One- to Four-Family Residential Real Estate Lending Program

EXAMINATION OBJECTIVES

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

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

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

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

To initiate corrective action as appropriate.

EXAMINATION PROCEDURES

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

LEVEL I

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

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

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

3. Determine the types of 1-4 family residential loan programs and note whether and to what extent the association makes nontraditional, hybrid, or subprime mortgages. Identify any new lending activities, programs, or strategies to evaluate as part of this review.

   - Determine whether the association's lending programs incorporate risk layering features such as high LTV lending, simultaneous second mortgages, or limited documentation.

4. Review loan portfolio performance for the various mortgage products offered. Ensure that the association has properly stratified loans by various risk elements.

   - Identify any performance concerns and determine whether additional review is needed to assess such concerns.

5. Review the audit reports and preceding report of examination and all lending related exceptions noted, and determine if management took appropriate corrective action.

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

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

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

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

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

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

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

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

LEVEL II

One- to Four-Family Residential Lending

1. Determine whether the association has established procedures to verify borrower provided information (such as sending out verification of deposit letters and verification of income letters).

2. Determine whether the association has established adequate procedures to perfect its interest in the security property.

3. Verify that the association adequately prices mortgage loans to provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit.

4. If applicable, determine whether the association has appropriate controls, oversight, and underwriting policies and procedures to address low-doc loan programs.

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5. For FHA-insured and VA-guaranteed loans:

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

Adjustable Rate Mortgages

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

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

8. For discounted, Hybrid, or "teaser" ARMs:

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

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

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

Home Equity Lending

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

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

Negative Amortization and Interest Only Loans

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

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

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

Subprime Mortgage Lending

13. If the association is engaging in subprime mortgage lending, verify that the association:

- Segregates its subprime loans to manage risks and monitor performance.
- Follows the Interagency Subprime Lending Guidance and the Expanded Subprime Lending Guidance.
- Has sufficient staff training and resources to manage any additional collection burden.
- Has sufficient ALLL and capital to cover the additional risks inherent in its subprime lending operation.

14. If the association makes hybrid 2-28 or 3-27 ARM loans, verify that underwriting standards require borrowers to qualify at the fully indexed rate, and not the start or "teaser" interest rate.

15. As appropriate, conduct additional subprime lending examination procedures detailed in Appendix B of Handbook Section 217.

16. Select a sample of subprime loans for review and analyses. **Sampling is mandatory for associations with subprime lending programs.**

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Reverse Mortgage Loans

17. Determine if the association engages in reverse mortgage lending. If so, verify that the association:

- Calculates the risk-based capital requirement separately for each reverse mortgage loan.
- Assesses each borrower's life expectancy for each reverse mortgage loan.
- Performs a sensitivity analysis on the reverse mortgage loan program's profitability for:
  - — A range of alternative mortality rates.
  - — A variety of possible appreciation and depreciation scenarios.

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

Manufactured Home Financing

19. Determine whether the association engages in manufactured home financing. If so, determine whether the association:

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

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- Sells manufactured home chattel paper without recourse.

Sampling

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

CONCLUSIONS

1. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.

2. Ensure that your review meets the objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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