Federal Banking Agencies Issue Proposed Guidance on Nontraditional Mortgage Products

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In response to a growing trend by lenders to develop and market and consumers to want mortgage products with nontraditional terms, the federal banking agencies have issued proposed guidance on Nontraditional Mortgage Products. The proposed guidance establishes the agencies' expectations regarding the assessment and management of the risks involved in these types of products as well as expectations regarding communications with consumers who want these types of loans. As a result of the concerns raised that the issuance of the proposed guidance will have a negative impact on the ability of lenders to continue to offer the mortgage products identified, the agencies have extended the comment period. The agencies have asked a number of questions seeking details about the products, how they are offered and what are their features.

This proposed guidance would have broad application in the lending industry but would exclude a diverse group of entities that originate mortgage loans that are not regulated by the federal banking agencies. It would apply to the activities of all banks and their subsidiaries, bank holding companies and their non bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries and credit unions. The lenders not included with the scope of this proposed guidance are the independent mortgage lenders, those with no affiliation with insured depositories.

The loan products to which the proposed guidance would apply are Interest Only Mortgage Loans. Payment Option ARMs, loans with reduced documentation, and Simultaneous Second Lien Loans. For purposes of this proposed guidance the terms mean:

- Interest-Only Mortgage Loan is a mortgage on which the borrower is required to pay only the interest due on the loan for a specified number of years, for example three or five years. During that time, the rate on the mortgage may fluctuate or may be fixed. At the conclusion of the specified interest-only period, the rate may be fixed or may fluctuate based on a prescribed index and the payments will include both principal and interest.

- A Payment Option ARM is a mortgage that allows the borrower to chose from a number of different payment options. A borrower may choose a minimum payment option based on an introductory 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 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.

- A loan that is frequently referred to a reduced documentation loan may include features such as " low doc/no doc," "no income/no asset," "stated income" or "stated assets." For loans with any of these features, the institution establishes reduced or minimal documentation standards to substitute the borrower's income and assets.

- A simultaneous second lien loan is an arrangement under which either a closed-end second-lien or a home equity line of credit is originated simultaneously with the first lien mortgage loan, frequently in lieu of a higher down payment.

Although the mortgages that are currently being labeled "nontraditional" have been available for a number of years in some markets to some borrowers, the trend to offer Option ARMS, Interest Only Loans and Hybrid Arms has become more widespread. For over 15 years, these types of loans were originated primarily by savings associations on the west coast. The institutions that offered these products did so, and continue to do so, using conservative underwriting and risk management strategies. The OTS, the primary federal regulator of most of the institutions with a history in making these types of loans, has developed supervisory processes to mitigate any concerns the agency may have. Given the historical analysis that is possible of the offerings of these products by these institutions, the OTS has an understanding of the product and has developed a comfort level based on the agency's experience.

Recently, a number of mortgage lenders, both insured depositories and independent mortgage companies have begun to offer these types of loan products at least partially because of consumer demand. The interest from consumers has been generated by a number of economic factors as well as changes in the way that consumers feel about mortgages. In many geographic areas, rapid house price appreciation has resulted in the inability of many consumers to be able to afford to buy a home. These types of ARM products make owning a home possible for many consumers who could not otherwise qualify for a loan. Another factor that makes these loans attractive is the reduced length of time many borrowers expect to be in the homes they are financing with these mortgages.

One of the results of the growing trend and expansion of the universe of lenders making these loans and of consumers requesting these loans has been an increase in the attention the products have received. The news media labeled these products "exotic" and called them risky while writing articles about concerns that the federal banking regulators were expressing. The agencies, particularly the OTS, have had experience supervising institutions originating these types of loans, but they determined that an increased level of scrutiny was necessary as the availability of these loan products became more wide spread. Another factor leading the agencies to want an additional review of these products was the concern that consumers did not understand the risks involved with these loans, especially in a rising rate environment.

