DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 05–21]

FEDERAL RESERVE SYSTEM

[Docket No. OP–1246]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2005–56]

NATIONAL CREDIT UNION ADMINISTRATION

Interagency Guidance on Nontraditional Mortgage Products

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA).

ACTION: Proposed guidance with request for comment.

SUMMARY: The OCC, Board, FDIC, OTS, and NCUA (the Agencies), request comment on this proposed Interagency Guidance on Nontraditional Mortgage Products (Guidance). The Agencies expect institutions to effectively assess and manage the risks associated with their credit activities, including those associated with nontraditional mortgage loan products. Institutions should use this guidance in their efforts to ensure that their risk management and consumer protection practices adequately address these risks.

DATES: Comments must be submitted on or before February 27, 2006.

ADDRESSES: The Agencies will jointly review all of the comments submitted. Therefore, interested parties may send comments to any of the Agencies and need not send comments (or copies) to all of the Agencies. Please consider submitting your comments by e-mail or fax since paper mail in the Washington area and at the Agencies is subject to delay. Interested parties are invited to submit comments to:

OCC: You should include ''OCC'' and Docket Number 05–21 in your comment. You may submit your comment by any of the following methods:

- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *OCC Web site: http://www.occ.treas.gov*. Click on ''Contact the OCC,'' scroll down and click on ''Comments on Proposed Regulations.''
- *E-Mail Address: regs.comments@occ.treas.gov.*
- *Fax:* (202) 874–4448.
- Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1–5, Washington, DC 20219.
- *Hand Delivery/Courier:* 250 E Street, SW., Attn: Public Information Room, Mail Stop 1–5, Washington, DC 20219.

Instructions: All submissions received must include the agency name (OCC) and docket number for this notice. In general, the OCC will enter all comments received into the docket without change, including any business or personal information that you provide.

You may review comments and other related materials by any of the following methods:

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874–5043.
- *Viewing Comments Electronically:* You may request that we send you an electronic copy of comments via e-mail or mail you a CD–ROM containing electronic copies by contacting the OCC at *regs.comments@occ.treas.gov.*
- *Docket Information:* You may also request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. OP–1246, by any of the following methods:

- *Agency Web site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov.* Include the docket number in the subject line of the message.
- *Fax:* 202/452–3819 or 202/452–3102.
- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at *www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons.

Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed in electronic or paper form in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments by any of the following methods:

- *Agency Web site: http://www.fdic.gov/regulations/laws/federal/propose.html*. Follow the instructions for submitting comments on the Agency Web site.
- *E-Mail: Comments@FDIC.gov.*
- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- *Hand Delivery/Courier:* Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name. All comments received will be posted without change to *http://www.fdic.gov/regulations/laws/federal/propose.html* including any personal information provided.

OTS: You may submit comments, identified by docket number 2005–56, by any of the following methods:

- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *E-mail address: regs.comments@ots.treas.gov*. Please include docket number 2005–56 in the subject line of the message and include your name and telephone number in the message.
- *Fax:* (202) 906–6518.
- *Mail:* Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2005–56.
- *Hand Delivery/Courier:* Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days. Address envelope as follows: Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2005–56.

Instructions: All submissions received must include the agency name and docket number for this proposed Guidance. All comments received will be posted without change to the OTS Internet site at *http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1*, including any personal information provided.

Docket: For access to the docket to read background documents or comments received, go to *http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1.* In addition, you may inspect comments at the OTS's Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906–5922, send an e-mail to *public.info@ots.treas.gov*, or send a facsimile transmission to (202) 906–7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

NCUA: You may submit comments by any of the following methods:

- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *NCUA Web site: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html.* Follow the instructions for submitting comments.
- *E-mail:* Address to *regcomments@ncua.gov*. Include ''[Your name] Comments on Interagency Guidance on Nontraditional Mortgages'' in the e-mail subject line.
- *Fax:* (703) 518–6319. Use the subject line described above for e-mail.
- *Mail:* Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.
- *Hand Delivery/Courier:* Same as mail address.

