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March 2008
Report No. AUD-08-009

Implementation of FDIC's Supervisory Guidance for Nontraditional Mortgage Products

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Federal Deposit Insurance Corporation

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Why We Did The Audit

The audit objectives were to assess (1) the implementation of the FDIC's *Supervisory Guidance for Nontraditional Mortgage Products* (Supervisory Guidance) and (2) examination coverage of the loan terms and underwriting standards set forth in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (NTM Guidance).

Background

The FDIC's Division of Supervision and Consumer Protection (DSC) is responsible for performing risk management and compliance examinations of FDIC-supervised institutions. The FDIC has provided its examiners the Supervisory Guidance and NTM Guidance to assist in assessing institutions' NTM product activities, including policies and procedures and risk management processes, recognizing that a number of different but prudent practices may exist.

NTM products generally include mortgage loans with interest-only, payment-option adjustable rates, and/or negative amortization terms. Borrowers increasingly turned to NTMs to purchase homes in 2001-2005, when mortgage rates remained historically low and home prices appreciated rapidly in many markets.

Although NTM products have been promoted as a way for consumers to make lower monthly payments in the near term, there is significant risk that consumers may not understand that these loan products are structured in a manner that may cause future payment obligations to increase significantly. Also, some NTM products have principal loan balances that increase due to negative amortization. This is particularly problematic when the value of the underlying collateral declines, making it difficult to sell or refinance the property.

The FDIC expects institutions to effectively assess and manage the risks associated with NTM product activities and to ensure that new and relatively untested products are being appropriately underwritten, managed, and marketed.

Audit Results

The FDIC's implementation of the Supervisory Guidance has provided a systematic process for the identification of FDIC-supervised institutions with significant involvement in NTM product activities (see the figure below) and the determination of supervisory strategies for those institutions. Further, the FDIC's examination coverage of institutions with NTM product activities has addressed the loan terms and underwriting standards set forth in the NTM Guidance. These standards also provide certain protections for consumers. We concluded that the FDIC's guidance and examination coverage have provided a means to identify and mitigate the risks to both institutions and consumers associated with NTM product activities.

Through its identification process, the FDIC determined that 30 of approximately 5,250 FDIC-supervised institutions had significant involvement in NTM product activities. To determine the scope and magnitude of NTM product activities at these 30 institutions, the FDIC conducted on-site examinations or visitations. On a continuing basis, the FDIC plans to identify and assess NTM product activities for all FDIC-supervised institutions through the examination process. These actions have provided a means for the FDIC to address the risks posed by NTM products to both institutions and consumers.

For our sample of 15 of the 30 FDIC-supervised institutions identified with significant NTM product activities, DSC had conducted on-site risk management examinations and visitations that covered the loan terms and underwriting standards set forth in the NTM Guidance. For another sample of seven institutions, whose NTM product activities fell under the thresholds DSC defined as significant, examiners had considered the extent of NTM product activities in planning risk management examinations. Also, for those seven institutions, we determined that the examiners had assessed selected activities and controls related to NTM products such as introductory rates, simultaneous second liens, and subprime borrowers. The FDIC's examinations and visitations have assisted in identifying and mitigating the risks to institutions and consumers associated with NTM products in accordance with the NTM Guidance. As a result of these positive findings, we do not make any recommendations in the report.

Thresholds Established by DSC for Significant NTM Product Activities as a Percentage of Tier 1 Capital

Loan Type	Loan Originations	Loans on Book
Interest-Only	250%	100%
Payment-Option Adjustable Rate Mortgages	100%	25%
Subprime	100%	25%

Source: DSC Senior Deputy Director memorandum dated August 8, 2007.

Management Response

DSC provided a written response, stating that the FDIC is focusing its attention on significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices, and disruptions in the credit and capital markets to ensure that FDIC-supervised institutions respond appropriately to maintain their safety and soundness.

To view the full report, go to www.fdicig.gov/2008reports.asp

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FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: March 31, 2008

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/
FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Implementation of FDIC's Supervisory Guidance for Nontraditional Mortgage Products*
(Report No. AUD-08-009)

This report presents the results of our audit of the FDIC's supervision and examination of nontraditional mortgage (NTM) product activities at FDIC-supervised institutions. The audit objectives were to assess (1) the implementation of the FDIC's *Supervisory Guidance for Nontraditional Mortgage Products* (Supervisory Guidance) and (2) examination coverage of the loan terms and underwriting standards set forth in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (NTM Guidance).

We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report discusses our audit objectives, scope, and methodology in detail.

BACKGROUND

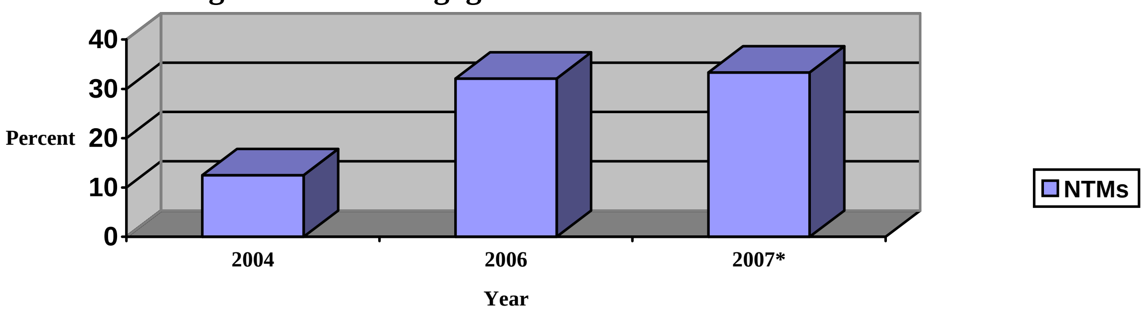
NTM products, sometimes called alternative mortgages or exotic mortgages, are generally defined to include products such as interest-only and hybrid adjustable rate mortgage (ARM) loans, payment-option ARMs, interest-only fixed rate mortgages, and extended maturity mortgage loans (terms beyond 30 years).[1] The potential advantages of NTMs in terms of lower payments and higher principal balances can be significant depending on the expected path of interest rates and home price appreciation. However, significant disadvantages can arise if interest rates and home price appreciation take unexpected turns that could be particularly challenging for borrowers with weak credit. NTM products have been offered to a wider spectrum of borrowers, who may not qualify for a traditional fixed-rate or other ARM loan and who may not fully understand that NTM products may cause future payment obligations to significantly increase.

