



# Interagency Guidance - Nontraditional and Subprime Mortgages

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# Overview

- Background
- Nontraditional and Subprime Loan Purchases
- Private Label Securities
- Borrower Protection Issues



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- Federal banking regulators and many state regulators have adopted guidance on Nontraditional (NTM) and Subprime mortgage products.
  - Interagency Guidance on Nontraditional Mortgage Products Risks (NTM Guidance).
  - Statement on Subprime Mortgage Lending (Subprime Statement).
- Regulators have provided “guidance” regarding:
  - Underwriting Standards, including:
    - Fully indexed rate and fully amortizing payment.
    - Prepayment penalties.
    - Reduced documentation loans.
  - Risk Management Practices.
  - Consumer Protection Issues.
  - Control Systems.
- OFHEO has directed Freddie Mac to take actions consistent with the NTM Guidance and Subprime Statement with respect to the purchase of loans **and** private label securities transactions.

- Covered loans.
  - NTM Loans - Interest only and Option ARMs.
  - Short-Term Subprime Loans – ARMs with a margin of 400 basis points or more and an initial fixed-rate period of three years or less.
  - Loans with applications dates on or after September 13, 2007.
- All Sellers regardless of whether Seller is a regulated institution to whom the NTM Guidance or the Subprime Statement applies directly.
- As part of the normal quality review process, Freddie Mac will assess compliance with these standards.

- NTM loans must be underwritten at the fully indexed rate and fully amortizing payment:
  - The borrower must be qualified using a monthly housing expense that includes, but is not limited to, the principal and interest payment on the mortgage.
  - The principal and interest payment must be based on a fully amortizing payment schedule for the term of the mortgage.
  - NTM fixed-rate mortgages - the borrower must be qualified using payments calculated using the note rate
  - NTM ARMs - the borrower must be qualified using payments calculated at the higher of the note rate or the fully indexed rate.
  - For NTM ARMs - the initial note rate must not be more than three percentage points below the fully indexed rate.
- Loan Prospector has been modified to underwrite to our standards.
- For NTM Mortgages originated with stated income or other forms of reduced documentation and verification of income and/or assets the mortgage file taken as a whole must demonstrate the reasonableness of the stated income.
  - If the mortgage file contains documentation that raises questions about the reasonableness of the stated income, further review of the information must be undertaken.

- Freddie Mac will not buy under a flow commitment, ARMs with a margin of 400 basis points or more and an initial fixed-rate period of three years or less (short-term subprime ARMs).
  - Effective as of October 1, 2007.
- Freddie Mac has the following requirements for Short-term subprime ARMs, purchased through our bulk or structured transactions paths:
  - Loans must be underwritten at the fully indexed rate and fully amortizing payment.
  - Representation and warranty that if the Seller has relied on reduced underwriting documentation, that reliance is consistent with the Subprime Statement.

- The Seller must represent and warrant that the Seller has implemented processes and controls to ensure that borrowers with NTM or short-term subprime ARMs receive written disclosure as discussed in the guidance and that such disclosure is provided in a timely manner.
  - NTM Disclosures should address payment shock, negative amortization (if any), prepayment penalties and the cost of reduced documentation loans, as appropriate.
  - Short-term subprime ARMs disclosures should address payment shock, prepayment penalties, balloon payments, the cost of reduced documentation loans and responsibility for taxes and insurance, as appropriate.
  - Option ARM Monthly Statement - processes and controls must be in place to ensure that borrowers are provided explanations in their monthly statements of each payment option and its impact on loan balance.
- Freddie Mac will continue to require that all mortgage loans be originated in compliance with all applicable federal, state and local laws, including anti-predatory lending and fair lending laws.

- Covered loans.
  - NTM loans - interest-only mortgages and option ARMs mortgages.
  - Short-term adjustable-rate subprime mortgages – mortgages identified by the counterparty as subprime, which have low initial payments based on a fixed introductory rate that expires after a short period (3 years or less) and then adjusts, and that may have high margin limits and/or no rate caps.
  - Loans with loan application dates on or after September 13, 2007. In transactions where data about loan application dates is not available, the new requirements will be effective for mortgages with note dates on or after October 1, 2007.
- Freddie Mac will continue to require that all mortgage loans be originated in compliance with all applicable federal, state and local laws, including anti-predatory lending and fair lending laws.
- Counterparties must represent and warranty that any NTM mortgage or short-term subprime ARM underlying the securities comply, in all respects, with the NTM Guidance and the Subprime Statement, including any interpretations, applications or implementation plans with respect to the NTM Guidance or the Subprime Statement that have been communicated and/or agreed to by an institution's regulator.
- Freddie Mac will enhance its existing operational on-site reviews to make sure that counterparties have policies, procedures and practices in place to ensure compliance.

- The NTM Guidance and Subprime Statement “recommend” that lenders provide consumers with clear and balanced information about the relative benefits and risks of the products.
  - NTM Loans - provide information about the risk of: (i) payment shock, (ii) prepayment penalties, (iii) negative amortization, and (iv) cost of reduced documentation loans.
  - Monthly Statement on Payment Option Arms - provide information that enables borrowers to make informed choices.
  - Subprime loans - provide information about the risks of: (i) payment shock, (ii) prepayment penalties, (iii) balloon payments, (iv) cost of reduced documentation loans and (v) responsibilities for taxes and insurance.
- Information should be provided in “a timely manner – before disclosures may be required under [TILA] or other laws – to assist the consumer in the product selection process.” NTM Guidance.
  - “This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan.” Subprime Statement.
- Regulators have published illustrations of consumer information.

- Regulators have reminded financial institutions not to engage in deceptive marketing practices.
- The NTM Guidance and Subprime Statement provide the following examples:
  - Giving unwarranted assurances or predictions about the future direction of interest rates (and consequently, the borrower’s future obligations) – NTM Guidance.
  - Making one-sided representations about the cash savings or expanded buying power to be realized from NTM compared with amortizing mortgages - NTM Guidance.
  - Suggesting that the initial minimum payments in an Option Arm will cover accrued interest – NTM Guidance.
  - Making misleading claims that interest rate or payment obligations for NTM are “fixed.” – NTM Guidance.
  - Steering customers to subprime products when they qualify for other products. Subprime Statements.

- The NTM Guidance and Subprime Statement provide that institutions “should develop and use strong control systems to monitor whether actual practices are consistent with the policies and procedures.”
- Controls should address:
  - Compliance.
  - Consumer information.
  - Safety and soundness.
- Control systems should cover both institution personnel and third parties, such as brokers and correspondents.

- Disclosure logistics.
  - Timing?
  - Placed in loan file?
  - Signed by borrower?
- Brokered loans?
- Correspondents?