FOR FURTHER INFORMATION CONTACT:

OCC: Gregory Nagel, National Bank Examiner/Credit Risk Specialist, Credit Risk Policy, (202) 874–5170; or Michael S. Bylsma, Director, or Stephen Van Meter, Assistant Director, Community and Consumer Law Division, (202) 874–5750.

Board: Brian Valenti, Supervisory Financial Analyst, (202) 452–3575; or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452–2521; or Sabeth I. Siddique, Assistant Director, (202) 452–3861, Division of Banking Supervision and Regulation; Minh-Duc T. Le, Senior Attorney, Division of Consumer and Community Affairs, (202) 452–3667; or Andrew Miller, Counsel, Legal Division, (202) 452–3428. For users of Telecommunications Device for the Deaf (''TDD'') only, contact (202) 263–4869.

FDIC: James Leitner, Senior Examination Specialist, (202) 898–6790, or April Breslaw, Chief, Compliance Section, (202) 898–6609, Division of Supervision and Consumer Protection; or Ruth R. Amberg, Senior Counsel, (202) 898–3736, or Richard Foley, Counsel, (202) 898–3784, Legal Division.

OTS: William Magrini, Senior Project Manager, (202) 906–5744; or Maurice McClung, Program Manager, Market Conduct, Consumer Protection and Specialized Programs, (202) 906–6182; and Richard Bennett, Counsel, Banking and Finance, (202) 906–7409.

NCUA: Cory Phariss, Program Officer, Examination and Insurance, (703) 518–6618.

SUPPLEMENTARY INFORMATION:

I. Background

In recent years, consumer demand and secondary market appetite have grown rapidly for mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, often referred to as nontraditional mortgage loans, including ''interest-only'' mortgages and ''payment option'' adjustable-rate mortgages have been available in similar forms for many years. Nontraditional mortgage loans offer payment flexibility and are an effective and beneficial financial management tool for some borrowers. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period as compared to the level payment structure found in traditional fixed-rate mortgage loans. In addition, institutions are increasingly combining these loans with other practices, such as making simultaneous second-lien mortgages and allowing reduced documentation in evaluating the applicant's creditworthiness. While innovations in mortgage lending can benefit some consumers, these layering practices can present unique risks that institutions must appropriately measure, monitor and control.

The Agencies recognize that many of the risks associated with nontraditional mortgage loans exist in other adjustable-rate mortgage products, but our concern is elevated with nontraditional products due to the lack of principal amortization and potential accumulation of negative amortization. The Agencies are also concerned that these products and practices are being offered to a wider spectrum of borrowers, including some who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans, and who may not fully understand the associated risks.

Regulatory experience with nontraditional mortgage lending programs has shown that prudent management of these programs requires increased attention in product

development, underwriting, compliance, and risk management functions. As with all activities, the Agencies expect institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products. The Agencies have developed this proposed Guidance to clarify how institutions can offer these products in a safe and sound manner, and in a way that clearly discloses the potential risks that borrowers may assume. The Agencies will carefully scrutinize institutions' lending programs, including policies and procedures, and risk management processes in this area, recognizing that a number of different, but prudent practices may exist. Remedial action will be requested from institutions that do not adequately measure, monitor, and control risk exposures in loan portfolios. Further, the agencies will seek to consistently implement the guidance.

II. Principal Elements of the Guidance

Prudent lending practices include the maintenance of sound loan terms and underwriting standards. Institutions should assess current loan terms and underwriting guidelines and implement any necessary changes to ensure prudent practices. In connection with underwriting standards, the proposed Guidance addresses:

- Appropriate borrower repayment analysis, including consideration of comprehensive debt service in the qualification process;
- The potential for collateral-dependent loans, which could arise when a borrower is overly reliant on the sale or refinancing of the property when loan amortization begins;
- Mitigating factors that support the underwriting decision in circumstances involving a combination of nontraditional mortgage loans and reduced documentation;
- Below market introductory interest rates;
- Lending to subprime borrowers; and
- Loans secured by non owner-occupied properties.