[1] Appendix 2 of this report provides details on the features and types of NTM products.

NTM product lending became popular in areas of the country that experienced strong home price appreciation because the products allowed borrowers to lower their initial monthly payments and borrow larger amounts. Borrowers increasingly turned to NTMs to purchase homes in 2001-2005 when mortgage rates remained historically low and home prices appreciated rapidly in many markets. In many cases, borrowers intended to refinance these loans or sell the houses before interest rates on the mortgages adjusted.

The number of NTMs surged between 2004 and 2006—up from 12.5 percent to 32.1 percent—and accounted for a substantial one-third share of total mortgage originations through the first 9 months of 2007 as depicted in the figure below.

NTMs as a Percentage of Total Mortgages



Source: FDIC data.
* Includes only the first 9 months of 2007.

An additional risk became apparent as subprime borrowers[2] increasingly turned to NTMs to finance home purchases. About three-quarters of the subprime mortgages securitized in 2004 and 2005 were structured as NTMs, such as hybrid ARMs. Further, these NTMs accounted for over half of the subprime loans made in 2006. About 1.7 million subprime hybrid loans, with a value of $367 billion, are scheduled to reset during 2008 and 2009, according to FDIC estimates.

FDIC Guidance Related to NTM Products

The FDIC expects institutions to effectively assess and manage the risks associated with NTM products and to ensure that new and relatively untested products are being appropriately underwritten, managed, and marketed. The FDIC, working individually and together with other banking agencies, has issued guidance to assist examiners and supervisory staff in scrutinizing institutions' NTM lending programs, including policies and procedures and risk management processes, recognizing that a number of different but prudent practices may exist.

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[2] Subprime borrowers typically have weakened credit histories that may include a combination of payment delinquencies, charge-offs, judgments, and bankruptcies.

On October 4, 2006, the federal financial institution regulatory agencies[3] issued final guidance[4] entitled, *Interagency Guidance on Nontraditional Mortgage Product Risks,* to clarify how institutions can offer NTM products in a safe and sound manner and in a way that clearly discloses the risks that borrowers may assume. The NTM Guidance provides an overview of the loan underwriting standards, portfolio and risk management practices, and consumer protection issues that should be reviewed during the safety and soundness and compliance examinations of institutions that offer NTM products or purchase them through subsidiaries or third parties. The Corporation forwarded this guidance to FDIC-supervised institutions on October 5, 2006.[5]

The NTM Guidance stresses that institutions should:

- assess a borrower's ability to repay the loan,
- recognize that certain NTM loans warrant strong risk management standards as well as appropriate capital and loan loss reserves, and
- ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

In particular, the guidance addresses financial institution underwriting standards to mitigate risks associated with negative amortization, reduced documentation, simultaneous second liens, and risk layering features (for example, combining reduced documentation or simultaneous second liens with an NTM loan).

The FDIC's Division of Supervision and Consumer Protection (DSC) is responsible for performing risk management and compliance examinations for FDIC-supervised institutions. On March 14, 2007, DSC issued the Supervisory Guidance[6] to provide DSC Regional Directors guidance on contacting FDIC-supervised institutions to ascertain their involvement with NTM and subprime mortgage products and to provide additional examiner guidance for supervising state nonmember institutions involved in NTM product activities. The Supervisory Guidance supplements the NTM Guidance with specific requirements for identifying and assessing the origination, purchase, sale, and servicing of NTM products by FDIC-supervised institutions and taking additional supervisory action where warranted.

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[3] The FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration.
[4] *Federal Register* Vol. 71, No. 192, Wednesday, October 4, 2006.
[5] Financial Institution Letter (FIL) 89-2006.
[6] DSC Transmittal No. 2007-008.

RESULTS OF AUDIT

DSC's implementation of the Supervisory Guidance has provided a systematic process for the identification of FDIC-supervised institutions with significant involvement in NTM product activities and the determination of supervisory strategies for those institutions. Further, the FDIC's examination coverage of institutions with NTM product activities has addressed the loan terms and underwriting standards set forth in the NTM Guidance. These standards also provide certain protections for consumers. We concluded that the FDIC's guidance and examination coverage have provided a means to identify and mitigate the risks associated with NTM product activities to both institutions and consumers **(Supervisory Process for Identifying FDIC-Supervised Institutions with Significant Involvement in NTM Product Activities).**

Through its identification process, the FDIC determined that 30 of approximately 5,250 FDIC-supervised institutions had significant involvement in NTM product activities.[7] To determine the scope and magnitude of NTM product activities by these 30 institutions, the FDIC conducted on-site examinations or visitations. On a continuing basis, the FDIC plans to identify and assess NTM product activities for all FDIC-supervised institutions through the examination process. These actions have provided a means to address the risks posed by NTM products to both the institutions and consumers **(Supervisory Strategies for FDIC-Supervised Institutions Involved in NTM Product Activities).**

For our sample of 15 of the 30 FDIC-supervised institutions identified with significant NTM product activities, we found that DSC had conducted on-site risk management examinations and visitations that covered the loan terms and underwriting standards set forth in the NTM Guidance. For another sample of seven institutions, whose NTM product activities fell under the thresholds defined as significant, DSC examiners had considered the extent of NTM product activities in planning risk management examinations. Also, for these institutions, we determined that the examiners had assessed selected activities and controls related to NTM products such as introductory rates, simultaneous second liens, and subprime borrowers. The examinations and visitations have assisted in identifying and mitigating the risks associated with NTM products to both institutions and consumers **(On-Site Coverage of NTM Guidance on Loan Terms and Underwriting Standards).**

[7] Significant involvement in NTM activities was determined by the dollar volume of non-traditional or subprime mortgages either originated or on-book as a percentage of Tier 1 Capital. See Table 1 on page 7 for more details.

