

## AGENCIES ISSUE GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

The federal bank regulatory agencies (the “Agencies”) have issued joint guidance (71 Fed. Reg. 58609) (the “Guidance”) intended to clarify how financial institutions can offer nontraditional mortgage products in a manner that is safe and sound for the institution, while clearly disclosing to borrowers the risks that these products may present. The Guidance was effective upon publication. Samples of the information that consumers must be given about such products were published in proposed form with the Guidance, but have not yet been finalized. The Guidance will remain separate, in that it will not become part of Regulation Z or any other regulation, but it will nonetheless apply to all federally regulated financial institutions.

The Guidance does not prohibit banks from offering nontraditional mortgage products or establish a suitability requirement to identify those consumers for whom this type of product is appropriate. Instead, it requires a bank to take steps to mitigate the risk of default that this type of loan represents to the bank and to better inform consumers about the features of these products and their potentially negative impact on consumers.

It is unlikely that the Guidance will be the final word on nontraditional mortgage products. Some members of Congress are advocating more restrictive legislation for those products and their potentially predatory aspects, while others are exploring the possibility of legislating a suitability test for all mortgage loan applicants. Some state legislatures are also considering the need to adopt statutory restrictions for this type of loan product.

### *NONTRADITIONAL MORTGAGE PRODUCTS*

The Guidance targets the increasing use of “nontraditional mortgage products” (“NMPs”) that allow borrowers to defer payment of principal or interest, in effect exchanging lower initial payments for higher payments during a later amortization period. NMPs specifically include “interest-only mortgages” and “payment option ARMs”, which are defined below. Increasingly, these products have been used to qualify borrowers, based on lower initial payments, for loans they would not otherwise be able to obtain. When the amortizing payments begin, payment amounts increase precipitously – often to a level that the consumer cannot pay. If he is not able to sell his home and pay off the loan or refinance the balance at a lower rate, default and foreclosure follow.

For purposes of the Guidance, an “interest-only mortgage loan” is a mortgage loan with terms that, for a specific number of years (typically three or five years), only require the borrower to pay the interest due on his loan, during which time the interest rate may vary or be fixed. When the interest-only period ends, the loan will begin to amortize, so that payments will include principal and interest.

A “payment option ARM” is a loan that allows the borrower to choose from among several alternative payment options. For example,

each month the borrower may be able to choose an option for a minimum payment based on a low introductory rate, an interest-only payment based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15- or 30-year loan term, plus any required escrow payment. The amount of the payment due under the minimum payment option may be less than the amount of interest actually accruing on the loan, resulting in negative amortization. (The payment due under the interest-only option covers accrued interest, so it does not result in negative amortization, but it does not amortize the principal balance.) After a specified number of years, or if the loan balance reaches a specified negative amortization cap, the required monthly payment is “recast”, or recalculated, to a required payment amount that will fully amortize the loan’s outstanding balance over the remaining loan term.

The Agencies excluded home equity lines of credit (“HELOCs”) from coverage under the Guidance, except in connection with simultaneous second-lien loans, discussed below, because HELOCs are already subject to specific guidance, issued in May 2005. However, as discussed in more detail below, the Agencies have amended the May 2005 HELOC guidance to address some of the same consumer disclosure recommendations that are included in the Guidance for closed-end loan products. Reverse mortgages are excluded altogether from the Guidance.

NMPs are not new products, but the number of institutions offering them has increased dramatically. In addition, these products are more frequently being offered to borrowers who cannot qualify for traditional mortgage loans. The Guidance was issued as a result of the Agencies’ concern that a borrower who gets an NMP loan may not fully understand the risk that, with an NMP, his principal balance is not amortizing and, with a payment option ARM, there is a possibility that his principal

balance could increase through negative amortization. Apparently, the Agencies believe that a full and accurate advance description of the NMP loan terms will dissuade consumers from undertaking loans that are also too risky for them.

In addition to their inherent risks, the hazards associated with NMPs may be heightened when institutions combine them with other loan features such as simultaneous second-lien mortgages and reduced documentation loans, a practice referred to as “risk layering” in the Guidance.

