

Department of the Treasury

## Regulatory Bulletin

## RB 37-11

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



Handbook: Examination Handbook

Subject: Asset Quality

Sections: 201, 211, 212

## Examination Handbook Update

**Summary:** This Regulatory Bulletin transmits Examination Handbook Section 201, Overview – Lending Operations and Portfolio Risk Management, Section 211, Loans to One Borrower, and Section 212, One- to Four-Family Residential Lending. The Office of Thrift Supervision (OTS) is substantially revising and reorganizing the asset quality sections of the Examination Handbook, and is issuing these sections as a first step in this process. The handbook sections replace existing guidance found in Thrift Activities Handbook Sections 210, Lending Risk Assessment; 211, Loan Portfolio Diversification; and 212, Real Estate Mortgage Loans.

**For Further Information Contact:** Your OTS Regional Office or Bill Magrini in the Credit Policy Division of the OTS, Washington, DC, at (202) 906-5744. You may access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

### Regulatory Bulletin 37-11

#### OVERVIEW

In the last year alone, house prices have increased by over 23% in California, nearly 23% in Washington, DC, and by over 32% in Nevada. Nationally, prices have risen by more than 11%. In the meantime, longer-term interest rates have remained near their historical lows. These conditions have led to a rapid expansion in residential mortgage and home equity lending as well as the introduction of new products, such as interest-only mortgages, tailored to this environment. Rapid growth, high refinance volumes, unseasoned portfolios, and a favorable business environment have created abnormally low loss rates on these and other mortgage-related products. This may cause some lenders to underestimate the actual risk inherent in these activities.

The strong growth in these higher-risk lending programs over the past few years requires a close evaluation of and a thorough assessment of the risks inherent in such programs. The Examination Handbook sections issued today outline OTS expectations that savings associations fully address the risks and challenges posed by these evolving lending products, establish prudent lending standards, and maintain risk management functions commensurate with their size and risk profile.

Examination Handbook Section 201 is new. Sections 211 and 212 have been substantially revised. While Section 201 focuses primarily on the need for sound credit policies and lending standards, Section 211, focuses on the statutory loans to one borrower lending limits, and Section 212 focuses on one- to four-family residential mortgage lending, including first mortgages, second mortgages, and home equity lines of credit.

# Regulatory Bulletin 37-11

---

The revisions to Section 212 reflect the growing diversity and sophistication of lending products in the one- to four-family first mortgage and home equity mortgage markets. Several new areas have been added to Section 212, including discussions on negative amortizing, interest only, and no-doc loans.

## SUMMARY OF HANDBOOK SECTIONS

### **201 Lending Overview – Lending Operations and Portfolio Risk Management**

The guidance in this section is designed to facilitate OTS's top-down, risk-focused examination process. This new handbook section addresses the board and management's responsibilities for establishing and overseeing a lending function that is consistent with the thrift's defined business strategy, risk capacity, and previous business practices. It addresses expectations for overall loan portfolio risk management, not just by product line, but also across portfolios and in relation to other risks managed by institutions.

The section discusses the board of directors and management's responsibilities to implement, manage, and oversee an effective lending operation, in terms of strategic planning, loan portfolio diversification, and loan policies (including underwriting standards, documentation standards, and credit administration). It addresses these responsibilities from an institution-wide perspective in order to assess management's and the board's ability to manage the overall lending function, not just its component parts. This section also discusses the importance of lending operations, risk management through appropriate management information systems, internal loan review, and adequate internal controls.

This handbook section and examination procedures should be used in conjunction with other handbook sections that provide guidance for specific lending programs. We have consolidated certain examination discussions and procedures into this section to eliminate redundant reviews.

Two revised questionnaires accompany Section 201: the revised Lending Overview Questionnaire and the revised Loan Portfolio Diversification Questionnaire.

### **211 Loans to One Borrower**

This handbook section addresses loans-to-one-borrower (LTOB) limitations applicable to savings associations. We revised this section to provide OTS examiners and savings association personnel with more comprehensive and updated guidance on the LTOB limitations, exceptions and exclusions.

