorporate interest rates increases and declines in home values. Since these events often occur simultaneously, the agencies recommend testing for these events together. Institutions should also periodically analyze markets in key geographic areas, including identified “soft” markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

Operations, Servicing, and Collections

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit risk management should oversee these support functions to ensure that operational risks are properly controlled.

Lien Recording - Institutions should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

Problem Loan Workouts and Loss Mitigation Strategies - Financial institutions should have established policies and procedures for problem loan workouts and loss mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's “Uniform Retail Credit Classification and Account Management Policy,” issued June 2000, and should, at a minimum, address the following:

- Circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes. Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms;
- Circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure; and

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- Appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans. For large portfolios, vintage delinquency and loss tracking also should be included.

While the agencies encourage financial institutions to work with borrowers on a case-by-case basis, an institution should not use workout strategies to defer losses. Financial institutions should ensure that credits in workout programs are evaluated separately for the ALLL, because such credits tend to have higher loss rates than other portfolio segments.

Secondary Market Activities

More financial institutions are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary market activities can enhance credit availability and an institution's profitability, they also pose certain risk management challenges. An institution's risk management systems should address the risks of HELOC securitizations.¹³

Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital

The FFIEC's "Uniform Retail Credit Classification and Account Management Policy" governs the classification of consumer loans and establishes general classification thresholds based on delinquency. Financial institutions and the agencies' examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Financial institutions should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for its HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.¹⁴

¹³ Refer to "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (May 23, 2002), OCC Bulletin 2002-22 (OCC); SR letter 02-16 (FRB); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, dated November 1997. The Federal Reserve also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21.

¹⁴ See the "Interagency Expanded Guidance for Subprime Lending Programs" issued in January 2001 for supervisory expectations regarding risk management processes, allowance for loan and lease losses, and capital adequacy for institutions engaging in subprime lending programs.

CONCLUSION

Home equity lending is an attractive product for many homeowners and lenders. The quality of these portfolios, however, is subject to increased risk if interest rates rise and home values decline. Sound underwriting practices and effective risk management systems are essential to mitigate this risk.

**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration**

October 4, 2006

**INTERAGENCY GUIDANCE ON NONTRADITIONAL MORTGAGE
PRODUCT RISKS**

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as “interest-only” mortgages where a borrower pays no loan principal for the first few years of the loan and “payment option” adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.¹

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (“reduced documentation”) and are increasingly combined with simultaneous second-lien loans.² Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

¹ Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (“HELOCs”), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

² Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) expect institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.³

Institutions should use this guidance to ensure that risk management practices adequately address these risks. The Agencies will carefully scrutinize risk management processes, policies, and procedures in this area. Institutions that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

Loan Terms and Underwriting Standards

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the agencies' real estate lending standards and appraisal regulations and associated guidelines.⁴

³ Refer to Interagency Guidelines Establishing Standards for Safety and Soundness. For each Agency, those respective guidelines are addressed in: 12 CFR Part 30 Appendix A (OCC); 12 CFR Part 208 Appendix D-1 (Board); 12 CFR Part 364 Appendix A (FDIC); 12 CFR Part 570 Appendix A (OTS); and 12 U.S.C. 1786 (NCUA).

⁴ Refer to 12 CFR Part 34 - Real Estate Lending and Appraisals, OCC Bulletin 2005-3 – Standards for National Banks' Residential Mortgage Lending, AL 2003-7 – Guidelines for Real Estate Lending Policies and AL 2003-9 – Independent Appraisal and Evaluation Functions (OCC); 12 CFR 208.51 subpart E and Appendix C and 12 CFR Part 225 subpart G (Board); 12 CFR Part 365 and Appendix A, and 12 CFR Part 323 (FDIC); 12 CFR 560.101 and Appendix and 12 CFR Part 564 (OTS). Also, refer to the 1999 Interagency Guidance on the "Treatment of High LTV Residential Real Estate Loans" and the 1994 "Interagency Appraisal and Evaluation Guidelines."