In view of the heightened risk levels these products present, the Guidance directs bank management to sufficiently consider and mitigate exposures created by NMPs by:

- Ensuring that loan terms and underwriting standards are consistent with prudent lending practices, including evaluation of a borrower’s repayment capacity; and
- Recognizing that many NMPs, particularly those that involve risk-layering, have never been tested in a stressed economic environment. An institution offering NMPs should implement strong risk management standards, capital levels that are adequate to cover the risks and an allowance for loan and lease losses that reflects the loan portfolio’s collectibility.

#### LOAN TERMS AND UNDERWRITING STANDARDS

The Agencies expect that, when underwriting an NMP, an institution will factor in the probable effect that a significant payment increase would have on the borrower’s capacity to repay when the loan begins to amortize. Banks are urged to maintain prudent lending

practices and not to relinquish underwriting standards to third parties with different business objectives, despite competitive pressures.

Qualifying Borrowers: An NMP's payment amount can increase dramatically when the amortization period starts – especially in the case of an option ARM that allows the borrower to make minimum payments, which could result in negative amortization. A drastic increase in the amount of the borrower's payment is referred to in the Guidance as “payment shock.”

A bank may attempt to minimize the possibility of “payment shock” by limiting the spread between the NMP loan's initial rate and the fully indexed rate, avoiding an extremely low initial rate. However, every bank (including one that caps the maximum spread) must recognize that potential payment shock may nevertheless create problems for the borrower and set its underwriting standards accordingly. Borrowers with high loan-to-value ratios, high debt-to-income ratios and low credit scores may be particularly vulnerable and, therefore, inappropriate candidates for this type of mortgage loan product.

The Guidance makes clear that, for any NMP and any potential borrower, the bank's analysis of the applicant's repayment ability should take into consideration the applicant's ability to continue making timely payments in a “worst case scenario”. That is, NMP underwriting procedures should include an evaluation of the applicant's ability to continue making timely payments and repay the debt by the maturity date at the fully indexed rate, assuming a fully amortizing repayment schedule.

For these purposes, a “fully indexed rate” is the index rate at origination plus the margin that will apply after any introductory discounted rate period ends. The fully amortizing payment schedule should be based

on the loan's term. For example, the amortizing payment for a loan with a five-year interest-only period and a thirty-year term would be based on a thirty-year amortization schedule. For a balloon payment loan that contains a borrower option for an extended amortization period, the fully amortizing payment calculation should be based on the full term that the borrower may choose.

The Guidance discourages an underwriting process that relies on an applicant's credit score, rather than actual verification of an applicant's income. The higher the credit risk that a loan presents - either from the perspective of loan terms or the applicant's characteristics – the more important it is for the bank to verify the borrower's income, assets and outstanding debts.

Collateral-Dependent Loans: The Guidance warns against the use of loan terms and underwriting practices that may increase the need for a borrower to rely on his ability to sell or refinance his property once amortization begins. It is generally an unsafe and unsound practice for a bank to make a loan to an individual who doesn't have the capacity to repay the loan as structured from sources other than the collateral property.

Risk-Layering: The risk of nonpayment is heightened in an NMP loan underwritten with reduced documentation or a simultaneous second-lien loan. (Each of these features is discussed below.) When risk features are layered, a bank should document the mitigating factors supporting its underwriting decision and the borrower's repayment capacity. Such mitigating factors include higher credit scores, lower loan-to-value and debt-to-income ratios, significant liquid assets or some form of credit enhancement. Merely increasing the price of a loan to address elevated risk levels does not eliminate the need for sound underwriting.

The Guidance does not prohibit risk-layering but urges the use of strong quality control and offsetting risk mitigation factors that reduce the risk of nonpayment. A reduced documentation, interest-only loan may be acceptable for one of the bank's better customers because of mitigating factors like a favorable debt-to-income ratio and significant liquid assets, whereas the same features in a loan to a less creditworthy borrower make the loan risky and, perhaps, inappropriate.