SUPERVISORY PROCESS FOR IDENTIFYING FDIC-SUPERVISED INSTITUTIONS WITH SIGNIFICANT INVOLVEMENT IN NTM PRODUCT ACTIVITIES

DSC developed a process to identify the FDIC-supervised institutions with significant involvement in NTM product activities, including those situations where subprime mortgage lending is significant relative to capital. The process involved identifying the types of NTM products that pose significant risk to consumers, identifying institutions that engage in those types of NTM product activities, and ongoing monitoring of the institutions' NTM lending activities. Through this approach, DSC has provided a systematic means to identify and mitigate the risks associated with these products from both an institution and consumer perspective.

Identification of High-Risk Mortgage Products

The Supervisory Guidance details the FDIC's approach for identifying and monitoring FDIC-supervised institutions involved in NTM product activities. According to DSC, not all NTMs are high-risk; however, certain loan characteristics can make them higher-risk loans for borrowers and institutions, such as payment options that may include teaser rates, low down payments, simultaneous second liens, interest-only periods, high-cost loans, and negative amortization. DSC specifically targeted payment option ARMs, interest-only, and subprime NTM products for review because they typically contain one or more of these high-risk characteristics. In addition, DSC decided to review subsidiary and affiliate loan origination activity and the risks associated with recourse and put-back agreements.[8]

Identification of FDIC-Supervised Institutions Involved in NTM Product Activities

Due to a lack of available off-site data related to NTM lending,[9] DSC developed a supervisory approach to identify FDIC-supervised institutions involved in NTM product activities. As described in the March 2007 Supervisory Guidance, DSC conducted a one-time targeted review to identify institutions involved in NTM product activities. As part of the one-time review, the regional offices gathered information related to NTM and subprime mortgage products. DSC headquarters compiled this regional data to identify (1) FDIC-supervised institutions involved in NTM product activities and (2) those institutions with significant involvement in NTM lending activities based on the volume of NTM products (originations and on book) as a percentage of Tier 1 Capital.

[8] Recourse and put-back agreements, also known as early payment default clauses, obligate the seller to repurchase all loans that default or become delinquent within a specified period of time from the sale date.
[9] The FDIC collects Reports of Condition and Income data (Call Reports) from insured institutions on a quarterly basis. The Call Reports have since been revised to capture NTM data. The revisions were documented in two FDIC Financial Institutional Letters (FIL): FIL-21-2007, *Revisions to Regulatory Reports Filed by Banks and Savings Association*, dated March 2, 2007; and FIL-13-2008, *Revisions to the Consolidated Reports of Condition and Income for 2008*, dated February 20, 2008.

On August 8, 2007, DSC issued additional reporting requirements to the regional offices, broadening the focus of the Supervisory Guidance, to include coverage of liquidity concerns that had affected the mortgage-backed securities market. Specifically, the instructions focused regional efforts on four areas: originations of NTM and subprime mortgage products, institutions affiliated with a top 40 mortgage originator, exposure to mortgage-backed securities, and exposure at large institutions.[10]

To identify institutions involved in NTM product activities, DSC used September 30, 2006 Call Report data to identify an initial list of institutions that included: (1) the top 100 ranking institutions with 1-4 family residential loans on book, (2) institutions with any sales volume of closed-end 1-4 family residential loans, and (3) institutions with sales and securitizations of 1-4 family loans where the institution serviced or sold the loans with recourse. The resulting list of 349 FDIC-supervised institutions identified by DSC represented 60 percent of the 1-4 family mortgage loans originated by FDIC-supervised institutions as of September 30, 2006. Regional office staff then obtained the following information from each of these institutions:

- the amount of interest-only, payment-option, and subprime mortgage loans originated in 2004, 2005, and 2006 and the balance of interest-only, payment-option, and subprime mortgage loans on the institution's balance sheet as of year-end 2004, 2005, and 2006;

- the volume of NTM and subprime mortgage loans sold into the secondary market and the volume of mortgage servicing rights retained; and

- the average FICO scores[11] of the institution's subprime residential mortgage loans.

Using this information, DSC then developed the thresholds shown in Table 1, on the next page, to identify which of the 349 FDIC-supervised institutions had significant involvement in NTM product activities (including subprime lending activities).

DSC established the thresholds, as a percentage of Tier 1 Capital, based on the different levels of risk of the products and the "natural breaks" that occurred in the data. DSC stated that the use of "natural breaks" to identify cut-off points was reasonable, considering the risk posed by the activity and the fact that the institutions fell significantly above or below the thresholds for significant involvement in NTM product activities. Institutions that met or exceeded the threshold cut-offs were defined as institutions with significant involvement in NTM product activities.

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[10] A large institution is defined as a financial institution with consolidated banking assets that exceed $10 billion.
[11] A FICO score, developed by Fair Isaac and Company, is a method of determining the likelihood that credit users will pay their bills.

Table 1: Thresholds Established for Significant Involvement in NTM Product Activities as a Percentage of Tier 1 Capital

Loan Type	Loan Originations	Loans on Book
Interest Only	250%	100%
Payment Option ARMs	100%	25%
Subprime	100%	25%

Source: DSC Senior Deputy Director memorandum dated August 8, 2007.

Of the 349 institutions, DSC identified 40 institutions with significant NTM product activities that were targeted for closer review. Subsequently, DSC excluded 10 of the 40 institutions because: 3 institutions were either acquired by institutions supervised by the Office of Thrift Supervision or were no longer active; 3 institutions had submitted incorrect data and did not actually engage in NTM product activities; 3 institutions had low levels of NTM product activities; and 1 institution was a subprime credit card institution. The remaining 30 institutions either had originated or had on book the types of NTM products noted in Table 2.

Table 2: NTM Products for the 30 Institutions

Type(s) of NTM Loans	No. of Institutions
Payment Option	1
Interest Only	10
Subprime	13
Interest Only and Subprime	3
Payment Option, Interest Only, and Subprime	3
Total	**30**

Source: DSC management and supporting documents.

For the purpose of our audit, we reviewed each of the thresholds to determine if there was a “natural break” that distinguished the 30 institutions DSC identified with significant NTM product activities. We applied the thresholds to each of the three types of loans (payment option, interest only, and subprime) for both loan originations and loans on book. Based on our review, we determined that DSC had consistently applied the thresholds in identifying the initial 40 institutions for on-site review. We also found that 7 of the 349 institutions fell just under the thresholds defined for significant involvement in NTM product activities. Specifically, 2 institutions’ NTM product activities were 10 percent or less under the thresholds for interest-only loans, and 5 institutions were 10 percent or less under the thresholds for subprime loans (see details in Table 3 on the next page).

