



Key Points in the Guidance on Nontraditional Mortgage Products

Overview

Issuers - On September 29, 2006 the federal financial regulators--the Board of Governors of the Federal Reserve (Fed), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA)--jointly issued Final Guidance on Nontraditional Mortgage Products (the Guidance).¹ Key aspects of the Guidance are the same as the proposed guidance issued for comment by the regulators over nine months ago, with a few significant clarifications.

Purpose and Coverage - The Guidance is intended to address risks posed to federally regulated financial institutions by the growing use of mortgage products that allow borrowers to defer payments of principal and, sometimes, interest. The Guidance specifically covers interest-only (IO) and payment option adjustable rate mortgages (Option ARMs). It generally excludes home equity lines of credit (HELOCs) and reverse mortgages.²

Applicability -The guidance applies to federally regulated institutions including federally chartered banks, S&Ls and credit unions but it has a “trickle down” effect since it requires such institutions to monitor the quality of third-party originations so they reflect the institutions’ lending standards and compliance with laws and regulations.

Scope - The Guidance addresses three sets of concerns:

1. Loan Terms and Underwriting Standards;
2. Portfolio and Risk Management Practices; and
- 3) Consumer Protection Issues.

¹ <http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf>

² The regulators did not include HELOCs in the Guidance, other than discussing them in the Simultaneous Second-Liens section, since these products are already covered by the May, 2005 Interagency Credit Risk Management Guidance for Home Equity Lending. The agencies are amending the May, 2005 issuance to address the consumer disclosure recommendations included in the Guidance.

Other Relevant Documents - Simultaneous with the issuance of the Guidance, the regulators proposed for public comment (for 60 days) Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products. These illustrations are intended to assist institutions in implementing the consumer protection provisions of the Guidance. MBA is seeking member input on these documents.

Significant Changes from Proposed - HELOCs and reverse mortgages are generally excluded from coverage, the underwriting language is slightly revised, suitability language is removed, third-party originations need not be reviewed at the loan level, and disclosures may be generic.

Effect - While the Guidance is not a regulation, its effect likely will be similar. Covered institutions will be examined in light of the Guidance and expected to address the matters in a manner consistent with it.

Next Steps - MBA is assisting its members in navigating and responding to the Guidance.

Specific Provisions

1. Loan Terms and Underwriting Standards - Purpose is to ensure that loan terms and underwriting standards for nontraditional mortgage loans are “consistent with prudent lending practices.” Specifically, the Guidance provides institution should:

- **Qualifying Borrowers** - Maintain qualification standards for non-traditional products that include “a credible analysis of the borrower’s capacity to repay the full amount of credit that may be extended considering principal and interest.” Specifically, qualify borrowers at “the fully indexed rate assuming a fully amortizing payment including potential negative amortization amounts.” Consider effect of a substantial payment increase on borrower’s repayment capacity. The higher the credit risk, either from features or borrower’s characteristics, more important to verify borrower’s income, assets and liabilities; avoid over reliance on credit scores as a substitute for income verification in the underwriting process.
- **Collateral Dependent Loans** - Avoid loan terms and underwriting that “may heighten the need for borrower to rely on sale or refinancing once amortization begins.” Regulators consider loans to individuals who do not demonstrate capacity to repay from sources other than collateral as generally “unsafe and unsound.” Important clarification - A loan will not be determined to be collateral dependent solely because it is underwritten using reduced documentation.

- **Risk Layering** - When features are layered such as interest-only loans with reduced documentation, demonstrate that mitigating factors including higher credit scores, lower LTV, liquid assets, mortgage insurance or other credit enhancements support the underwriting decision and the borrower's ability to repay.
- **Reduced Documentation** - Use with caution. Establish clear policies for reduced documentation, for example, stated income should be accepted only if there are mitigating factors that minimize need for direct verification. As credit risk increases, more diligently verify and document a borrower's income and debt reduction capacity.
- **Simultaneous Second Lien Loans** - Loans with minimal or no owner equity "generally" should not have a payment structure that allows for delayed or negative amortization without significant risk mitigating factors.
- **Introductory Interest Rates** - In developing products consider the spread between introductory and fully indexed rates to minimize the likelihood of disruptive early recasting and extraordinary payment shock.
- **Loans to subprime borrowers** - Mortgages that target subprime borrowers should follow the interagency guidelines on subprime lending³ which, among other things, discusses circumstance under which subprime lending can be predatory or abusive.
- **Non-Owner Occupied Investor Loans** - Borrowers financing non-owner occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan.

2. Risk Management - Purpose is to ensure risk management practices keep pace with portfolio growth and changing risks of nontraditional mortgage loans. Specifically, the Guidance provides institutions should:

- **Policies** - Assure institutions' policies set acceptable levels of risk in operating practices, accounting procedures and policy exception tolerances. Policies should reflect appropriate limits on risk layering and include risk management tools for risk mitigation, set growth and volume limits with special attention to products and product combinations in need of heightened attention because of easing terms or rapid growth.
- **Concentrations** - Have well developed monitoring systems and risk management practices when institutions have concentrations in nontraditional products. Monitoring should keep track of concentrations in key

³ Interagency Guidance on Subprime Lending, March 1, 1999 and expanded guidance for Subprime Lending Programs, January 31, 2001. Credit Unions have additional guidance.

segments including loan types, third-party originations, geographic area, property occupancy status as well as key portfolio characteristics, high LTVs, DTIs, Neg Am, lower credit scores, risk layered and non-owner occupied properties. Concentrations that are not effectively managed will be subjected to elevated supervisory attention.