The section describes the statutory and regulatory requirements governing loans to one borrower, as well as the General Lending Limitation applicable to most loans and how that limitation is calculated.

The section also discusses the various exceptions to the General Lending Limitation, including: the \$500,000 exception; statutory exceptions for loans with special lending limits and loans not subject to lending limits; loans to develop domestic residential housing units; the extended special rule for residential, small business and small farm loans; and other exceptions regarding government sponsored agency obligations, corporate debt and commercial paper, asset-backed securities, and bank owned life insurance.

Included in this handbook section are discussions of the general recordkeeping requirement for LTOB lenders, definitions of borrower and loans; and a savings association's authority to use salvage powers, in certain situations, to exceed the LTOB limitations.

## 212 One- to Four-Family Residential Lending

This handbook section, addressing one- to four-family residential real estate lending, has been substantially revised to address the elements necessary for a successful real estate lending operation; and, to highlight risk and underwriting considerations for specific types of mortgage loan products, including:

- Low- or no-documentation mortgage loans.
- Adjustable-rate mortgage loans, including those with interest-only and negative amortization features.
- Home equity loans and lines of credit.
- Reverse mortgage loans.

This handbook section discusses recent trends in the mortgage origination business and the risks associated with the different types of lending products. It incorporates the Interagency Real Estate Lending Standards, including documentation standards (particularly standards for reduced documentation loan programs), supervisory loan-to-value limits, loan administration, loan exceptions, appraisals and evaluations. It also addresses portfolio risk management, as well as interest rate risk, automated underwriting, compliance and capital considerations.

This section provides new or updated guidance related to subprime mortgage loans, adjustable-rate mortgage loans (particularly those with negatively amortizing and interest-only features), home equity loans and lines of credit, manufactured housing loans, and reverse mortgage loans.

Included with this handbook section are appendices on: Questions and Answers on the Interagency Real Estate Lending Standards; Interagency Guidance on High Loan-To-Value Residential Real Estate Lending; Additional Guidance on Reverse Mortgage Loan Programs; Additional Guidance on NegAm Loan Programs; and Credit Risk Management Guidance for Home Equity Lending.



—Scott M. Albinson




**Managing Director  
Examinations and Consumer Protection**

**THIS PAGE INTENTIONALLY LEFT BLANK**

## Overview: Lending Operations and Portfolio Risk Management

Lending is the principal business activity for most savings associations. The loan portfolio is typically the largest asset and the most predominant source of income. As such, it is one of the greatest sources of risk to an association. Lax credit standards, poor portfolio risk management, or poor internal controls can expose an association to excessive loss. Effective management of the loan portfolio and the credit function is fundamental to an association's safety and soundness.

The risks associated with any specific lending program or activity will depend in large part on:

- | L I N K S  |   |
|--|---|
|  <a href="#">Program</a>                                    | <ul style="list-style-type: none"><li>• The extent to which the activity is in keeping with the strategic direction and risk capacity of the association</li><li>• How it fits in with the other activities of the association</li><li>• The adequacy of lending policies and procedures, underwriting and documentation practices, and pricing decisions</li><li>• Monitoring and reporting systems, and internal controls</li></ul> |
|  <a href="#">Questionnaire: Lending Overview</a>            |   |
|  <a href="#">Questionnaire: Portfolio Diversification</a> |   |
|  |   |
- The experience and knowledge of staff
  - Current and prospective market conditions
  - Interest rates
  - Financial condition of the association

Credit risk should be assessed across the entire loan portfolio and within the context of other noncredit related risks. A risk management system that provides the board of directors and management the ability to identify, measure, monitor, and control risks associated with an association's lending activities as a whole is essential and must be appropriate to the size, complexity, and risk profile of the association.