Table 3: Institutions Within 10 Percent of Threshold Limits

Institution	NTM Product	Institution Exposure	DSC Threshold
Institution 1	Interest Only - On Book	98%	100%
Institution 2	Interest Only - On Book	98%	100%
Institution 3	Subprime - Originations	95%	100%
Institution 4	Subprime - Originations	91%	100%
Institution 5	Subprime - On Book	24%	25%
Institution 6	Subprime - On Book	23%	25%
Institution 7	Subprime - On Book	23%	25%

Source: OIG analysis of data for the 349 FDIC-supervised institutions identified by DSC as involved in NTM product activities.

For the remaining 302 institutions, we determined that the NTM product activities fell well below the DSC thresholds.

During our discussions with DSC regional office staff, we found that one of the regional offices identified four additional institutions for monitoring, even though the institutions did not meet the DSC thresholds for significant involvement in NTM product activities. This regional office decided to apply reduced thresholds to capture those institutions warranting additional attention.

We also found that another regional office plans to continue to collect annually the information initially requested by DSC. Some of the information will be collected by examiners during the normal examination cycle. For institutions with no scheduled examination in a specific year, the Relationship Manager[12] will be responsible for collecting the information that year. As a result of this continuous monitoring effort, the regional office identified an additional institution that did not meet the thresholds at the time of the initial request but now qualifies for monitoring.

Monitoring of FDIC-Supervised Institutions with Significant Involvement in NTM Product Activities

DSC's initial findings regarding the 349 FDIC-supervised institutions were reported in the first quarter 2007 monitoring report,[13] dated July 31, 2007, as follows:

> Overall, 40 institutions (11.5 percent of the institutions surveyed) were identified as a higher supervisory concern based on exposure related to the dollar volume of interest only, payment option ARMs, and subprime mortgages. Nine of these 40 institutions are reported in the first quarter 2007 monitoring report.

[12] A Relationship Manager is designated for every FDIC-supervised institution to serve as an FDIC point of contact.
[13] DSC sources of information for the monitoring report include recent safety and soundness examinations conducted by the FDIC and other banking agencies, as well as direct contact with the other banking agencies and institution management.

The monitoring report is a DSC internal reporting mechanism for identifying those institutions involved in activities that inherently pose an increased risk to the institution and, thereby, to the Deposit Insurance Fund. A significant component of the monitoring report is information on those financial institutions involved in subprime lending. In the second quarter 2007 monitoring report, DSC concluded that asset quality at most of the institutions with significant involvement in NTM product activities was generally satisfactory, portfolio management practices were generally sound, underwriting practices continued to tighten, and most of the institutions were generally adhering to the NTM Guidance.

According to DSC, the established NTM product activity thresholds will serve as a continuing basis for identifying institutions that should be included in the monitoring report for ongoing monitoring purposes. If institutions later drop below the thresholds, the institutions will remain in the monitoring report for 2 quarters before being removed.

SUPERVISORY STRATEGIES FOR FDIC-SUPERVISED INSTITUTIONS INVOLVED IN NTM PRODUCT ACTIVITIES

Through its identification process, the FDIC determined that 30 of approximately 5,250 FDIC-supervised institutions had significant involvement in NTM product activities. To determine the scope and magnitude of NTM product activities by these 30 institutions, the FDIC conducted on-site risk management examinations or visitations. On a continuing basis, the FDIC plans to identify and assess NTM product activities for all FDIC-supervised institutions through the examination process. These actions have provided a means to address the risks posed by NTM products to both the institutions and consumers.

The Supervisory Guidance requires DSC regional directors to determine an appropriate supervisory strategy and examination frequency for institutions involved in NTM product activities. The Supervisory Guidance states that institutions with significant NTM product activities would have some type of on-site examination activity (such as an accelerated, traditional, point-in-time examination; targeted examination; or visitation). The guidance further states that other institutions will be monitored through examinations and scheduled off-site activities.

We reviewed documentation related to DSC's supervisory activities for the 30 institutions identified as having significant involvement in NTM product activities. Specifically, we reviewed DSC supervisory plans, Reports of Examination (ROE), visitation reports, summaries of reviews or visitations, and supervisory tracking reports. In addition, we interviewed appropriate DSC regional office and field office staff. We found that DSC had conducted an on-site review for all 30 institutions by the end of September 2007 in the form of either a full scope examination or a visitation. During the on-site examinations and visitations, DSC regional and field office staff were able to document the levels of NTM product activities and risk to both institutions and consumers at each of the 30 institutions, as shown in Table 4 on the next page.

Table 4: Results of On-site Reviews of the 30 Institutions

Regional Office	NTM Lending Risk Not Considered Significant	Problems with NTM Lending Identified	No Longer Conducting NTM Lending	Totals
Atlanta	5	1	0	6
Chicago	2	0	0	2
Dallas	2	1	0	3
Kansas City	0	0	0	0
New York	11	0	2	13
San Francisco	4	1	1	6
Totals	**24**	**3**	**3**	**30**

Source: OIG analysis of DSC's on-site examinations and visitations.

The on-site reviews of those institutions with significant NTM product activities provided DSC the means for addressing the risks posed by NTM products to both the institutions and consumers.

ON-SITE COVERAGE OF NTM GUIDANCE ON LOAN TERMS AND UNDERWRITING STANDARDS

For our sample of 15 of the 30 institutions with significant NTM product activities, DSC's on-site risk management examinations or visitations covered the loan terms and underwriting standards set forth in the NTM Guidance. These standards also provide certain protections for consumers. Additionally, for another sample of seven institutions, whose NTM product activities fell below the DSC thresholds defined as significant, DSC examiners considered the extent of NTM activities in planning the risk management examinations and assessed selected activities and controls related to NTM products such as introductory rates, simultaneous second liens, and subprime borrowers. These examinations and visitations have assisted in identifying and mitigating the risks to institutions and consumers associated with NTM products.

