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

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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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