While this and other sections of this handbook focus largely on **credit risks** and risk mitigation factors for various types of lending programs, there are obviously a number of other risks associated with lending activities, such as interest rate risk, market risk, operational risk and compliance risk. Management and the board of directors must ensure that lending activities are managed and evaluated in the context of the broad array of risks and their potential impact on the association's earnings and capital. For example, a loan portfolio that, although performing well financially, is riddled with

operational or compliance problems (e.g. inaccurate truth in lending disclosures, deceptive marketing practices, RESPA problems) exposes the association to substantial legal, restitution, and ultimately reputation consequences.

This overview section presents guidance fundamental to all lending programs and overall loan portfolio and credit risk management. The subsequent sections and appendices provide comprehensive detail on prudent lending and risk management practices for specific lending programs. The sections completed during an examination will depend on the types of lending activity conducted at the association and the adequacy of portfolio risk management practices. This overview section might be the only one you use for the asset quality phase of the examination for some small or low-risk associations, or for completing the lending review during a risk-focused or targeted examination. However, you should consult with the examiner-in-charge (EIC) when making this determination.

In this overview section, we will focus primarily on the responsibilities of the board of directors and management in overseeing and managing the lending function of an association including:

- Strategic planning
- Portfolio diversification
- Lending policies:
  - Underwriting standards
  - Documentation standards
  - Credit administration
- Portfolio Risk Management:
  - Internal loan review
  - Management Information Systems
  - Internal controls

## **RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT**

### **Strategic Planning**

The board of directors has the fiduciary responsibility for all of the activities of the association. The board is responsible for establishing the strategic direction and investment objectives of the association. An association's lending activities should be in keeping with the strategic direction of the association. When developing the lending strategies, the board and management should consider:

- The association's strategic plan and risk tolerances.
- The desired composition of the portfolio: loan product mix, portfolio diversification, loan quality goals, loan growth rates, etc.
- The association's defined and targeted market areas and market conditions within those areas.
- The size, financial condition and financial goals of the association.
- The expertise of its lending and credit administration as well as compliance personnel.
- Legitimate credit needs and nature of its community.

The board of directors is also responsible for establishing a lending framework and portfolio risk-management program consistent with the size, complexity, and risk profile of the association. Elements of a sound risk-management system include:

- Adequate board and management oversight.
- Adequate policies, procedures, and strategic lending goals including lending limits.
- Adequate portfolio monitoring, risk assessment, and management information systems.
- Comprehensive internal controls.

The board of directors relies on management to operate the association on a day-to-day basis. Thus, it must select a management team that is experienced and competent, and that will follow its guidance and directives.

Management is responsible for the day-to-day operation of the association and for implementing the policies established by the board in a manner consistent with safe and sound banking practices and in accordance with laws, regulations, and supervisory policies. Management is also responsible for providing timely and accurate reports to the board of directors, to OTS, and to any other applicable regulatory agencies, such as the SEC.

## **Portfolio Diversification**

*The board of directors should address diversification strategies as part of the strategic planning process, and its decision should be reflected in the board of directors' minutes, the association's lending and risk management policies, the annual budget, and the strategic business plan. A diversification policy should contain quantified goals and objectives that establish the composition of the loan portfolio mix and limits in dollar amount or percentage of assets for each loan type, category, or geographic area.*

*Loan portfolio diversification is a means of controlling and limiting overall credit risk.* By prudently diversifying loans among different loan types, industries, borrower groups, and locations, the association can spread credit risk and limit losses that may arise from a regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics.

## *Limits and Guidelines for Concentrations of Credit*

The board of directors should establish limits on and monitor the association's concentrations of credit. A credit concentration will typically relate to a key factor (such as a common industry or employer), and when weakness develops in that key factor, every individual loan in the concentration may be affected. Certain types of concentrations may be unavoidable (or even desirable, such as single-family mortgage loans in the association's primary lending area).

**It is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.**

To evaluate both the need for diversification and collectibility of an association's loan portfolio, management should be alert to indicators of weakness in the markets served. Management should also be alert for indicators of actual or potential problems in the individual projects or transactions financed.

Indicators of potential or actual difficulties in local markets and projects may include:

- Increase in unemployment.
- High or increasing vacancy rates in the area.
- Numerous similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buy-outs.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.



- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a local market, business, or project become more pronounced, problems with related credits may also surface.

*In general, you should include in the Report of Examination concentrations that present a supervisory concern, for example, those that exceed 25 percent of core capital plus the allowance for loan and lease losses (ALLL) or two percent of total assets for undercapitalized associations. When loans have an especially high risk of loss, you should report lower levels of concentrations, such as ten percent of capital plus ALLL or one percent of assets. Moreover, it is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.*

### *Loans-to-One Borrower*

Multiple loans, or a very large loan, to one borrower, related entities, or a common enterprise, are a form of credit concentration. OTS regulation 12 CFR § 560.93 establishes a general 15 percent of an association's unimpaired capital and unimpaired surplus limit on loans-to-one borrower or a related group of borrows. The loans-to-one borrower (LTOB) regulatory limitations are an important safety and soundness standard intended to prevent financial institutions from concentrating too great a portion of their assets in any one borrower. (For further information on the LTOB limits, exceptions, and additional requirements, consult 12 CFR § 560.93 of the OTS regulations.)

### *Aggregate Limits on Loans Outstanding*

In addition to establishing controls for credit concentration risks, savings associations should establish procedures and guidelines to monitor and limit the total volume of loans outstanding (usually expressed relative to deposits, capital, or total assets), primarily to ensure adequate liquidity. In setting such guidelines, the association should consider various factors such as credit demand, the volatility of the deposit structure, and availability of alternative funding sources.

### *Limits and Guidelines for Purchasing Loans*

Associations that purchase whole and/or participation loans must thoroughly review such loans prior to purchase or commitment. The association's loan policies should address the acquisition of purchased or participation loans, establish standards for review, and require that such loans meet the underwriting, documentation, and compliance standards applied to loans originated by the association. When purchasing loans, the association may rely on the stated written underwriting standards of the originating lender, provided it performs a due diligence review of the purchased portfolio that includes a review of the loan portfolio's performance as well as a review of a statistically valid and representative sample of individual loans within the portfolio.

Major loan purchases should have board of directors or designated loan committee authorization. In addition, the association should determine the financial health and capability of the selling institution, and if the selling party retains the servicing of the loan, the association should ensure that all contracts require the selling party to administer the loan in accordance with prudent industry standards, and enable the association to change servicers if performance is inadequate. Finally, the policy should consider establishing aggregate limits on the amount of loans purchased from any single outside source.

## Loan Policies

An association's loan policies, and underwriting guidelines and procedures should communicate and support the strategic objectives for the portfolio. The loan policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it is also a statement of the bank's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the lending activities in a manner consistent with the bank's strategic direction. Loan policy sets forth standards for portfolio composition, individual credit decisions, fair lending and compliance management.

The board of directors and management should formulate lending policies that are appropriate for the size and complexity of the association's existing and planned lending operations, and ensure that the association has sufficient staff with the expertise to originate, service, and monitor the lending programs and loan portfolio. Lending policies must be specific and detailed enough to foster prudent and compliant credit practices.

If properly formulated, communicated to all lending personnel, and monitored, a well-structured and prudent lending policy will serve to guide, direct, and control the decisions of lending officers consistent with safe and sound and compliant lending practices. Because each association is unique, no single policy can best serve all associations; rather, each association should tailor its policy and procedures to its own needs and characteristics.

*It is an unsafe and unsound banking practice for a savings association not to have written well-defined policies and procedures in place for the type and complexity of its lending activity.* The lending policy should include a statement of the general credit philosophy of the association (referencing the importance of compliance with consumer credit protection laws and regulations), portfolio diversification objectives, underwriting standards, loan structure and documentation standards, loan administration policies, risk mitigation strategies, and requirements for an internal monitoring and reporting system. OTS requires general lending standards for all loans under 12 CFR § 560.1(b). In addition, 12 CFR § 560.100-101 requires associations to have written real estate lending standards. ([Examination Handbook Section 212](#) covers the latter standards in detail.)

The association's lending standards should:

- Clearly state the board of directors' objectives for the composition and risk of the loan portfolio, including the types of investments to avoid or exclude.

- Apply to loan purchases and loan participations as well as to loans originated by the association for portfolio and/or sale. *The association may not transfer the responsibility for risk analysis to another lender. The association assumes the risk of noncompliance with consumer protection laws and regulations by another lender when acquiring loans.*
- Establish a system of internal controls, monitoring, and reporting.
- State the types of management and board reports for monitoring the association's lending activities, including delinquency and asset classification reports.
- Undergo review by the board of directors at least annually to ensure that policy remains appropriate as loan performance, market conditions, and regulatory obligations change.
- Set forth the composition of the loan committee(s), the frequency of meetings, and loan approval responsibilities.
- Require the board to ratify all significant loans either prospectively or through a series of subsequent reporting events.
- Require that loan review or other monitoring personnel systematically review all credit portfolios for consistency with established lending policies, and regularly review problem credits, identify problem relationships in a timely manner, and initiate remedial action.
- Establish loan authorities and prudent officer lending limits. Moderate limits are generally established for individuals, based on the officer's position, experience, and tenure with the association. Higher lending limits are typically allowed for groups of officers or loan committees.
- Set forth underwriting requirements including the extent of financial information necessary for the type and risk of the loan, acceptable collateral limits and the means for securing a lien against the collateral, and credit file content requirements, such as loan offering sheets, records of officer, committee, and board approvals, business and guarantor credit reports, financial statements and analysis, and memoranda supporting and/or criticizing the credit.
- Establish loan administration procedures for the servicing, collection, charge-off, and foreclosure of loans and establish guidelines to ensure that charge-offs are taken in accordance with interagency standards. Establish effective collection policies and procedures to reduce lending risk and prevent loan losses.
- Establish policies and procedures for the use of automated underwriting and credit scoring systems.
- Address standards for loans made as exceptions to standard underwriting requirements, paying particular attention to fairness in underwriting exception practices.

- Establish effective loan product pricing strategies consistent with sound financial planning.

## *Underwriting Standards*

An association's first defense against excessive credit risk is the initial credit-granting process. Sound underwriting standards are key. The association's lending policies and procedures should include prudent underwriting standards to mitigate and manage credit risk. The application of sound underwriting principles to the lending process is essential to a high-quality loan portfolio.

Underwriting standards should be in keeping with the types of loans being originated. The extent of the credit evaluation needed to support the lending decision should be commensurate with the size and complexity of the loans. In today's environment, the underwriting process for certain types of credit (e.g., single-family mortgage loans, automobile financing and credit cards) is often highly standardized, automated and largely driven by secondary market requirements. For single-family mortgages, credit evaluation is often based on the borrower's credit score, debt to income ratios and the loan to value ratio. More complex lending (e.g., commercial and income property, agricultural and large consumer loans) is often not standardized and requires careful evaluation and consideration of the borrower's ability and willingness to repay the loan. Prudently underwritten loans should reflect consideration of all credit evaluation factors relevant to the type of loan, including:

- The borrower's *capacity*, or income from the underlying property or business, to adequately service the debt. (Note that in certain lending programs, including small balance consumer loans, or well-secured, low-documentation residential loans, the lender may assess the ability and willingness to repay from the borrower's credit history, collateral, and other factors.) The capacity to successfully repay debt is a critical consideration. It is important that the lender have a clear understanding of the purpose of the loan and the source of repayment so that it can be structured in a way that is consistent with realistic prospects of repayment. For business loans, the lender may determine capacity from income statements, debt coverage ratios, or cash flow analyses. For consumer loans, the lender may assess capacity from debt-to-income ratios, where the borrower's total monthly obligations are compared with gross income. The lender may use other methods. For example, if a borrower has difficulty documenting income, but has performed well on other loans of similar size with the association or with other lenders, the lender may determine that the borrower has demonstrated capacity.
- *Capital* or the money a borrower has personally invested in the property or business. How much does the borrower have at risk? Savings associations should consider the amount of equity in the property, capital invested in the business, and/or subordinated financing invested in the property or business by the borrower, guarantors or other interested parties, such as government agencies and partnerships in many CRA related investments. The association should ensure that borrowers have sufficient capital and cash flow to repay the loan even during economic downturns. Small businesses are often thinly capitalized and illiquid and may not have access to external sources of capital. Very often, the small business must rely on borrowings, secured by equity in business assets or the personal assets of the business owner to finance growth or to assist the business through a difficult period. Associations are encouraged to find

ways to accommodate the small business credit needs in their communities without exposing themselves to excessive credit risk.