NTM and Supervisory Guidance Related to Loan Terms and Underwriting Standards

The NTM Guidance provides an overview of the loan underwriting standards, portfolio and risk management practices, and consumer protection issues that should be reviewed during the risk management and compliance examinations of institutions that offer NTM products or purchase them through subsidiaries or third parties. The NTM Guidance states that when an institution offers NTM products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. The guidance also states that loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Additionally, DSC's Supervisory Guidance states that, ". . . risk management and compliance examiners will scrutinize institutions' underwriting standards and risk management and compliance management policies and practices to ensure that they adequately address the risk of these [NTM] products." This guidance further states that examiners will identify, assess, and monitor institutions involved in NTM product activities through the normal supervisory process.

Examination Coverage for Institutions with Significant Involvement in NTM Product Activities

We sampled 15 of the 30 institutions identified as having significant NTM product activities. The 15 institutions had current 2007 risk management examinations or visitations and concentrations of payment option ARMs and/or interest-only loans. For those 15 institutions, we reviewed the 2007 ROEs and visitation reports to determine the extent of examiner coverage of the loan terms and underwriting standards of the NTM Guidance (see Appendix 3). With the exception of one institution, we found that examiners had generally addressed the loan terms and underwriting standards as required by the NTM Guidance. For the one institution, we found evidence that some aspects of the institution's NTM lending activities had been addressed.

For 8 of the 15 institutions, full scope, on-site risk management examinations had been conducted by the FDIC in 2007.[14] As illustrated in Table 5, we found that the NTM Guidance was addressed in either the ROE or a supervisory activity that occurred shortly after the examination.

Table 5: Examinations or Visitations that Addressed NTM Guidance

No. of Institutions	ROE Addressed NTM Guidance	Relevant Supervisory Activity
2	Yes	N/A
2	No	Within 1 month of the completed examinations, the FDIC conducted on-site, targeted visitations that addressed the NTM Guidance.
3	No	Within 6 months of the examinations, the FDIC conducted on-site, targeted visitations that addressed the NTM Guidance.
1	No	This institution had no identified NTM lending problems. Seven months after the examination, the FDIC conducted an on-site targeted visitation that focused on the volume of NTM loans the institution was obligated to repurchase, due to early payment defaults for mortgages it sold to investors.

Source: OIG Analysis.

[14] Examinations for five of the eight institutions were conducted during January and February 2007 - only 3 to 4 months after the issuance of the NTM Guidance.

For the remaining seven institutions in our sample, targeted risk management visitations and, in some cases, compliance visitations, were conducted 10 to 11 months after issuance of the NTM Guidance and 5 to 6 months after issuance of the Supervisory Guidance, and the related visitation reports addressed the NTM Guidance.

Examination Coverage for Institutions Involved in NTM Product Activities That Fell Below DSC Thresholds for Significant Involvement

We sampled an additional seven FDIC-supervised institutions whose NTM product activities fell under the DSC thresholds defined as significant. We found that the examiners had considered the extent of NTM product activities in planning risk management examinations and assessed selected activities and controls related to NTM lending.

From the initial 349 institutions identified as involved in NTM product activities, we determined that 74 institutions had NTM product lending activities that fell under the thresholds defined as significant and that a risk management examination or visitation had been conducted for the 74 institutions from March to October 2007. We selected 7 of these 74 institutions for review.

We reviewed the ROEs, pre-examination planning memoranda, and supervisory plans for our sample of seven institutions. Additionally, we interviewed Relationship Managers, Examiners-in-Charge, field supervisors, and examiners who participated in the asset reviews for these examinations and visitations. In some cases, DSC field office personnel provided us with additional documentation, such as Visitation Memoranda, mortgage banking examination documentation modules and summaries, NTM line sheets, and NTM summary memoranda, which we also reviewed. We found that the examiners:

- Targeted NTM product activities in examinations for three institutions.

- Conducted visitations for two institutions and made recommendations to improve the internal controls of the mortgage banking division in one institution—the mortgage banking division ceased its underwriting operations at the other institution.

- Focused on the mortgage banking activities of the subsidiary of one institution, including the review of recourse clauses in the agreements with investors because the limited NTM products originated by the institution's subsidiary were sold in the secondary market.

- Determined that the only NTM product activities conducted by one institution were short-term, low-risk, interest-only mortgages, which did not have the risk characteristics outlined in the NTM guidance.

By conducting on-site reviews of institutions' NTM product activities, DSC has provided a means to identify and mitigate the risks associated with these products. Additionally, examiner assessment of FDIC-supervised institutions' implementation of the NTM Guidance has assisted in determining whether the institutions are addressing these risks.

CORPORATION COMMENTS

On March 27, 2008, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 4 of this report. DSC stated that the FDIC is focusing its attention on significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices, and disruptions in the credit and capital markets to ensure that FDIC-supervised institutions respond appropriately to maintain their safety and soundness.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives and Scope

The audit objectives were to assess (1) the implementation of DSC's March 2007 *Supervisory Guidance for Nontraditional Mortgage Products* and (2) examination coverage of the loan terms and underwriting standards set forth in the October 2006 *Interagency Guidance on Nontraditional Mortgage Product Risks*.

For the scope of our audit, we reviewed the FDIC's processes for identifying institutions involved in NTM product activities, developing supervisory strategies for FDIC-supervised institutions with significant NTM product activities, and conducting on-site reviews of those institutions.

We conducted this performance audit from August 2007 through January 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Methodology

To obtain an understanding of DSC's procedures for the identification of FDIC-supervised institutions involved in NTM product activities, we:

- Assessed the validity of and the process for establishing the criteria DSC used to identify institutions involved in NTM product activities as provided in DSC Transmittal No. 2007-008, entitled *Supervisory Guidance for Nontraditional Mortgage Products*, issued on March 14, 2007.

- Reviewed the process DSC regional office staff used to obtain data for the screening of applicable institutions and the DSC headquarters process to determine institutions with significant NTM product activities.

- Reviewed the process for selecting institutions to be included in the quarterly monitoring report.

- Identified the types of examiner instructions and training provided for coverage of NTM and subprime mortgage risks.

- Contacted appropriate DSC and FDIC Division of Insurance and Research officials in FDIC headquarters, regional, and field offices to obtain their perspectives on NTM product activities risk.

- Reviewed various tracking and monitoring reports prepared by DSC.

