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 filly 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.