Reduced Documentation: The reduced documentation feature is often referred to as "low doc/no doc", "no income/no asset," "stated income" or "stated assets". In a loan with this feature, a bank requires reduced or minimal documentation to substantiate the applicant's income and assets.

Banks are increasingly relying on reduced documentation (especially unverified income) to qualify borrowers for NMPs. This practice is based on assumption and unverified information, rather than an analysis of a borrower's general creditworthiness, and, for that reason, should be used with caution. A bank should have clear policies that define when it may use reduced documentation. For example, stated income should be accepted without verification only when mitigating factors minimize the need for direct verification.

Reduced documentation loans should be the exception rather than the rule. For most borrowers, a bank generally should be able to document an applicant's income using W-2 statements, pay stubs or tax returns.

Simultaneous Second-Lien Loans: The Guidance defines a simultaneous second-lien loan as a lending arrangement in which a second-lien loan – closed-end or a HELOC – is originated simultaneously with the first lien loan, usually in lieu of a higher down payment. As a result of this arrangement, the borrower typically has

little or no equity in the home and may be less inclined to attempt to avoid foreclosure. Last year, in a significant percentage of purchase money loans made nationwide, borrowers made no down payment and financed 100% of the cost of their homes. Historically, high loan-to-value ratios translate into a high rate of defaults. Furthermore, if the second-lien loan is subject to a variable interest rate, it is likely that the interest rate and monthly payment amount will increase over the life of the loan.

Introductory Interest Rates: In some markets, it is not uncommon for a lender to offer an introductory rate that is set significantly below the fully indexed rate in order to make payment option ARMs more appealing. When the initial discount period elapses, the borrower's payment amount may increase dramatically – resulting in severe payment shock and increasing the risk of default. The Guidance recommends limiting the potential spread between the initial and the fully-indexed rates, limiting (but not eliminating) the likelihood of extraordinary payment shock.

Lending to Subprime Borrowers: Subprime mortgage products should comply with the interagency guidance specifically for subprime lending (Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Program, January 31, 2001). A bank entering the subprime market should be careful to comply with that guidance and recognize that risk-layering features in loans to subprime borrowers can result in predatory or abusive lending, which may significantly increase risks for both the bank and the borrower.

Non-Owner-Occupied Investor Loans: A borrower seeking a loan to finance the purchase of investment property should qualify based on his ability to service the debt over the life of the loan. Underwriting standards should require evidence that the applicant has sufficient

savings to service the loan during extended periods when the investment property is vacant.

### **PORTFOLIO AND RISK MANAGEMENT PRACTICES**

The Guidance stresses the need for a bank to ensure that its risk management policies evolve so as to keep up with the growth of its NMP portfolio. This is especially important for a bank that expects to have or has already had significant growth in its NMP portfolio. Banks that offer NMPs should adopt more robust risk management practices.

The following procedures might be incorporated into risk management practices that are appropriate for NMP products:

- 1) Develop written policies that identify acceptable product features, production and portfolio limits and risk management expectations. Banks with significant concentrations in NMPs should develop strong monitoring systems and risk management practices;
- 2) Implement enhanced performance measures and management reporting requirements that will alert management early on to increasing risk;
- 3) Set appropriate allowances for loan and lease losses (“ALLL”) levels that reflect the portfolio’s credit quality and conditions that affect collectibility; and
- 4) Hold capital in amounts commensurate with the risk characteristics of the bank’s NMP portfolio.

Third-Party Originations: The Agencies have emphasized that banks using brokers or correspondents to originate NMPs should have

strong controls in place for establishing and managing relationships with these third parties, including due diligence procedures. Reliance on third-party relationships to originate NMP loans can increase a bank’s risk profile significantly. Oversight of third parties should include monitoring the quality of the loans they originate, so that those loans reflect the bank’s lending standards and compliance with applicable law and regulations. A bank’s risk management system should reflect the complexity of its third party relationships and the overall level of risk involved.

Secondary Market Activities: A bank that sells a significant number of loans in the secondary market should have in place comprehensive, formal risk management strategies. A bank with significant secondary market activity should have a contingency plan that specifies how the bank will respond to a downturn in secondary market demand.