- Reviewed applicable prior audit reports issued by the FDIC Office of Inspector General and the Government Accountability Office (GAO).

To obtain an understanding of the procedures for the determination of supervisory strategies for identified institutions, we:

- Contacted DSC regional office staff to determine the methods used to gather institution-specific data related to NTM and subprime mortgage lending.

- Reviewed supervisory strategies, ROEs, and summaries of visitations for the 30 institutions identified by DSC with significant NTM product activities.

To obtain an understanding of DSC's coverage of NTM loan terms and underwriting standards during on-site risk management examinations and visitations, we contacted FDIC regional and field office staff and reviewed applicable examination and visitation documentation.

Our audit conclusions are based on two non-statistical samples.[15] The FDIC determined that 30 of approximately 5,250 FDIC-supervised institutions had significant involvement in NTM product activities. Our first sample consisted of 15 of those 30 institutions. We reviewed examination and visitation documentation to determine the FDIC's coverage of loan terms and underwriting standards for NTM product activities at these institutions.

The second sample consisted of 7 out of 74 FDIC-supervised institutions, whose NTM product activities fell below the thresholds defined as significant and for which a risk management examination or visitation had been conducted from March to October 2007. We reviewed the examination and visitation documentation for these seven institutions to determine the FDIC's examination of loan terms and underwriting standards for NTM products.

Internal Control

To assess the relevant control activities, we identified the processes related to identifying those FDIC-supervised institutions involved in NTM product activities and the FDIC's implementation of supervisory strategies for those institutions. We reviewed DSC policies and procedures as presented in the FDIC's *Supervisory Guidance for Nontraditional Mortgage Products*, issued in March 2007. We also reviewed the results of DSC Internal Control Reviews related to risk management and compliance examinations. DSC conducts internal control reviews under its Regional Office Review Program. The review program focuses on examinations and supervision, management, and administration and is structured in a checklist format. Each review covers either a 24-month period or the period since the last review, whichever is less.

[15] The results of a non-statistical sample cannot be projected to the intended population by standard statistical methods.

We identified and documented the following relevant internal controls:

- In October 2006, DSC distributed the NTM Guidance to assist financial institutions in managing the risks associated with underwriting NTM loan products. The guidance provides an overview of the loan underwriting standards, portfolio and risk management practices, and consumer protection issues that should be reviewed during the safety and soundness and compliance examinations of institutions that offer NTM products or purchase them through subsidiaries or third parties.

- DSC issued guidance for regional office staff and examiners to identify the risk exposure associated with NTM product activities at FDIC-supervised institutions.

- DSC required on-site reviews of institutions identified as having significant NTM product activities.

- The FDIC revised its quarterly monitoring report related to high-risk activities to include the risks related to NTM product activities in FDIC-supervised institutions and the impact of those activities on the mortgage-backed securities markets.

Reliance on Computer-processed Data. Our audit objective did not require that we assess the reliability of computer-processed data, and we did not rely on computer-processed data to support our significant findings and conclusions. Our assessment centered on reviews of hardcopy ROEs, visitation reports, planning documents, and on-site review summaries.

During the audit, we determined that the FDIC tracks the status of FDIC-supervised institutions with significant NTM product activities. Regional office staff manually update this information to reflect on-site visitation and examination reporting and forward the information to FDIC headquarters. Additionally, Call Reports do not require the reporting of NTM product activities data by FDIC-insured institutions and, as a result, examinations serve as the primary source for this data. However, as of March 2007, institutions are required to report negative amortization loans in their quarterly Call Report submissions.

We reviewed the supervisory tracking data for the original list of 40 institutions identified as having significant involvement in NTM product activities and found the information to be generally reliable. Because of the limited sources of information available between examinations, the FDIC generally does not track, on an off-site basis, the level of NTM lending activity or the condition of NTM loan portfolios in FDIC-supervised institutions.

Performance Measurement. We reviewed annual performance plans and FDIC strategic plans to identify goals, objectives, and results and determine whether the

Corporation has (1) established quantifiable performance measures and (2) developed and analyzed data to assess program, project, or function performance related to its efforts to identify risk in institutions involved in NTM product activities. In fulfilling its primary supervisory responsibilities, the FDIC pursues two strategic goals: (1) FDIC-supervised institutions are safe and sound, and (2) consumers' rights are protected and FDIC-supervised institutions invest in their communities. These strategic goals and objectives do not directly relate to NTM product activities.

In its 2006 Annual Performance Plan, the FDIC has a strategic goal that FDIC-supervised institutions are safe and sound and a strategic objective that FDIC-supervised institutions appropriately manage risk. The plan also contains an annual performance goal to conduct on-site risk management examinations to assess the overall financial condition, management practices and policies, and compliance with applicable laws and regulations of FDIC-supervised depository institutions. Although these strategic goals and objectives do not directly relate to NTM product activities, the 2008 Strategic Priorities address, directly and indirectly, aspects of NTM product activities for risk identification purposes, as well as for consumer protection purposes.

In addition, we reviewed the FDIC's 2005-2010 Strategic Plan, 2007 Annual Performance Plan, 2008 Strategic Priorities, 2008 Corporate Performance Objectives, and 2007 Annual Report.

Compliance With Laws and Regulations

To assess compliance with NTM-related laws and regulations, we requested that the Counsel to the Inspector General review a list of laws and FDIC regulations to determine specific requirements that would apply to FDIC-supervised institutions, in general, and DSC examinations, in particular. In response, Counsel identified certain laws and regulations that could apply to some aspects of NTM product activities, including descriptions of the FDIC's supervisory responsibilities, but these requirements were not directly related to our audit objectives. During the course of the audit, no instances of noncompliance come to our attention.

We assessed the risk of fraud related to the audit objective in the course of evaluating audit evidence.