The proposed Guidance also describes appropriate portfolio and risk management practices for institutions that offer nontraditional mortgage products. These practices include the development of policies and internal controls that address, among other matters, product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. In connection with risk management practices, the Guidance also proposes that institutions should:

- Maintain performance measures and management reporting systems that provide warning of potential or increasing risks;
- Maintain an allowance for loan and lease losses (ALLL) at a level appropriate for portfolio credit quality and conditions affecting collectibility;
- Maintain capital levels that reflect nontraditional mortgage portfolio characteristics and the effect of stressed economic conditions on collectibility; and
- Apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages.

Finally, the proposed Guidance describes consumer protection concerns that may be raised by nontraditional mortgage loan products, particularly that borrowers may not fully understand the terms of these products. Nontraditional mortgage loan products are more complex than traditional fixed-rate products and adjustable rate products and present greater risks of payment shock and negative amortization. Institutions should ensure that consumers are provided clear and balanced information about the relative benefits and risks of these products, at a time that will help consumers' decision-making processes. The proposed Guidance discusses applicable laws and regulations and then describes recommended practices for communications with and the provision of information to consumers. These recommended practices address promotional materials and product descriptions, information on monthly payment statements, and the avoidance of practices that obscure significant risks to the consumer or raise similar concerns. The proposed Guidance also describes control systems that should be used to ensure that actual practices are consistent with policies and procedures.

When finalized, the Guidance would apply to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

III. Request for Comment

Comment is requested on all aspects of the proposed Guidance. Interested commenters are also asked to address specifically the proposed Guidance on comprehensive debt service qualification standards, which provides that the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. For products with the potential for negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue through the negative amortization provision. In this regard, comment is specifically requested on the following:

(1) Should lenders analyze each borrower's capacity to repay the loan under comprehensive debt service qualification standards that assume the borrower makes only minimum payments? What are current underwriting practices and how would they change if such prescriptive guidance is adopted?

(2) What specific circumstances would support the use of the reduced documentation feature commonly referred to as ''stated income'' as being appropriate in underwriting nontraditional mortgage loans? What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? Please include specific comment on whether and under what circumstances ''stated income'' and other forms of reduced documentation would be appropriate for subprime borrowers.

(3) Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?

The text of the proposed Interagency Guidance on Nontraditional Mortgage Products follows:

Interagency Guidance on Nontraditional Mortgage Products

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years, there has been a growing consumer demand, particularly in high priced real estate markets, for residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, often referred to as nontraditional mortgage loans, include ''interest-only'' mortgages where a borrower pays no loan principal for the first few years of the loan and ''payment option'' adjustable-rate mortgages (ARMs) where a borrower has

flexible payment options with the potential for negative amortization.[1] More recently, nontraditional mortgage loan products are being offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are also being underwritten with less stringent or no income and asset verification requirements (''reduced documentation'') and are increasingly combined with simultaneous second-lien loans.[2] These risk-layering practices, combined with the broader marketing of nontraditional mortgage loans, expose financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when combined with risk-layering features, are untested in a stressed environment and, therefore, warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
- Ensure that consumers have information to clearly understand loan terms and associated risks prior to making a product choice.

As with all activities, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) expect institutions to effectively assess and manage the increased risks associated with nontraditional mortgage loan products.[3]

Institutions should use this guidance in their efforts to ensure that their risk management practices adequately address these risks. The Agencies will carefully scrutinize institutions' risk management processes, policies, and procedures in this area. Remedial action will be requested from institutions that do not adequately manage these risks. Further, the Agencies will seek to consistently implement this guidance.

Loan Terms and Underwriting Standards

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Moreover, the institution's underwriting standards should comply with the agencies' real estate lending standards and appraisal regulations and associated guidelines.[4]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualification Standards—Nontraditional mortgage loans can result in significantly higher payment requirements when the loan begins to fully amortize. This increase in monthly mortgage payments, commonly referred to as payment shock, is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, and that nontraditional mortgage loans often are inappropriate for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores.

For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,[5] assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The amount of the balance increase should be tied to the initial terms of the loan and estimated assuming the borrower makes only minimum payments during the deferral period. Institutions should also consider the potential risks that a borrower may face in refinancing the loan at the time it begins to fully amortize, such as prepayment penalties. These more fully comprehensive debt service calculations should be considered when establishing the institution's qualifying criteria.