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualifying Borrowers – Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution’s qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution’s underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower’s characteristics and the product’s attributes.

For all nontraditional mortgage loan products, an institution’s analysis of a borrower’s repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,⁵ assuming a fully amortizing repayment schedule.⁶ In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.⁷

Federally Insured Credit Unions should refer to 12 CFR Part 722 - Appraisals and NCUA 03-CU-17 – Appraisal and Evaluation Functions for Real Estate Related Transactions (NCUA).

⁵ The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

⁶ The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

⁷ The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or “teaser” rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans – Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.⁸ Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering – Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation – Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans – Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

Introductory Interest Rates – Many institutions offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing

⁸ A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

Lending to Subprime Borrowers – Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime lending.⁹ Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

Non-Owner-Occupied Investor Loans – Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.¹⁰

Portfolio and Risk Management Practices

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should:

- Develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Design enhanced performance measures and management reporting that provide early warning for increasing risk;

⁹ Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Programs, January 31, 2001. Federally insured credit unions should refer to 04-CU-12 – Specialized Lending Activities (NCUA).

¹⁰ Federally insured credit unions must comply with 12 CFR Part 723 for loans meeting the definition of member business loans.

- Establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- Maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Policies – An institution’s policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations – Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Monitoring should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as loans with high combined LTV ratios, loans with high DII ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, loans with risk-layered features, and non-owner-occupied investor loans. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls – An institution’s quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third-Party Originations – Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the

quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.¹¹

Secondary Market Activity – The sophistication of an institution's secondary market risk management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary market activities should have comprehensive, formal strategies for managing risks.¹² Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the agencies' view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is implicit recourse. Under the agencies' risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.¹³ Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

Management Information and Reporting – Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by loan type (e.g., interest-only mortgage loans and payment option ARMs); by risk-layering features (e.g., payment option ARM with stated income and interest-only mortgage loans with simultaneous second-lien mortgages);

¹¹ Refer to OCC Bulletin 2001-47 – Third-Party Relationships and AL 2000-9 – Third-Party Risk (OCC). Federally insured credit unions should refer to 01-CU-20 (NCUA), Due Diligence over Third Party Service Providers. Savings associations should refer to OTS Thrift Bulletin 82a – Third Party Arrangements.

¹² Refer to “Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations,” May 23, 2002; OCC Bulletin 2002-22 (OCC); SR letter 02-16 (Board); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, November 1997. See OTS Examination Handbook Section 221, Asset-Backed Securitization. The Board also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21. Federally insured credit unions should refer to 12 CFR Part 702 (NCUA).

¹³ Refer to 12 CFR Part 3 Appendix A, Section 4 (OCC); 12 CFR Parts 208 and 225, Appendix A, III.B.3 (FRB); 12 CFR Part 325, Appendix A, II.B (FDIC); 12 CFR 567 (OTS); and 12 CFR Part 702 (NCUA) for each Agency's capital treatment of recourse.

by underwriting characteristics (e.g., LTV, DTI, and credit score); and by borrower performance (e.g., payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk tolerance levels.

Stress Testing – Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring and managing risk, as well as developing appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

Capital and Allowance for Loan and Lease Losses – Institutions should establish an appropriate allowance for loan and lease losses (ALLL) for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. In accordance with

interagency guidance, the valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.¹⁴

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner – before disclosures may be required under the Truth in Lending Act or other laws – to assist the consumer in the product selection process.

Concerns and Objectives – More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the “recast” of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

¹⁴ Refer to the “Interagency Advisory on Mortgage Banking,” February 25, 2003, issued by the bank and thrift regulatory agencies. Federally Insured Credit Unions with assets of \$10 million or more are reminded they must report and value nontraditional mortgages and related mortgage servicing rights, if any, consistent with generally accepted accounting principles in the Call Reports they file with the NCUA Board.