Prior Coverage

In March 2003, we issued Audit Report No. 03-019 entitled, *The Division of Supervision and Consumer Protection's Examination Assessment of Subprime Lending*. The objective of the audit was to determine whether DSC had taken reasonable steps to ensure that institutions: (1) managed risks associated with subprime lending programs effectively and priced loans based on risk, (2) established adequate allowance levels to cover losses, and (3) maintained capital levels that reflect the additional inherent risks associated with subprime lending. We conducted the audit because of concerns stemming from financial institution failures involving subprime lending activities. Due to the disproportionate impact these institutions were having on losses to the deposit insurance funds (at that time, there were two deposit insurance funds), the audit focused on the implementation of examiner guidance for institutions with subprime lending programs. As of June 30, 2002, 128 institutions were officially identified with subprime lending programs, and 60 of those institutions were supervised by the FDIC. The audit sampled 11 of those institutions, which were rated 3, 4, or 5, and found that FDIC examiners generally adhered to applicable guidance.

In September 2006, the GAO issued Report No. GAO-06-1021 entitled, *Alternative Mortgage Products' Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*. The objective of the audit was to study the potential risks of alternative mortgage products for borrowers and lenders. The report discusses (1) recent trends in the alternative mortgage product market, (2) the impact of alternative mortgage products on borrowers and on the safety and soundness of financial institutions, (3) the extent to which mortgage disclosures discuss the risks of alternative mortgage products, (4) the federal regulatory response to the risks of alternative mortgage products for lenders and borrowers, and (5) selected state regulatory responses to the risks of alternative mortgage products for lenders and borrowers. GAO concluded that because alternative mortgage product borrowers can defer repayment of principal, and sometimes part of the interest, for several years, they may eventually face payment increases large enough to cause "payment shock."[16] As a result, delinquencies and defaults could rise.

According to GAO, officials from the federal banking regulators stated that most institutions appeared to be managing their credit risk by diversifying their portfolios or through loan sales or securitizations. However, because the monthly payments for most alternative mortgage products that were originated between 2003 and 2005 have not reset to cover both interest and principal, GAO reported that it was too soon to tell the extent to which payment shock would result in increased delinquencies or foreclosures for borrowers and in losses for institutions and other lenders. GAO also reported that regulators and others are concerned that borrowers may not be well informed about the risks of alternative mortgage products, due to their complexity and because promotional materials by some lenders and brokers do not provide balanced information on alternative mortgage product benefits and risks.

Additionally, the federal standards on disclosures do not currently require specific information on alternative mortgage products that could better help borrowers understand key terms and risks. According to GAO, in December 2005, the federal banking regulators issued draft interagency guidance on alternative mortgage product lending that discussed prudent underwriting, portfolio and risk management, and consumer disclosure practices. State regulators contacted by GAO generally relied on the existing regulatory structure of licensing and examining independent mortgage lenders and brokers to

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[16] A borrower may experience "payment shock" due to a significant increase in the amount of the monthly payment on a mortgage product when the interest rate adjusts to a fully indexed rate. NTM products that do not have payment caps or periodic interest rate caps, or that contain very high caps, can result in much higher payments under the fully indexed rate.

oversee alternative mortgage product lending. GAO recommended that during its review of existing disclosure standards, the Board of Governors of the Federal Reserve (FRB) consider revising federal requirements for mortgage disclosures to improve the clarity and comprehensiveness of alternative mortgage product disclosures. In response, the FRB noted that it will conduct consumer testing to determine appropriate content and formats and will use design consultants to develop model disclosure forms intended to better communicate this information.

FEATURES AND TYPES OF NTM PRODUCTS

Features of Nontraditional Mortgage Products

NTMs have some combination of variable interest rates, low down payments, interest-only periods, and/or negative amortization. Borrowers have increasingly chosen one or more of the following features.

- Adjustable Rates: There are many varieties of ARMs. One of the simplest ARMs offers an initial low rate, called a teaser rate, at the beginning of the loan which then resets after an introductory period. The teaser rate may apply for 2 to 3 years or for as little as 1 month. The mortgage contract may specify a reset interest rate or may tie the rate to another interest rate by a formula. The resulting interest rate may be fixed or variable. Adjustable rate mortgages can be tied to a variety of market interest rates. One common reference rate is the London Interbank Offered Rate (LIBOR).[17]

- Low or Zero Down Payment: Lending programs have gradually reduced the required down payment options to 10, 5, 3, and 0 percent of the purchase price, allowing buyers to purchase with no money down. Some programs even roll in closing and other acquisition costs for greater-than-100 percent financing. A related practice is using a second mortgage to finance the down payment. Sometimes called "piggyback" loans, or silent seconds, the home buyer uses the second loan to borrow the funds for a 20-percent down payment, which is enough to improve the interest rate and other terms of the first mortgage. However, the second mortgage carries a higher interest rate and other less desirable features because the first mortgage has prior claim on the collateral.

- Interest Only: An interest-only mortgage allows the home buyer to carry the loan balance for a period of time without having to pay back any principal. The current mortgage payment covers only the monthly interest due on the existing balance. Eventually, the monthly payment must also cover the principal. If the duration of the mortgage is not extended, then the payments will have to amortize the remaining balance over a shorter period of time. Therefore, a homeowner choosing to pay only the interest for a few months or 2-3 years increases the later monthly payments.

- Negative Amortization: Unlike interest-only mortgages, which leave the loan balance unchanged, a mortgage with negative amortization allows the borrower to increase the loan's principal by paying less than the current interest due. The remaining interest is added to the loan balance. Future payments are then recalculated based on the increased principal. The homeowner gets lower current payments but at the cost of greater debt and higher future payments.

[17] LIBOR rates are determined in the London market for unsecured institution loans. It is a rate that institutions charge each other for short-term loans (less than 12 months). Typical ARMs will specify a reset date at which time the mortgage rate will adjust to the LIBOR, or similar rate, and a predetermined markup.

Types of Nontraditional Mortgage Products

Interest-only ARMs, payment-option ARMs, interest-only fixed rate mortgages, and extended-term mortgages are four popular types of NTM products offered by lenders.

- Interest-only ARMs allow borrowers to defer principal payments for typically the first 2-3 years, before resetting to higher monthly payments that cover principal as well as interest, to pay off the outstanding balance over the remaining term of the loan. Hybrids of the interest-only ARMs include “2/28” and “3/27” loans that provide borrowers with a fixed rate of interest for 2-3 years that adjusts to a variable rate of interest for the remaining 27-28 years.