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. As the level of credit risk increases, either from loan features or borrower characteristics, the importance of actual verification of the borrower's income, assets, and outstanding liabilities also increases.

[1] Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans.

[2] Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

[3] Refer to Interagency Guidelines Establishing Standards for Safety and Soundness. For each Agency, those respective guidelines are addressed in: 12 CFR Part 30 Appendix A (OCC); 12 CFR Part 208 Appendix D–1 (Board); 12 CFR Part 364 Appendix A (FDIC); 12 CFR Part 570 Appendix A (OTS); and 12 U.S.C. 1786 (NCUA).

[4] Refer to 12 CFR Part 34—Real Estate Lending and Appraisals, OCC Bulletin 2005–3—Standards for National Banks' Residential Mortgage Lending, AL 2003–7—Guidelines for Real Estate Lending Policies and AL 2003–9—Independent Appraisal and Evaluation Functions (OCC); 12 CFR 208.51 subpart E and Appendix C and 12 CFR Part 225 subpart G (Board); 12 CFR Part 365 and Appendix A, and 12 CFR Part 323 (FDIC); 12 CFR 560.101 and Appendix and 12 CFR Part 564 (OTS). Also, refer to the 1999 Interagency Guidance on the ''Treatment of High LTV Residential Real Estate Loans'' and the 1994 ''Interagency Appraisal and Evaluation Guidelines.'' Federally Insured Credit Unions should refer to 12 CFR Part 722—Appraisals and NCUA 03–CU–17—Appraisal and Evaluation Functions for Real Estate Related Transactions (NCUA).

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

Collateral-Dependent Loans—Institutions should avoid the use of loan terms and underwriting practices that may result in the borrower having to rely on the sale or refinancing of the property once amortization begins. Loans to borrowers who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Institutions determined to be originating collateral-dependent mortgage loans, may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering—Nontraditional mortgage loans combined with risk-layering features, such as reduced documentation and/or a simultaneous second-lien loan, pose increased risk. When risks are layered, an institution should compensate for this increased risk with mitigating factors that support the underwriting decision and the borrower's repayment capacity. Mitigating factors might include higher credit scores, lower LTV and DTI ratios, credit enhancements, and mortgage insurance. While higher pricing may seem to address the increased risks associated with risk-layering features, it raises the importance of prudent qualification standards discussed above. Further, institutions should fully consider the effect of these risk-layering features on estimated credit losses when establishing their allowance for loan and lease losses (ALLL).

Reduced Documentation—Institutions are increasingly relying on reduced documentation, particularly unverified income to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and alternate information for the waived data in analyzing a borrower's repayment capacity and general creditworthiness, they should be used with caution. An institution should consider whether its verification practices are adequate. As the level of credit risk increases, the Agencies expect that an institution will apply more comprehensive verification and documentation procedures to verify a borrower's income and debt reduction capacity.

Use of reduced documentation in the underwriting process should be governed by clear policy guidelines. Reduced documentation, such as stated income, should be accepted only if there are other mitigating factors such as lower LTV and other more conservative underwriting standards.

Simultaneous Second-Lien Loans—Simultaneous second-lien loans result in reduced owner equity and higher credit risk. Historically, as combined loan-to-value ratios rise, defaults rise as well. A delinquent borrower with minimal or no equity in a property may have little incentive to work with the lender to bring the loan current to avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal owner equity should generally not have a payment structure that allows for delayed or negative amortization.

Introductory Interest Rates—Many institutions offer introductory interest rates that are set well below the fully indexed rate as a marketing tool for payment option ARM products. In developing nontraditional mortgage products, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial monthly mortgage payments are based on these low introductory rates, there is a greater potential for a borrower to experience negative amortization, increased payment shock, and earlier recasting of the borrower's monthly payments than originally scheduled. In setting introductory rates, institutions should consider ways to minimize the probability of disruptive early recastings and extraordinary payment shock.

Lending to Subprime Borrowers—Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime lending.[6] Among other things, the subprime guidance discusses the circumstances under which subprime lending can become predatory or abusive. Additionally, an institution's practice of risk layering for loans to subprime borrowers may significantly increase the risk to both the institution and the borrower. Institutions should pay particular attention to these circumstances, as they design nontraditional mortgage loan products for subprime borrowers.