The federal banking agencies responded to these concerns by issuing proposed guidance that if adopted will provide insight into what the agencies are looking for in an examination from both a safety and soundness and a consumer protection perspective. The agencies have indicated that they will carefully scrutinize the lending programs, including policies and procedures, and risk management processes relative to these types of lending products. The agencies will look for an effective risk management function and will expect institutions to implement the guidance.

The consumer protection aspects of the proposed guidance are important elements of what the agencies are trying to accomplish and are an indication of how important the consumer provisions are. The current form of the guidance is a proposal and the agencies have asked a number of questions as part of the comment process.

Principal Elements of the Proposed Guidance

The agencies focus attention on the necessity of maintaining sound loan terms and underwriting standards in any program The proposal urges institutions to assess what is currently in place and being followed and to implement any necessary changes. The proposed guidance addresses the following underwriting standards:

- Appropriate borrower repayment analysis, including consideration of the comprehensive debt service in the qualification process;
- The potential for collateral-dependent loans which could arise when the borrower is overly reliant on the sale or refinancing or the property when the amortization occurs;
- 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 describes appropriate portfolio and risk management practices for institutions that offer nontraditional mortgage products. The policies and internal controls should address product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. As part of developing risk management practices, the agencies proposed that institutions:

- Maintain performance measures and management reporting systems that provide warning of potential or increasing risks;
- Maintain an allowance for loan and lease losses 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, an important factor in the proposed guidance is the discussion of the possible consumer protection concerns raised by nontraditional mortgage loan products, particularly if consumers do not fully understand the terms of these products. There is a concern that the complexity of the products relative to the traditional fixed rate and ARM products presents a greater risk of payment shock. The agencies urge institutions to ensure that consumers are provided clear balanced information about the relative benefits and risks of the products at the time during which consumers are making decisions on which mortgage loan they should obtain.

Consumer Protection Issues

The proposed guidance includes a separate section on consumer protection issues. The agencies are concerned that consumers may entering into transactions for these types of loan products without understanding the terms. The marketing for these types of loans uses advertising and promotional materials that frequently focus on the near-term monthly payment affordability. The agencies are concerned that consumers are not 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 describing the benefits of these products, the agencies urge institutions to ensure that consumers have been alerted to the risks of the products, including the likelihood of increased future payment obligations. The agencies also urge institutions to provide timely and sufficient information for making a sound product selection decision.

These products can carry risks of significant payment shock that may not be planned for by the consumer. The increases can be the result of a "recast" of the payment option ARM or the end of the interest only period. The increases can be affected by the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. In the event the consumer wishes to refinance the loan, any negative amortization may result in the reduction or elimination of home equity even if property values have appreciated. The agencies urge institutions to provide clear, balanced, and timely communication about the risks of the products. The proposed guidance reinforces that the information must be provided at the point when consumers are making decision or shopping for loans. The proposed guidance also reminds institutions about their legal obligations under the Truth in Lending Act, section 5 of the Federal Trade Act, the Real Estate Settlement Procedures Act and the fair lending laws for ensuring accurate and timely disclosures. Recommended practices for communications with customers as well as developing control systems and policies to ensure that the practices are being followed.

Requests for Information

The agencies ask several questions about the actual practice of institutions that offer these products. The preamble to the proposed guidance seeks input on particular aspects of the proposal in an effort to determine industry standards. For example, the agencies ask whether proposed guidance that provides that the analysis of borrower's repayment capacity should include an evaluation of the ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. Other questions ask commenters to provide information on the kinds of information that institutions should review for reduced documentation loans. Information is also sought on qualification standards for borrowers for these types of loans.

Conclusion

It is important for lenders that originate these types of loans to look at the guidance carefully. While it is not a regulation, the proposal establishes the standard that the agencies will use to supervise institutions making these loans. The comment period will be important as industry information that is provided will enable the agencies to make adjustments. The ultimate

goal is for any final guidance to be reasonable and to permit the continued offering of these products as they serve an important need in the mortgage market for lenders and consumers.