- Payment-option ARMS allow borrowers to make minimum payments that do not cover principal or all accrued interest. Typically, four payment options are offered: (1) fully amortized payments on a 30-year amortization schedule, (2) fully amortized payments on a 15-year amortization, (3) interest-only payments, and (4) minimum payments that do not cover all of the interest. Any interest that does not get paid is capitalized into the loan balance owed, resulting in an increase in the loan balance through negative amortization. Typically after 5 years, or if the loan balance increases (due to negative amortization) to a cap specified in the mortgage terms, payments reset to include an amount that will fully amortize the outstanding balance over the remaining years of the loan.

- Interest-only fixed rate mortgages offer borrowers interest-only payments for up to 10 years but at a fixed rate over the life of the loan.

- The 40-year mortgage offers borrowers lower monthly payments of principal and interest that amortize over 40 years. After 10 years, the loan is reset to require higher monthly payments that fully amortize over the remainder of the 30-year term. Another option is the standard 30-year mortgage loan with lower fixed monthly payments based on a 40-year amortization schedule for a part of or the entire loan. In this case, the borrower may be required to make a balloon payment at the end of the 30-year term to pay off the remaining loan balance.

According to FDIC officials, a payment-option ARM is the riskiest NTM product because it is more complex and has the potential for negative amortization and bigger payment shock.

Risk Associated with Nontraditional Mortgage Products

If not adequately managed, NTM products can present substantial risks to both borrowers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments.

Potential risks to borrowers:

- Borrowers may not be well informed about the risks of NTM products due to their complexity and the lack of balanced information on the benefits and risks of NTM products in lenders' promotional materials.

- Borrowers may face payment shock (discussed earlier) when loans reset because borrowers can initially defer repayment of principal, and sometimes part of the interest (negative amortization), for several years.

- Borrowers can reach a negative amortization cap well before the expiration of the multi-year payment option period, triggering (1) the loan to reset to fully amortizing payments, (2) the need to refinance, and (3) the imposition of prepayment penalties.

- Borrowers may have difficulty in refinancing or selling homes, particularly if interest rates have risen and home values have declined, or if their home equity fell because only minimum monthly payments had been made that did not fully cover current interest costs.

Potential risks to lenders:

- Lenders may be qualifying borrowers under low or no documentation standards, which allow for less detailed or no proof of income or assets.

- Lenders have allowed borrowers with limited or no down payments to finance a down payment through second mortgages, or "piggyback" mortgages. A typical "piggyback" mortgage usually includes a second mortgage or home equity line of credit for part or all of the remaining 20 percent of the property value. The first mortgage would cover 80 percent. Typically, this is done to avoid private mortgage insurance.

In both of these scenarios, lenders are at risk because borrowers may not be able to afford the minimum payments, leading to increasing rates of delinquencies and defaults.

In addition, mortgage delinquency and default rates are typically higher for borrowers who purchased investment properties compared with borrowers who purchased primary residences. Borrowers who purchased investment properties may have less incentive to pay their mortgages when faced with payment shock or difficulties in refinancing or selling such properties. According to the FDIC, this is of particular concern when the borrower has made little or no down payment.

COVERAGE OF NTM GUIDANCE IN 2007 DSC EXAMINATIONS AND VISITATIONS

Institution Number	Type of NTM Product			Exams Conducted After NTM Guidelines Were Issued	ROE Generally Covered NTM Guidance Requirements	2007 NTM Visitations Conducted	Visitation(s) Generally Covered NTM Guidance Requirements
	Payment Option ARMs	Interest Only	Subprime				
Institution 1		X	X	1/16/07*	No*	8/17/07	No[a]
Institution 2	X	X	X	1/22/07*	No*	8/24/07; 8/28/07	Yes
Institution 3	X	X	X	1/29/07*	No*	8/22/07	Yes
Institution 4	X	X	X	2/20/07*	Yes*	8/23/07 2/26/07	Yes
Institution 5		X		2/26/07*	No*	8/20/07; 8/17/07	Yes
Institution 6	X			7/23/07	Yes	None	N/A
Institution 7		X	X	8/20/07	No[b]	9/11/07	Yes
Institution 8		X		9/24/07	No[c]	8/27/07	Yes
Institution 9		X		FDIC Exam in Process +	N/A	8/31/07	Yes
Institution 10		X	X	Joint Exam in Process +	N/A	8/20/07	Yes
Institution 11		X		Joint Exam in Process +	N/A	8/31/07	Yes
Institution 12		X		2007 State Exam	N/A[d]	8/29/07	Yes
Institution 13		X		2007 State Exam	N/A[d]	8/29/07	Yes
Institution 14		X		2007 State Exam	N/A[d]	8/20/07	Yes
Institution 15		X		2007 State Exam	N/A[d]	8/27/07; 8/31/07	Yes

[a] Visitation provided minimal coverage of the NTM Guidance requirements.
[b] Examination was conducted 1 month before the visitation; the visitation generally covered the NTM Guidance requirements.
[c] Examination was conducted 1 month after the visitation; the visitation generally covered the NTM Guidance requirements.
[d] This audit did not review state examination coverage of NTM lending.
* The examination predates DSC's *Supervisory Guidance for Nontraditional Mortgage Products*, Transmittal No. 2007-008, issued on March 14, 2007.
+ As of January 31, 2008.

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

March 27, 2008

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Report Entitled:
***Implementation of FDIC's Supervisory Guidance for Nontraditional Mortgage Products* (2007-030)**

The Division of Supervision and Consumer Protection (DSC) has received and considered your audit of the Implementation of FDIC's Supervisory Guidance for Nontraditional Mortgage (NTM) products. We appreciate that this report's findings validated DSC's process for identifying FDIC-supervised institutions engaged in significant NTM activities and determining the supervisory strategy for those institutions.

We also are pleased that this report concluded that the DSC's examination coverage has provided a means to identify and mitigate the risks associated with NTM products at FDIC-supervised institutions in accordance with the *Interagency Guidance for Nontraditional Mortgage Product Risks*. During *The State of the Banking Industry Testimony*, Committee on Banking, Housing, and Urban Affairs, US Senate, March 4, 2008; FDIC Chairman Bair stated in part: "The vast majority of FDIC-insured institutions remain well-capitalized as they face significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices and disruptions in the credit and capital markets. In response, the FDIC is focusing its attention on these risks to ensure that the institutions it supervises respond appropriately to maintain their safety and soundness."