Non Owner-Occupied Investor Loans—Borrowers financing non owner-occupied investment properties should be qualified on their ability to service the debt over the life of the loan. Loan terms should also reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, nontraditional mortgages to finance non owner-occupied investor properties should require evidence that the borrower has sufficient cash reserves to service the loan in the near term in the event that the property becomes vacant.[7]

Portfolio and Risk Management Practices

Institutions should recognize that nontraditional mortgage loans are untested in a stressed environment and, accordingly, should receive higher levels of monitoring and loss mitigation. Moreover, institutions should ensure that portfolio and risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentrations of nontraditional products. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner by:

- Developing written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Designing enhanced performance measures and management reporting that provide early warning for increasing risk;
- Establishing appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- Maintaining capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Policies—An institution's policies for nontraditional mortgage lending activity should set forth acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations—Concentration limits should be set for loan types, third-party

[6] Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Programs, January 31, 2001. Federally Insured Credit Unions should refer to 04–CU–12 " Specialized Lending Activities (NCUA).

[7] Federally Insured Credit Unions must comply with 12 CFR Part 723 for loans meeting the definition of member business loans.

originations, geographic area, and property occupancy status, to maintain portfolio diversification. Concentration limits should also be set on key portfolio characteristics such as loans with high combined LTV and DTI ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, and nontraditional mortgage loans with layered risks. The combination of nontraditional mortgage loans with risk-layering features should be regularly analyzed to determine if excessive concentrations or risks exist. Institutions with excessive concentrations or deficient risk management practices will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action. Further, institutions should consider the effect of employee incentive programs that may result in higher concentrations of nontraditional mortgage loans.

Controls—An institution's quality control, compliance, and audit procedures should specifically target those mortgage lending activities exhibiting higher risk. For nontraditional mortgage loan products, an institution should have appropriate controls to monitor compliance and exceptions to underwriting standards. The institution's quality control function should regularly review a sample of reduced documentation loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Since payment option ARMs require higher levels of customer support than other mortgage loans, customer service and collections personnel should receive product-specific training on the features and potential customer issues.

Third-Party Originations—Institutions often use third-party channels, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. When doing so, an institution should have strong approval and control systems to ensure the quality of third-party originations and compliance with all applicable laws and regulations, with particular emphasis on marketing and borrower disclosure practices. Controls over third parties should be designed to ensure that loans made through these channels reflect the standards and practices used by an institution in its direct lending activities.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics in order to identify problems, such as early payment defaults, incomplete documentation, and fraud. A strong monitoring process should enable management to determine whether third-party originators are producing quality loans. If appraisal, loan documentation, or credit problems are discovered, the institution should take immediate action, which could include terminating its relationship with the third-party.[8]

Secondary Market Activity—The sophistication of an institution's secondary market risk management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary market reliance should have comprehensive, formal approaches to risk management.[9] This should include consideration of the risks to the institution should demand in the secondary markets dissipate.

While sale of loans to third parties can transfer a portion of the portfolio's credit risk, an institution continues to be exposed to reputation risk that arises when the credit losses on sold loans or securitization transactions exceed expected losses. In order to protect its reputation in the market, an institution may determine that it is necessary to repurchase defaulted mortgages. It should be noted that the repurchase of mortgage loans beyond the selling institution's contractual obligations is, in the Agencies' view, implicit recourse. Under the Agencies' risk-based capital standards, repurchasing mortgage loans from a sold portfolio or from a securitization in this manner would require that risk-based capital be maintained against the entire portfolio or securitization.[10] Further, loans sold to third parties typically carry representations and warranties from the institution that these loans were underwritten properly and all legal requirements were satisfied. Therefore, institutions involved in securitization transactions should consider the potential origination-related risks arising from nontraditional mortgage loans, including the adequacy of disclosures to investors.