Legal Risks – Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages in advertisements, with an application,¹⁵ before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.¹⁶

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Agencies note that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:¹⁷

Communications with Consumers – When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when a consumer is shopping for a mortgage – such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products, or when marketing relating to nontraditional mortgage products is provided by the institution to the consumer – not just upon the submission of an application or at

¹⁵ These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

¹⁶ The OCC, the Board, and the FDIC enforce this provision under the FTC Act and section 8 of the FDI Act. Each of these agencies has also issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. *See* OCC Advisory Letter 2002-3 - Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. Federally insured credit unions are prohibited from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition. 12 CFR 740.2. The OTS also has a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered. 12 CFR 563.27. This regulation supplements its authority under the FTC Act.

¹⁷ Institutions also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

consummation.¹⁸ The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.¹⁹

Promotional Materials and Product Descriptions. Promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

- **Payment Shock.** Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.²⁰ Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.
- **Negative Amortization.** When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home).

¹⁸ Institutions also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

¹⁹ Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

²⁰ Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

- **Prepayment Penalties.** If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.²¹
- **Cost of Reduced Documentation Loans.** If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

Monthly Statements on Payment Option ARMs. Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid. Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.²² Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

²¹ Federal credit unions are prohibited from imposing prepayment penalties. 12 CFR 701.21(c)(6).

²² For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

Control Systems – Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending 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. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

Appendix: Terms Used in this Document

Interest-only Mortgage Loan – A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM – A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation – A loan feature that is commonly referred to as “low doc/no doc,” “no income/no asset,” “stated income” or “stated assets.” For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.

Simultaneous Second-Lien Loan – A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

Dated: September 25, 2006.

John C. Dugan, *Comptroller of the Currency*.

By order of the Board of Governors of the Federal Reserve System, September 27, 2006.

Jennifer J. Johnson, *Secretary of the Board*.

Dated at Washington, D.C., this 27th day of September, 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman, *Executive Secretary*.

Dated: September 28, 2006.

By the Office of Thrift Supervision.

John M. Reich, *Director*.

By the National Credit Union Administration on September 28, 2006.

JoAnn M. Johnson, *Chairman*.

**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration**

ADDENDUM TO CREDIT RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

This addendum to the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending* (interagency HE lending guidance) provides additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only features. While HELOCs with these features may provide flexibility for consumers, the Agencies are concerned that consumers may not fully understand the product terms and associated risks. This addendum provides guidance addressing the timing and content of communications with consumers obtaining interest-only HELOCs. These consumer protection recommendations are similar to the guidance contained in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (September 2006) for closed-end home purchase, refinance, and home equity mortgage products.

Credit Risk Management Systems

Product Development and Marketing

When promoting or describing HELOCs that permit interest-only payments, institutions should provide consumers with information that is designed to help them make informed decisions regarding product selection and use. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers.

Communications with consumers, including advertisements, oral statements, promotional materials, and periodic statements, should provide clear and balanced information about the relative benefits and risks of HELOCs with interest-only features. This includes information about the risk of increased future payment obligations.²³ Information about potential increases in payment obligations should address, among other things, circumstances in which interest rates reach a contractual limit.

²³ The Agencies are concerned about increased future payment obligations due to interest rate increases and the end of a non-amortizing payment period, not payment increases due to additional draws on the line of credit.

If applicable, these materials should also alert the consumer to any prepayment penalty,²⁴ and the need to seek additional information on the amount of any penalty. Consumers should also be informed of any premium that may be charged for a reduced documentation program.

This information should be provided in a timely manner, to assist the consumer in the product selection process. Clear and balanced information should be provided at the time a consumer is shopping for a loan, not just when an application form is provided or at consummation. For example, this information could be provided when a consumer inquires about a home equity product and receives information about products with interest-only features, or when the institution provides the consumer with marketing materials for such products.²⁵

²⁴ For purposes of this guidance, a prepayment penalty for a HELOC is a fee that will be imposed if the borrower pays off the balance and terminates the account in advance of the contractual end date.

²⁵ Institutions also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers.