Interagency Guidance on Nontraditional Mortgage Products

On October 4, 2006, the federal financial regulatory agencies—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)—published in the Federal Register final guidance to address concerns regarding the risks posed by nontraditional mortgage products (Guidance).[1] The Agencies also issued two additional related documents, *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products* and an addendum to the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending*.

The Agencies published the proposed *Interagency Guidance on Nontraditional Mortgage Products* (Proposed Guidance) for comment on December 29, 2005. Comments regarding the Proposed Guidance were received from financial institutions, trade associations, consumer and community organizations, state and financial regulatory organizations, and other members of the public. The final Guidance responds to industry criticisms raised in the comment letters, but retains the basic structure of the original proposal. For example, the final Guidance removes language that suggested the Agencies sought to impose a "suitability" standard on underwriting of nontraditional mortgage products, akin to the standard for broker-dealer recommendations of securities. It also eliminates a proposal to hold lenders responsible for the marketing practices of third-party originators such as mortgage brokers and correspondents.

The Agencies have also proposed revisions to the Call Report and Thrift Financial Report to require additional reporting on such nontraditional mortgage loans. Moreover, state regulators now must decide whether to issue similar guidelines for non-depository, state-supervised mortgage firms. The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) recently distributed a model set of guidelines similar to the federal Guidance that could be adopted by the individual states for the institutions they supervise.

Agencies Express Concern about Nontraditional Mortgage Products

Nontraditional mortgage products, which have been available for many years, are considered an effective wealth management tool and have successfully helped to increase the homeownership rate. Nevertheless, the Agencies have expressed concern that the rapid growth in these products, including "interest-only" and "payment option" adjustable-rate mortgage (ARM) loans, may impact the health of the banking system, particularly as housing price growth slows or even declines. The Agencies have also indicated concern that the repayment terms of nontraditional mortgages pose an increased risk of default because they do not follow traditional level payment and amortization structures. Instead, these products generally allow borrowers to exchange lower initial payments for higher payments during a later amortization period by deferring repayment of principal and sometimes interest, resulting in the potential for negative amortization. The Agencies are also concerned that such potential risk is compounded by "risk-layering" because these products may be underwritten with less stringent income and asset verification (e.g., low-doc loans) and may be combined with second-lien mortgages. There is also Agency concern that borrowers may not fully understand the repayment risks associated with these products.

The Agencies' unease has grown as the market for these products has expanded and as lenders have begun offering them to a wider spectrum of borrowers, including some who may not qualify for traditional mortgage loans. The General Accounting Office (GAO) recently reported that the market share of these products tripled in two years, rising from 10% of all mortgages in 2003 to 30% in 2005. According to a 2006 *Wall Street Journal*/Harris Interactive poll, 35% of respondents indicated that they had obtained nontraditional mortgage financing.

The Agencies want to ensure that lenders appropriately manage these heightened risks by implementing prudent management practices that emphasize increased attention to product development, underwriting and risk management. The Guidance also directs lenders to explain fully to borrowers the risks posed by these products.

Scope

The Agencies have clarified the types of products covered by the Guidance to include all interest-only and negative amortization mortgages. Home equity lines of credit (HELOCs) (except as discussed in connection with simultaneous second-lien mortgages) and reverse mortgages are expressly excluded, as are fully amortizing products. Moreover, the Guidance applies only to lenders subject to federal supervision. The Guidance will be used by regulators during bank examinations, and lenders who fail to comply may be subject to increased regulatory scrutiny, criticism, corrective action or higher capital requirements. In addition, failure to consider the Guidance carefully–especially all consumer-facing aspects–could increase lenders' litigation risk, e.g., the risk that borrowers may later claim that a lender's failure to follow the Guidance is tantamount to engaging in an unfair or deceptive practice.

