



*Announcement 07-10*

*July 13, 2007*

*Amends these Guides: Selling*

***Updates in Response to Interagency Guidance on  
Nontraditional Mortgage Product Risks***

**Introduction**

On October 4, 2006 the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (collectively referred to as the Federal Banking Agencies) jointly issued the *Interagency Guidance on Nontraditional Mortgage Product Risks* (the Guidance).<sup>1</sup> The Guidance applies to all institutions regulated by the Federal Banking Agencies, and was effective upon publication.

The Guidance applies to “nontraditional mortgage loans,” which are mortgage products that allow borrowers to defer principal and, sometimes, interest. This includes products with an interest-only (IO) feature and products with the potential for negative amortization (including those with flexible payment options).

In response to the Guidance, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators developed similar model guidance, and encouraged state agencies that regulate residential mortgage lenders and brokers to adopt the model guidance and apply it to those entities not already subject to the federal Guidance. This effort is designed to ensure consistent application of underwriting standards, risk management practices, and consumer protections for all lenders and brokers providing nontraditional mortgage products to borrowers. To date, numerous states have adopted the model guidance, and more states are expected to follow.

Fannie Mae is not covered by the Guidance or by comparable state guidance. However, the Office of Federal Housing Enterprise Oversight (OFHEO), our safety and soundness regulator, has directed Fannie Mae to take action consistent with the practices referenced in

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<sup>1</sup> 71 FR 58609

the Guidance. As a result, Fannie Mae is establishing policies to ensure that nontraditional mortgage products purchased or securitized by Fannie Mae comply with the Guidance.

In addition, on July 10, 2007, the Federal Banking Agencies published in the *Federal Register* the final *Statement on Subprime Mortgage Lending* (Subprime Guidance)<sup>2</sup>, which became effective immediately. OFHEO has directed Fannie Mae to take action consistent with the practices referenced in the Subprime Guidance. Accordingly, we expect to issue a subsequent announcement related to the Subprime Guidance in the near future.

This Announcement outlines recent policy changes applicable to nontraditional mortgage products and provides information about the additional actions to be taken to ensure Fannie Mae's compliance with the Guidance. As directed by OFHEO, our standard policies apply to all mortgage loans delivered, regardless of whether the lender is subject to federal or state regulation relative to nontraditional mortgage products.

### **Effective Date**

We encourage all lenders to comply with the Guidance as soon as possible. As prescribed by OFHEO, all nontraditional mortgage loans with an application date on or after September 13, 2007 that are sold to Fannie Mae, must be in compliance with all aspects of the Guidance. Lenders are expected to make updates to their systems, policies, and procedures to ensure compliance with the Guidance for mortgage loans delivered to Fannie Mae as soon as possible.

### **Updates to Policies in Response to the Guidance**

In relation to nontraditional mortgage products, the Guidance covers three broad areas of the mortgage process: underwriting standards, risk management, and consumer protection. OFHEO expects that the nontraditional mortgage loans purchased by Fannie Mae will be in compliance with all aspects of the Guidance. Below are updates to our standard policies, including an additional representation and warranty, and our expectations for lender compliance. These updates apply to loans underwritten with Desktop Underwriter<sup>®</sup> (DU<sup>®</sup>) as well as mortgage loans underwritten manually or through the use of another automated underwriting system.

#### ***Underwriting Standards***

Pursuant to the Guidance, mortgage loan underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay a nontraditional mortgage loan when amortization begins. Below are the recent updates made to our standard policies to address the requirements of the Guidance.

- For *mortgage loans with an IO feature*, an analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate (if adjustable-rate), or note rate (if fixed-rate), assuming a fully amortizing repayment schedule.

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<sup>2</sup> 72 FR 37569

The fully amortizing repayment schedule is based on the term of the mortgage. The fully indexed rate generally equals the index value prevailing at the time of underwriting plus the applicable margin that will apply after the expiration of any introductory interest rate period (for more details on determining the fully-indexed rate, refer to Part VII, Section 106.03 of the Selling Guide).

- For *mortgage loans with a negative amortization feature*, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.

The balance that may accrue from the negative amortization provision may be calculated by taking the lesser of the negative amortization cap per the mortgage note (the highest percent the loan amount can increase through negative amortization), or the maximum negative amortization percentage that the loan may accrue based on the spread between the introductory or “teaser” rate and the accrual rate before the end of the initial payment option period.

**Note:** Fannie Mae requires a negotiated contract to deliver mortgage loans with a negative amortization feature.

DU Version 5.7 will be updated on July 22, 2007 to support the qualifying calculations for nontraditional mortgage products referenced above.

For additional details related to qualifying calculations, lenders may refer to the *Desktop Originator® (DO®)/ Desktop Underwriter® (DU®) Version 5.7 Release Notes* dated May 22, 2007, and Announcement 06-26 - *Expansion of the Interest-Only Mortgage Loans Eligible for Delivery to Fannie Mae and Elimination of the InterestFirst™ Product Name*.

### ***Risk Management***

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of nontraditional mortgage loan portfolios, while also monitoring changes in the mortgage market. Active portfolio management is important to enable an institution to detect changes in the risk profile of its nontraditional mortgage loan portfolio.

### ***Consumer Information***

The Guidance highlights the importance of consumer information and disclosure about the benefits and risks associated with nontraditional mortgage products. This includes information related to payment shock and negative amortization. Consumer communications are subject to the requirements of various state and federal laws and regulations.

### ***Additional Lender Representation and Warranty***

Fannie Mae has existing lender representations and warranties that require all mortgage loans delivered to be originated in compliance with all applicable federal, state, and local laws that apply to any of the lender’s origination, selling or servicing practices or other business practices that may have a material effect on Fannie Mae (see Selling Guide, Part I, Section 306). In addition to any representations and warranties a lender already makes with respect

to loans, Fannie Mae will require a new representation and warranty for nontraditional mortgage products, as detailed below.

When a lender sells us a nontraditional mortgage product, it represents and warrants that the mortgage complies in all respects with the Guidance (or comparable state guidance), including the underwriting and consumer protection portions of the Guidance. Regulated lenders may rely on interpretations, applications, or implementation plans of the Guidance (or comparable state guidance) as communicated and/or agreed to by their regulator. For lenders not subject to the Guidance or state guidance promulgated by a federal or state agency, in order for the mortgage to be eligible for sale to Fannie Mae, mortgage loans with an IO feature and/or a negative amortization feature must be underwritten in accordance with the guidelines contained in the “Underwriting Standards” section above.

***This representation and warranty will apply to all lenders, including those that are not subject to the Guidance at the federal or state level.***

***Fannie Mae Quality Control Reviews***

Fannie Mae currently performs quality control reviews of mortgage loans delivered to us. The existing quality control reviews will be expanded to ensure that nontraditional mortgage loans delivered comply with the underwriting requirements in the Guidance. In instances where noncompliance is identified, appropriate action will be taken, as necessary, up to and including a request that the lender repurchase the loan.

Fannie Mae continues to assess current policies in light of the Guidance and OFHEO’s directive, and will communicate any further updates as necessary.

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Lenders should contact their Customer Account Team if they have questions about this Announcement.

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