Selling a loan to a third party may transfer a portion of that loan’s credit risk to the purchaser. However, the originating bank remains exposed to reputation risk when credit losses on sold mortgage loans or securitized transactions exceed expected levels. When problems develop with those secondary market loans, a bank may conclude that, in order to protect its reputation and maintain its access to the market, it must repurchase the defaulted loans. The Agencies view such a repurchase that goes beyond the selling bank’s contractual obligation as implicit recourse. Classifying those loans as recourse loans would require a repurchasing bank to maintain risk-based capital against the entire pool of loans or securitization. Before deciding to repurchase defaulting loans, a bank should become familiar with these capital guidelines.

Management Information: A bank’s reporting systems should enable management to detect changes in the risk profile of its portfolio of

NMP loans. At a minimum, information about NMP loans should be available for analysis by loan type (e.g., interest-only mortgage loans and payment option ARM loans), by risk-layering features (e.g., interest-only loans with simultaneous second-lien mortgage loans), by underwriting characteristics (e.g., loan-to-value and debt-to-income ratios and credit scores) and by borrower performance (e.g., payment patterns, delinquencies, interest accrual and negative amortization).

NMP portfolio volume and performance should be tracked against expectation, internal lending standards and policy limit. When actual performance deviates from established policies and thresholds, qualitative analysis should be undertaken.

*Stress Testing:* A bank involved in NMP lending should conduct a sensitivity analysis on key loan portfolio segments to identify events that could potentially increase risk in the bank's NMP portfolio. The analysis should encompass key performance elements, such as interest and unemployment rates, economic growth, fluctuation in housing value and other factors beyond the bank's immediate control. A "stress test" typically assumes rapid deterioration in one or more performance factors and attempts to estimate the potential influence on default rates and loss severity.

With stress testing, a bank should be better able to identify, monitor and manage risk, while developing appropriate loss mitigation strategies. The results should provide direct feedback for use in setting underwriting standards, product terms, concentration limits and capital levels.

*Capital and ALLL:* A bank's level of activity in the NMP market should be reflected in the appropriate ALLL for the estimated credit loss inherent in its NMP loan portfolio. The higher

risk of loss posed by layered risks should also be considered when a bank sets its ALLL.

A bank's limited performance history with NMP products – particularly in a stressed environment – increases performance uncertainty, which increases the need for higher capital levels. When determining an appropriate ALLL and considering its capital adequacy, a bank should segment its NMP loan portfolio with similar risk characteristics, including:

- Collateral and loan characteristics;
- Geographic concentrations; and
- Borrower qualifying attributes.

Segments could also identify loans by payment and characteristics, such as:

- Loans on which the borrower usually makes only the minimum payment;
- Loans with existing balances higher than original balances; and
- Loans subject to significant payment shock.

The goal of this analysis should be to identify credit quality indicators that affect collectibility for purposes of ALLL measurement and gather meaningful information about future loss exposure to help determine adequate capital levels.

### **CONSUMER PROTECTION ISSUES**

The Guidance resulted in large part from the Agencies' concern that consumers often enter into NMP loans without fully understanding their loan terms. These products have been promoted based on the lower initial monthly payments when compared to traditional mortgage loans, typically with little or no discussion about what will happen to later

payments. To address this concern, the Guidance requires banks to take appropriate steps to inform consumers about the risks of these products and to provide that information in a timely manner – before Truth in Lending Act (“TILA”) disclosures are required.

The Guidance mandates that *any* communications with consumers relating to NMP products – including advertisements, oral statements, promotional materials and monthly statements – must provide clear information about both the relative benefits and the risks these products present, including the risk of payment shock and negative amortization. Informal advice from the Federal Reserve Board indicates that the “monthly statements” with which the additional information must be included was really intended to target the statements that are provided to payment option ARM borrowers. It was not meant to include HELOC statements unless they include a solicitation for an NMP loan.

A bank offering NMPs must also ensure that the loans comply with all applicable laws and regulations, including TILA and Regulation Z (including its advertising requirements), Section 5 of the Federal Trade Commission Act prohibiting unfair or deceptive acts or practices, the fair lending laws and the Real Estate Settlement Procedures Act. State laws may also apply.