The Guidance

By its terms, the Guidance declares that it is not intended to discourage lenders from offering nontraditional mortgage products, but instead seeks to clarify how lenders can offer these products both safely and soundly and in a manner that clearly discloses potential risks to borrowers. The Agencies urge lenders to:

- 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 those with risk-layering features, are untested in a stressed environment. These products 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 sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

Accordingly, the Guidance addresses three key areas that bank and thrift management should review to mitigate these exposures: (1) loan terms and underwriting standards; (2) portfolio and risk management practices; and (3) consumer protection issues.

Loan Terms and Underwriting Standards

In the Guidance, the Agencies explain that the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures is central to prudent lending and address the following key areas of concern:

Qualification Standards

Since payments on nontraditional loans can increase significantly at amortization, lenders should utilize comprehensive qualification standards based upon the borrowers' repayment ability. The borrowers' ability to repay should include an evaluation of ability to pay back the debt at maturity, assuming a fully amortizing repayment schedule. When analyzing repayment ability, lenders should avoid over-reliance on credit scores as a substitute for income verification. As the level of credit risk increases due to loan features or borrower characteristics, the importance of verification of the borrower's income, assets and outstanding liabilities also increases. In addition, lenders should consider the potential impact of "payment shock" that may result from significant payment increases by establishing qualification tolerances based on borrowers' loan-to-value and debt-to-income ratios and credit scores.

Collateral Dependent Loans

Lenders should avoid the use of loan terms and underwriting practices that increase the need for borrowers to sell the property or refinance the loan in order to repay the loan once amortization begins. The Agencies state that collateral-dependent mortgage loans are generally considered unsafe and unsound.

Reduced Documentation

Reduced underwriting documentation should be employed cautiously, governed by clear polices and accepted only in connection with certain mitigating factors. For example, lenders should be able to establish income for most borrowers using W-2s, pay stubs or tax returns, and stated income should be accepted by lenders only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity.

Simultaneous Second-Lien Loans

Simultaneous second-lien loans result in reduced owner equity and, as a result, historically have posed a greater default risk. In the absence of significant risk-mitigating factors, these loans should not have payment structures that allow for delayed or negative amortization.

Introductory Interest Rates

In developing nontraditional mortgage products, particularly payment option ARM products, lenders should consider the spread between the introductory rate and the fully indexed rate. In setting introductory rates, lenders should consider ways to minimize disruptive early recastings and payment shock, for example, by avoiding a wide initial spread.

Lending to Subprime Borrowers

Mortgage programs that target subprime borrowers should follow the applicable interagency guidance on subprime lending,[2] especially the circumstances under which subprime lending can become predatory or abusive. The risk to both lenders and borrowers associated with risk layering should be considered when developing subprime loan products.

Non-owner-Occupied Investor Loans

For non-owner-occupied investor loans, borrowers should be qualified based on their ability to service the debt over the life of the loan and should require evidence that they have sufficient cash reserves to service the loan in the event of vacancy or variability of debt service.

Portfolio and Risk Management Practices

The Agencies want to ensure that lenders recognize that nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards. Portfolio and risk management practices should keep pace with the growth and risk profile of nontraditional mortgage loan portfolios, particularly for lenders with significant concentrations of nontraditional products. Lenders that originate or invest in nontraditional mortgage loans should adopt robust risk management practices. The principal areas of concern identified by the Agencies are discussed below.

Policies

Lenders should develop written policies for nontraditional mortgage products that specify acceptable product attributes (including limits on risk-layering), production and portfolio limits, sales and securitization practices, and risk management expectations. Lenders should manage acceptable levels of risk through operating practices, accounting procedures and policy exception tolerances. They should also set growth and volume limits by loan type.

Concentrations

Lenders with concentrations in nontraditional mortgage products should have well-developed monitoring and risk management practices. Concentrations should be monitored based on portfolio segments and characteristics, including loan type, third-party originations, geographic areas and property occupancy status. Lenders should consider the effect of employee incentive programs that may result in higher concentrations of nontraditional mortgage loans.

