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.

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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 portfolio[1]. 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 RELS 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 and Underwriting Standards for Loans Originated for Sale

When lenders originate loans for sale, 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. In some cases, 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 documentation errors or omissions, where fraud is involved, or when a loan becomes 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 less stringent than the institution's, a loan is more likely to become delinquent during the reps and warranty period, and the lender may be required 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.

It has been and remains OTS policy that savings associations use prudent underwriting and documentation standards for all loans they originate, both for those to be held in portfolio and those originated for sale. OTS expects that loans originated for sale will be underwritten to comply with both the institution's Board-approved loan policies for such programs and with all existing regulations and supervisory guidance governing the documentation and underwriting standards for residential mortgages.

Experience has shown that the level of pipeline, warehouse, and credit-enhancing repurchase exposure for mortgage loans originated for sale to non-government sponsored enterprise purchasers can constitute a concentration risk that should be aggressively identified, measured, monitored, controlled, and reported to the Board. Given the concentration risk, the Board-approved loan policy should

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

establish a limit for aggregate pipeline, warehouse, and credit-enhancing repurchase exposure from such lending programs. A savings association will receive closer supervisory review of its concentration risk when such exposure exceeds its Tier 1 capital.

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:

> A sound real estate lending policy should be augmented by strong and effective internal controls.

- 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

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

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®.

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 Mortgage Lending

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

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 (llth 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

> 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.

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.

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 RELS 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 paper[3] 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.

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.

[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.

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 RELS 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