There has already been litigation<sup>1</sup> involving an NMP loan in which the trial court ruled that the plaintiffs could rescind their NMP loan because of the lender’s failure to clearly and conspicuously make several material disclosures. Furthermore, the judge ruled that the plaintiffs could represent a class of similarly situated consumers in a class action seeking rescission. While this district court decision seems to be based on equity rather than statute,

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<sup>1</sup> Andrews v. Chevy Chase Bank, FSB, No. 05C0454, 2007 U.S. Dist. Wisconsin (Jan. 16, 2007).

it may be an indication of the types of claims that could arise from ambiguous NMP documents. To those banks offering these products, it is crucial to clearly, conspicuously and unambiguously describe the terms of an NMP loan to minimize litigation risk.

The supplementary materials published with the Guidance reflect the fact that the Agencies anticipate that information about NMPs may be provided to consumers in a brief narrative format, using examples based on hypothetical loans rather a transaction specific to the reader. The additional information will most likely be provided in the form of a supplement to other materials that are being furnished to an applicant, such as the early ARM disclosures that Regulation Z requires.

Rather than publishing required model disclosures as part of the Guidance, the Agencies have provided a set of “best practices” (discussed below) to help banks address NMP risks. In addition, they published several potential suggested disclosures (71 Fed. Reg. 58672, attached) simultaneously with the Guidance and are currently considering the public comments received in response to the publication of the proposed forms. We will advise you when the sample illustrations are finalized. Use of the illustrations of consumer information regarding Agencies’ NMPs is purely voluntary. These are not model forms, and banks are free to develop their own consumer information documents to satisfy the Guidance requirements. In addition, it has been reported that the Mortgage Bankers Association is drafting its own set of disclosures that banks may elect to use.

In view of the complexity of these products, it will be especially important to ensure consistency among the NMP information, early ARM disclosures, TIL disclosures and promissory note terms that your bank utilizes in connection with NMP loans. You may wish to have your legal counsel

review the various disclosures and documents for consistency.

### RECOMMENDED PRACTICES

Communications With Consumers: The Guidance requires banks to provide consumers with information about NMPs at a point in time when that information will help a consumer select a product and payment option that are most appropriate for him. Information should be provided when the consumer is shopping for a mortgage loan – such as when he makes an inquiry about a mortgage product and receives information about an NMP – before he submits an application or consummates a loan. This information would supplement any early disclosures required by Regulation Z, and should be closely reviewed with those disclosures to identify and eliminate any inconsistencies. Product descriptions should provide information about the costs, terms and risks of NMPs, including information about the following features.

(1) Payment Shock: Consumers should be informed about the potential increases in payment amounts for NMPs, including circumstances in which interest rates or negative amortization could reach a contractual maximum. For example, a product description could reflect:

- The maximum monthly payment a consumer could be required to pay in a hypothetical example, once amortizing payments are required and the interest and negative amortization caps are reached;
- When structured payment changes will occur (e.g., when the initial discounted rate expires or amortizing payments are required);

- What the new payment amount would be or how it would be calculated; and
  - The possibility, when applicable, that a higher payment may be required at other points during the term of the loan due to factors like negative amortization or interest index rate increases.
- (2) Negative Amortization: If this is a feature of an NMP loan, the consumer should be warned of the potential for increasing the loan's principal balance, decreasing home equity and any other adverse impacts of negative amortization. For example, the description of this feature could disclose:
- The effect of negative amortization on loan balances and home equity; and
  - The potential consequences of making minimum payments that cause the loan balance to increase because of negative amortization.
- (3) Prepayment Penalties: If prepayment penalties are possible, the consumer should be alerted to that fact and instructed to ask the lender about the amount of the penalty.
- (4) Cost of Reduced Documentation Loans: If your bank offers both reduced and full documentation loans and there is a difference in the pricing – that is, if there is an additional cost for the reduced documentation product – consumers should be informed of that.
- (5) Payment Option ARMs – Monthly Statements: If your bank provides

monthly statements to borrowers with payment option ARMs, the statement must include information that would enable a consumer to make an informed payment choice, including an explanation of each available choice and the impact of that choice on the loan balance. For example, next to the minimum payment amount, there should be an explanation of the fact that, as a result of choosing this option, the consumer's loan balance would increase. The statement should also reflect how the previous payment was allocated to principal and interest and, if applicable, the amount by which the principal increased. Banks offering payment option ARMs should avoid using the format or content of monthly statements to encourage consumers to select a non-amortizing payment or one that results in negative amortization.