Controls

Quality control, compliance and audit procedures should include appropriate controls to monitor compliance with, and exceptions to, underwriting standards. Regular quality control reviews should be performed on a sample of loans from all origination channels to confirm that policies are being followed, especially with regard to reduced documentation loans. Business line managers should be held accountable for correcting deficiencies in a timely manner.

In connection with nontraditional mortgage products that permit deferral of principal and/or interest payments, lenders should have strong controls over accruals, customer service and collections. Policy exceptions should be carefully monitored to confirm that practices such as re-aging, payment deferrals and loan modifications are not inadvertently increasing risk. Personnel should receive product-specific training on the features and potential customer issues.

Third-Party Originations

Lenders should have strong systems for establishing and maintaining relationships with third-party originators, including due diligence procedures, to ensure quality and compliance with all applicable laws and regulations. Lenders should monitor loan quality by origination channel and borrower characteristics. If appraisal, loan documentation, fraud or credit problems are discovered, immediate action, such as re-underwriting or termination of the third-party, should be taken.

Secondary Market Practices

Secondary market risk management practices should be commensurate with the nature and volume of activity, including consideration of the risks associated with decreased product demand and reputation risk. The Agencies reiterated that under their applicable capital standards,[3] repurchase of mortgage loans beyond the selling institution's contractual obligations is implicit recourse, which may require risk-based capital to be held by the repurchasing institution against the entire portfolio of such loans sold or securitized.

Management Information and Reporting
Lenders should have the reporting capability to detect changes in the risk profile of their nontraditional mortgage loan portfolios and to allow management to isolate key loan products, risk-layering features and borrower characteristics for early identification of performance deterioration. At a minimum, information should be available by loan type, risk-layering feature, underwriting characteristics and borrower performance. Portfolio volume and performance results should be tracked against expectations, internal lending standards and policy limits, and should be established at the subportfolio and aggregate portfolio levels.

Stress Testing
Lenders should perform a sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio, including stress tests on key performance factors (e.g., interest rates, employment levels, economic growth and housing value fluctuations). Stress tests should allow lenders to identify, monitor and manage risk, as well as develop appropriate and cost-effective loss-mitigation strategies. Testing results should be utilized to determine underwriting standards, product terms, portfolio concentration limits and capital levels.

Capital and Allowance for Loan and Lease Losses
Lenders should establish allowances for loan and lease losses (ALLL) for the estimated credit losses in their nontraditional mortgage loan portfolios and hold capital commensurate with the risk characteristics of these portfolios. When establishing ALLL and capital levels, lenders should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics to identify key credit quality indicators that affect the appropriate capital levels. Further, sound practices should be adopted with regard to valuing the mortgage servicing rights of these products in accordance with interagency guidance.

Consumer Protection Issues

In addition to addressing risks to the lenders, the Agencies also want to ensure that consumers have sufficient information to clearly understand the terms and risks associated with nontraditional mortgages prior to making a product or payment choice.

Concerns and Objectives
The Agencies are concerned that current marketing practices may emphasize potential benefits of nontraditional mortgage products, such as lower payments, without effectively providing information about material risks. The Agencies want to ensure that communications with consumers—including advertisements, oral statements, promotional materials and monthly statements—are consistent with product terms and provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and negative amortization. The risks and benefits should be communicated at crucial decision-making times, such as when the consumer is shopping for a loan or selecting a monthly payment option.

The Agencies recommend various practices to address consumer protection issues, including:

Communications with Consumers
Promotional materials should provide consumers with information that will enable them to make informed decisions and to use these products responsibly. Since addressing these objectives requires appropriate attention to the timing, content and clarity of consumer information, lenders should provide consumers with information prior to making product selection and payment decisions. Accordingly, lenders should offer clear and balanced product descriptions during the product "shopping" process, not just upon the submission of an application or at consummation.