- **Controls** - Establish Quality controls, compliance and auditing that focus on mortgage lending activities posing high risks. Quality control should regularly review a sample of nontraditional loans from all channels to confirm that policies are being followed. Where deficiencies, managers should be held responsible. Institutions should have strong controls including monitoring and training regarding accruals, customer service and collections.
- **Third-party Originations** - Have strong systems and controls in place to monitor the quality of third-party originations by origination source and borrower characteristics so they reflect institutions lending standards and compliance with laws and regulations. If problems are discovered, institutions should take immediate action including termination of third-party relationship.
- **Secondary Market Activity** - Institutions with significant secondary market activities, should undertake comprehensive formal strategies for managing risks including repurchase of defaulted mortgages. Where there are such buybacks, institutions are directed to the agencies risk based capital rules which may require capital for the entire pool or securitization.
- **Management Information and Reporting** - Assure reporting systems allow management to detect changes in the in the risk profile of its nontraditional mortgage loan portfolio to recognize deteriorating performance. Reports should isolate key loan products, risk-layering features and borrower characteristics and provide sufficient warning of deteriorating performance.
- **Stress Testing** - Based on the size and complexity of their lending operations institutions, perform sensitivity analysis on key portfolio segments including stress tests on key performance drivers, including interest rates and employment levels, housing value fluctuations and other factors beyond the institutions control.
- **Capital** - Maintain capital levels that reflect portfolio characteristics including appropriate allowances for loan and lease losses (ALLL) levels that consider the credit quality of the portfolio and conditions that affect collectibility.

3. Consumer Protection - Purpose is to assure consumers understand product terms, risks as well as benefits in a “timely manner.” The Guidance provides that Institutions should:

- **Concerns and Objectives** - Assure that communications with consumers, including advertisements oral statements, promotional materials and monthly statements should provide “clear and balanced information” about the relative benefits and risks of these products, including payment shock and the risk of negative amortization to help them make informed. Requires attention to timing, content and clarity.
- **Legal Risks** - Assure that products are offered in a manner that complies with all applicable laws and regulations the Truth in Lending Act (TILA), Section 5 of the Federal Trade Commission Act prohibiting unfair and deceptive acts and practices, and the Real Estate Settlement Procedures Act (RESPA).
- **Communications with Consumers** - Provide Information at crucial decision points, when borrowers are shopping for loans—before disclosures may be required under the TILA and other laws-- and when borrowers are deciding which monthly payment amount to make. Transaction specific disclosures are generally not required.
- **Promotional Materials and Product Descriptions** - Provide in promotional materials and other product descriptions information about the costs, terms, features and risks of nontraditional mortgage products to assist consumers in their selection decisions
- **Payment Shock** - Apprise consumers of the maximum monthly payment a consumer would be required to pay in under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps are reached.
- **Negative amortization** - Apprise consumers of the potential for increasing principal balances and decreasing home equity including refinance difficulties.
- **Prepayment Penalties** - Provide information on prepayment penalties including the need to ask the lender the amount.
- **Reduced Documentation** - Provide information on the cost of reduced documentation loans including any pricing premium attached to them.
- **Monthly Statements on Payment Option ARMS** - Provide information in monthly statements on option ARMs that allow consumers to make an informed payment choice including an explanation next to the minimum payment that such payment may result in an increase in the outstanding loan balance as well as the current loan balance.
- **Practices to Avoid** - Avoid practices that obscure significant risks to consumers including assurances about the future direction of rates, one sided

representations about cash savings or suggesting that minimum payments in an option ARM will cover interest charges and misleading claims that payments are “fixed.”

- **Control Systems** - Develop and use strong controls to monitor whether actual practices are consistent with policies and procedures for loan personnel and third-party originators. Should take steps with third parties including conducting due diligence and establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this Guidance.

4. Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products - In light of the regulators stated appreciation that some institutions may prefer not incur the costs and other burdens of developing their own information to address the consumer protection issues raised in the Guidance, simultaneous with the publication of the Guidance, the agencies proposed illustrations which could be used voluntarily by institutions.⁴ Specifically, the illustrations include:

- A document presenting key facts about interest-only and payment option mortgages.
- A comparison chart of mortgage payments for a fixed rate, interest-only, ARM, and option ARM mortgages over an 8 year span.
- A sample monthly payment form for payment option mortgages to assist borrowers in making informed payment choices.
- **Note:** The regulators have requested comments on the usefulness of the proposed illustrations for institutions and consumers. The comment periods closes 60 days after Federal Register publication on or about November 29, 2006.

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⁴ <http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment2.pdf>