Management Information and Reporting—An institution should have the reporting capability to detect changes in the risk profile of its nontraditional mortgage loan portfolio. Reporting systems should allow management to isolate key loan products, risk-layering loan features, and borrower characteristics to allow early identification of performance deterioration. At a minimum, information should be available by loan type (e.g., interest-only mortgage loans and payment option ARMs); the combination of these loans with risk-layering features (e.g., payment option ARM with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); underwriting characteristics (e.g., LTV, DTI, and credit score); and borrower performance (e.g., payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance results should be tracked against expectations, internal lending standards, and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should be undertaken when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of the portfolio's risk characteristics and should be an integral part of an institution's forecasting process to establish and adjust risk tolerance levels.

Stress Testing—Institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. This

[8] Refer to OCC Bulletin 2001–47—Third-Party Relationships and AL 2000–9—Third-Party Risk (OCC). Federally Insured Credit Unions should refer to 01–CU–20 (NCUA), Due Diligence Over Third-Party Service Providers.

[9] Refer to ''Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations,'' May 23, 2002; OCC Bulletin 2002–22 (OCC); SR letter 02–16 (Board); Financial Institution Letter (FIL–54–2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, November 1997. The Board also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97–21. Federally Insured Credit Unions should refer to 12 CFR Part 702 (NCUA).

[10] Federally Insured Credit Unions should refer to 12 CFR Part 702 for their risk based net worth requirements.

should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Through stress testing, an institution should be able to identify, monitor and manage risk, as well as develop appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

Capital and Allowance for Loan and Lease Losses—Institutions should establish appropriate allowances for the estimated credit losses in their nontraditional mortgage loan portfolios and hold capital commensurate with the risk characteristics of these portfolios. Moreover, institutions should recognize that the limited performance history of these products, particularly in a stressed environment, increases performance uncertainty. As loan terms evolve and underwriting practices ease, this lack of seasoning may warrant higher capital levels.

In establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Credit risk segments should also distinguish among loans with differing payment and portfolio characteristics, such as borrowers who habitually make only minimum payments, mortgages with existing balances above original balances due to negative amortization, and mortgages subject to sizable payment shock. The objective is to identify key credit quality indicators that affect collectibility for ALLL measurement purposes and important risk characteristics that influence expected performance so that migration into or out of key segments provides meaningful information about future loss exposure for purposes of determining the level of capital to be maintained.

Further, those institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages in accordance with interagency guidance.[11] This guidance requires institutions to follow generally accepted accounting principles and conservatively treat assumptions used in valuing mortgage-servicing rights.

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their near-term monthly payment affordability, and consumers have been encouraged to select nontraditional mortgage products based on the lower monthly payments that such products permit compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should ensure that they also appropriately alert consumers to the risks of these products, including the likelihood of increased future payment obligations. Institutions should also ensure that consumers have information that is timely and sufficient for making a sound product selection decision.[12]

Concerns and Objectives—More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the ''recast'' of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. As a result, it may be more difficult for consumers to refinance these loans. In addition, in the event of a refinancing or a sale of the property, negative amortization may result in the reduction or elimination of home equity, even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also effectively providing complete information about material risks.

In light of these considerations, institutions should ensure that communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, are consistent with product terms and payment structures. These communications should also provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products is important to ensuring that consumers have appropriate information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

Legal Risks—Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages in advertisements, with an application,[13] before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[14]

[11] Refer to the ''Interagency Advisory on Mortgage Banking,'' February 25, 2003, issued by the bank and thrift regulatory agencies. Federally Insured Credit Unions with assets of $10 million or more are reminded they must report and value nontraditional mortgages and related mortgage servicing rights, if any, consistent with generally accepted accounting principles in the Call Reports they file with the NCUA Board.

[12] Institutions also should review the recommendations relating to mortgage lending practices set forth in other sections of this guidance and any other supervisory guidance from their respective primary regulators, including the discussion in the Subprime Lending Guidance referenced in footnote 6 about abusive lending practices.