Promotional Materials and Product Descriptions
Promotional materials and product descriptions should provide specific information to consumers regarding the following:

- Payment shock
- Negative amortization
- Prepayment penalties
- Cost of reduced documentation loans/premium pricing

Monthly Statements
Monthly statements for payment option ARMs should provide information that enables consumers to make responsible payment choices, including an explanation of each payment option and information describing the effect of selecting various payment options on the principal balance. For example, if applicable, next to the minimum payment amount, the monthly payment statement should contain an explanation that the minimum payment will result in an increase to the consumer's outstanding loan balance. Statements may also provide information regarding the allocation of the consumer's previous payments. The Agencies caution lenders to be careful to avoid leading payment option ARM borrowers to select a non-amortizing or negatively amortizing payment (e.g., through the format or content of monthly statements).

Illustrations of Consumer Information

To assist lenders in implementing the contemplated consumer disclosures, the Agencies have published for comment *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products*.[4] The illustrations are not intended as model forms and lenders are not required to use them. Instead, they are provided as illustrations of the type of information the Guidance contemplates that lenders will provide to consumers. The Agencies seek public comment on all aspects of the proposed illustrations, including whether these particular illustrations or a modified form should be adopted. Comments on the proposed illustrations are due by December 4, 2006.

Practices to Avoid

Lenders are also cautioned to avoid the following:

- Placing advertisements that emphasize comparatively lower initial payments without also providing clear and comparably prominent information alerting the consumer to risks (e.g., that these payment amounts will increase, that a balloon payment may be due and/or that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments, as applicable)
- Promoting payment patterns that are structurally unlikely to occur
- Making (1) unwarranted assurances or predictions about the future direction of interest rates; (2) inappropriate representations about the "cash savings" to be realized from nontraditional mortgage products in comparison with amortizing mortgages; (3) statements suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and (4) misleading claims that interest rates or payment obligations for these products are "fixed"

Legal Risks

Lenders offering nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations, including TILA, Section 5 of the FTC Act, fair lending laws, RESPA and any relevant state laws. Moreover, the Agencies caution lenders that the sale or securitization of a loan may not affect the lender's potential liability for violations of laws relating to loan origination.

Control Systems

The Agencies recommend that lenders develop and use strong control systems to ensure that for all loans, including third-party originations and loans purchased from other lenders, actual practices are consistent with the lender's policies and procedures. Lenders should design control systems to address the foregoing compliance, disclosure, and safety and soundness concerns. They should also ensure that personnel are trained and able to convey information to consumers about product terms and risks in a timely, accurate and balanced manner. Lending personnel should be monitored to determine whether they are conveying appropriate information, and lenders should review consumer complaints to identify potential compliance, reputation and other risks. Attention should also be paid to appropriate legal review and to using compensation programs that do not improperly encourage originators to direct consumers to particular products.

With respect to nontraditional mortgage loans made, purchased or serviced using a third party, such as a mortgage broker, correspondent or other intermediary, lenders should take appropriate steps to mitigate risks relating to compliance and consumer information concerns. Steps include, but are not limited to, (1) conducting due diligence and establishing criteria for third-party relationships, (2) structuring third-party compensation to avoid providing incentives for originations inconsistent with the Guidance, and (3) implementing corrective action in the event that the third party fails to comply with applicable agreements, bank policies or laws.

Consumer-Friendly Brochure

In an effort to educate consumers regarding nontraditional products, on October 18, 2006, the Agencies published a consumer-friendly brochure entitled *Interest-Only Mortgage Payments and Payment-Option ARMs – Are They For You?* This new resource is intended to help consumers make more informed choices when considering nontraditional mortgage loans and gauge whether a nontraditional product is right for them. The brochure, which includes a glossary of industry terms and a "mortgage shopping worksheet," stresses the importance of understanding key mortgage loan terms, warns of the risks consumers may face when selecting nontraditional products and urges borrowers to be realistic about whether they can handle future payment increases. If consumers are not comfortable with these risks, the brochure suggests that they ask about other mortgage products.