Practices to Avoid: The Guidance urges banks offering NMPs to avoid the following practices:

- (1) Obscuring significant risks to the borrower. If a bank advertises an NTM product by emphasizing the lower initial rate for that product, it must also include a prominent warning about the risks to consumers.
- (2) Promoting payment patterns that are structurally unlikely to occur.
- (3) Giving consumers baseless predictions about the future movement of interest rates (and the amount of borrower payments).
- (4) Making one-sided representations about the savings or expanding buying power that the consumer will realize by choosing the NMP product over an amortizing mortgage.

- (5) Suggesting that initial minimum payments in a payment option ARM will cover accrued interest charges.
- (6) Making misleading claims that interest rates or payment amounts for these products are fixed.

### **STATE LAW ACTION**

The Guidance applies only to federally insured deposit institutions, and their subsidiaries, which puts them at a competitive disadvantage with nonbank lenders that are not subject to the restrictions of the Guidance. To level the playing field, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have published guidance equivalent to the Agencies' Guidance and encouraged state regulators to adopt it for nonbank mortgage lenders. To date, regulators in 27 states (which do not include Louisiana) have adopted that guidance, and that number is expected to increase.

### **HELOCs**

HELOCs are excluded from coverage under the Guidance, except to the extent that a HELOC may be a risk-layering feature when it is issued as a simultaneous second-lien line, because HELOCs are subject to prior guidance from the Agencies (May 2005).

The Agencies have issued a separate addendum to their prior HELOC guidance (the "Addendum"), instructing banks to provide certain information to consumers when promoting HELOCs that permit interest-only payments. The interest-only feature is very popular among banks that offer HELOCs, so this Addendum may have wider applicability among community banks than the Guidance.

The Addendum requires that any promotion or description of a HELOC that permits interest-only payments should provide

consumers with information that will help them make better informed decisions about the products that are best for them.

Any communications with consumers about HELOCs, including advertisements, oral statements, promotional materials and periodic statements, should provide concise information about the relative benefits and risks of HELOCs with interest-only features. The Addendum specifies that this material should inform the consumer about the risk of increased future obligations that may result from interest rate increases and the end of the interest-only payment period. If applicable, HELOC materials should also alert the consumer about any prepayment penalty that the consumer will incur if he pays off the balance and terminates the HELOC before its contractual maturity date and the need to inquire about that amount of that penalty. Consumers should also be advised of any premium that may be charged for reduced documentation HELOCs.

This information should be provided early in the product selection process, when the consumer is shopping for a loan, not just when an application is provided or at consummation. For example, this information could be provided when a consumer asks about HELOCs and receives information about products with interest-only features, or when the bank gives the consumer HELOC marketing materials.

The Addendum indicates that banks should also make an effort to (1) focus on the information that is important to the consumer in selecting a HELOC product; (2) emphasize key information so it will be more easily noticed; (3) use plain language with concrete, realistic examples. It may also be useful to utilize comparative tables and information describing key features of available loan products.

As the Guidance emphasized, the Addendum's requirements supplement but do

not replace Regulation Z's disclosure requirements for HELOCs.

The Addendum does not include any illustrations of how the required information might be provided to consumers. You may wish to review the proposed illustrations accompanying the Guidance and, as applicable, adapt them for use with interest-only HELOCs.

### ***CONCLUSION***

We will continue to monitor activity involving nontraditional mortgage products at the state and federal levels and will advise you of any future developments.

You can review a copy of the Guidance and the Addendum on the Compliance Center website, or obtain hard copies by calling Tammy Arrigo at (504) 596-2821.