[13] These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

[14] The OCC, the Board, and the FDIC enforce this provision under the FTC Act and section 8 of the FDI Act. Each of these agencies has also issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002–3—Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002; Joint Board and

Continued

Institutions should also ensure that they comply with fair lending laws and the Real Estate Settlement Procedures Act (RESPA). Other federal laws also apply to these loan products. Moreover, the Agencies note that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may be applicable. It is important that institutions have their communications and other acts and practices reviewed by counsel for compliance with all applicable laws. Institutions also should monitor applicable laws and regulations for revisions to ensure that communications continue to be fully compliant.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:

Communications with Consumers—As with all communications with consumers, institutions should present important information in a clear manner and format such that consumers will notice it, can understand it to be material, and will be able to use it in their decision-making processes.[15] Furthermore, when promoting or describing nontraditional mortgage products, institutions should provide consumers with information that will enable them to make informed decisions and to use these products responsibly. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers make product selection and payment decisions. For example, institutions should offer full and fair product descriptions when a consumer is shopping for a mortgage, not just upon the submission of an application or at consummation.

• Promotional materials and descriptions of these products should provide information that enables consumers to prudently consider the costs, terms, features, and risks of these mortgages in their product selection decisions, including information about:

—Payment Shock. Institutions should apprise consumers of potential increases in their payment obligations (e.g., in both dollar and percentage terms), including situations in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[16] Information provided to consumers also could clearly describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that the new payment amount may be required sooner, and may be even higher than the amount indicated, due to factors such as negative amortization or increases in the interest rate index.

—Negative Amortization. When negative amortization is possible under the terms of the loan, consumers should be apprised of the potential consequences of increasing principal balances and decreasing home equity. For example, product descriptions should include, with sample payment schedules, corresponding examples showing the effect of those payments on the consumer's loan balance and home equity.

—Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact, and to the amount of any such penalty.[17]

—Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

• Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make responsible payment choices, including information about the consequences of selecting various payment options on the current principal balance. Institutions should present each payment option available, explain each option, and note the impact of each choice. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that this payment would result in an increase to the consumer's outstanding loan balance due to negative amortization. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment option ARM borrowers to select the minimum payment (for example, through the format or content of monthly statements).

• Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, institutions should avoid such practices as promoting payment patterns that are structurally unlikely to occur.[18] Such practices could raise legal and other risks for institutions, as described more fully above.

• Institutions also should avoid such practices as: Unwarranted assurances or

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FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. Federally insured credit unions are prohibited from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition. 12 CFR 740.2. The OTS also has a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered. 12 CFR 563.27. This regulation supplements its authority under the FTC Act.

[15] In this regard, institutions should strive to: (1) Focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering these nontraditional mortgage products and other loan features described in this guidance.

[16] Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

[17] Federal credit unions are prohibited from imposing prepayment penalties. 12 CFR 701.21(c)(6).

[18] For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. At the same time, the minimum payments may be so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); inappropriate representations about the ''cash savings'' to be realized from nontraditional mortgage products in comparison with amortizing mortgages; statements suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and misleading claims that interest rates or payment obligations for these products are ''fixed.''

Control Systems—Institutions also should develop and use strong control systems to ensure that actual practices are consistent with their policies and procedures, for loans that the institution originates internally, those that it originates through mortgage brokers and other third parties, and those that it purchases. Institutions should design control systems to address compliance and fair disclosure concerns as well as the safety and soundness considerations discussed above. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. Lending personnel should be monitored through, for example, call monitoring or mystery shopping, to determine whether they are conveying appropriate information. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention also should be paid to appropriate legal review and to using compensation programs that do not improperly encourage originators to direct consumers to particular products.

Appendix: Terms Used in this Document

Interest-only Mortgage Loan—A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM—A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a ''start'' or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on either a 15-year or 30-year loan term plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation—A loan feature that is commonly referred to as ''low doc/no doc,'' ''no income/no asset,'' ''stated income'' or ''stated assets.'' For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan—A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

This concludes the text of the proposed Interagency Guidance on Nontraditional Mortgage Products.

Dated: December 19, 2005.

John C. Dugan,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, December 19, 2005.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, the 19th day of December, 2005.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: December 19, 2005.

By the Office of Thrift Supervision.

John M. Reich,

Director.

By the National Credit Union Administration on December 20, 2005.

Rodney E. Hood,

Vice Chairman.

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