Call Report and TFR Revisions

On October 31, 2006, the OCC, Board and FDIC also proposed revisions to bank Call Reports that would require all banks to report the total amount of their single-family, closed-end mortgage loans with negative amortization features.[5] Banks with a "significant volume" of such loans would also be required to report additional information, including the total maximum remaining amount of negative amortization contractually permitted, the total amount of negative amortization included in the carrying amount, and year-to-date non-cash income on such loans. The three banking agencies requested comments on the proposal—including suggestions for the specific dollar amount and percentage of portfolio "significant volume" thresholds to trigger the additional reporting requirements—by January 2, 2007. The changes would be effective March 31, 2007.

The banking agencies explained that these reporting changes would enable regulatory monitoring because the current reporting classifications do not provide a readily available means for identifying the industry's exposure to negative amortization loans. The OTS proposed similar revisions to the Thrift Financial Report in July 2006 to require reporting of the total amount of single-family adjustable rate loans with negative amortization and the total capitalized negative amortization on such loans.[6] These reporting changes could further increase scrutiny of nontraditional mortgage lending, possibly resulting in the imposition of heightened capital requirements on lenders with concentrations of such portfolios.

State Guidance?

The Guidance applies only to mortgage lenders that are supervised by the federal banking Agencies, and it does not apply to other lenders. Recently, however, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed similar model guidance to state agencies that regulate residential mortgage brokers and companies on the risks posed by nontraditional mortgage products. CSBS and AARMR stated that their proposal is intended to mirror substantially the federal interagency Guidance except for the deletion of sections that do not apply to nondepository institutions and sections that are not appropriate for brokers and other nonbank lenders who are merely facilitating the transactions (e.g., by connecting the borrower with the lender) and are not holding these loans in portfolio. CSBS and AARMR encouraged state regulatory agencies to adopt the guidance for the brokers and lenders they regulate. Unlike the federal Guidance, however, the CSBS and AARMR proposal is not binding, and each state regulator must decide whether to adopt and enforce such model guidelines or make changes to them. The Mortgage Bankers Association and federal regulators have urged the states to adopt such similar guidelines so that all mortgage companies may operate on a level, nationwide playing field.

Conclusion

The Guidance and other changes discussed in this newsletter demonstrate regulators' increased scrutiny of nontraditional mortgage products, but the long-term impact of these developments is unclear. The Guidance does not propose any new regulations, nor does it apply many specific limits. Instead, it sets forth a series of guidelines regarding appropriate lending practices. Accordingly, the impact of the Guidance may ultimately depend on the manner in which it is interpreted and applied in individual cases by the Agencies and their examination staffs.

NOTES

1. 71 Fed. Reg. 58609.
2. 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).
3. Refer to 12 CFR Part 3 Appendix A, Section 4 (OCC); 12 CFR Parts 208 and 225, Appendix A, III.B.3 (FRB); 12 CFR Part 325, Appendix A, II.B (FDIC); 12 CFR 567 (OTS); and 12 CFR Part 702 (NCUA) for each Agency's capital treatment of recourse.
4. 71 Fed. Reg. 58672.
5. 71 Fed. Reg. 63848.
6. 71 Fed. Reg. 43286.

FOR MORE INFORMATION ON THIS OR OTHER FINANCIAL INSTITUTIONS AND SECURITIES MATTERS, PLEASE CONTACT:

Russell Bruemmer +1 202 663 6804 russell.bruemmer@wilmerhale.com

Reginald Brown +1 202 663 6430 reginald.brown@wilmerhale.com

David Luigs +1 202 663 6451 david.luigs@wilmerhale.com

Lia Silva Grassi +1 202 663 6520 lia.grassi@wilmerhale.com