- *Collateral* or guarantees as an additional form of security against the loan. Collateral is a secondary source of repayment for a loan should the borrower become unable to repay. Generally, lenders require collateral when the purpose of the loan is to purchase or refinance real estate, automobiles, recreational vehicles, or long-lived business assets. In general, the longer the term or the greater the size of the loan, the more likely and appropriate it is for the lender to require collateral. Often lenders will also require collateral for smaller, short-term loans when the borrower has not established or has only marginal credit. The association should appropriately consider any secondary sources of repayment, including any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or take-out commitments.

The association's lending policy should include an explanation of when collateral is required as well as loan-to-value or margin requirements, what constitutes acceptable collateral, and the means for perfecting liens against various collateral types. The association should generally not rely on collateral liquidation as the primary source of repayment. The association should base loan term and amortization on the economic life of the asset being financed, and take into account market price variances, depreciation, condition, usefulness, and any technological and functional obsolescence.

When collateral is necessary or prudent to support the loan decision, sound banking practices require that the association obtain an accurate valuation of the security property. An appraisal or evaluation of the primary collateral for real estate loans should be in accordance with 12 CFR § 564. The association should also document its perfected security interest and the insurance policies protecting the collateral (such as hazard insurance, hurricane, flood, business interruption, etc.).

- *Character* or the overall creditworthiness of the borrower. A positive assessment of the borrower's character or willingness to repay is essential in the underwriting process. The borrower's payment record on existing and previous loans with the association, his or her credit history in general and reputation in his or her business or industry or community all provide evidence of the borrower's character and willingness to repay the loan and should be documented in the loan file. For most consumer loans, character is generally documented by the borrower's credit report and credit score.
- The *conditions* surrounding the loan. What is the purpose of the loan? How will the proceeds be used? What are the key economic factors that could contribute to the success or failure of a loan's repayment? The credit analysis should reflect consideration of such external factors as: area income-level; employment trends; vacancy rates; the market for the products or services of a business; the customer base; competition; any competitive advantage or disadvantage the business may have; the likely effect of national and local economic conditions on continued employment or the success of the business; and other factors that affect the borrower's ability to repay the loan.

- Conformance with consumer protection and fair lending laws.

You should closely scrutinize from both a safety and soundness and compliance perspective any underwriting standard that gives consideration to credit factors that are not directly relevant to the borrower's ability or willingness to repay the debt. The lending policies should provide clear and measurable standards that enable the lending staff to determine whether the loans comply with the association's underwriting standards.

Underwriting standards should address the following items:

### **Loan Types**

Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered and should take into consideration the economic composition of its entire market area.

### **Maximum Maturities**

The association should establish realistic repayment plans for loans, including maturities that relate to the anticipated source of repayment, the purpose of the loan, and the useful life of any collateral. For each type of loan, the lending policy should state the maximum number of months for amortization or the maximum length of time to maturity. The association may also develop specific procedures for unique situations. For example, when making a home improvement loan to a borrower on fixed income, the association could offer extended terms or a loan with a balloon payment and option to renew.

### **Loan Pricing**

The association's loan pricing should reflect the association's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be at a level that is competitive in the market. It is not uncommon to see some lenders adequately estimate their cost of funds and losses, yet fail to estimate the true servicing costs of the loans. Pricing models should also take into account the high degree of variance in loan losses and servicing costs associated with higher-risk lending programs, including subprime. In making such an assessment, management must ensure that risk-based pricing is applied equitably and does not result in pricing based on a prohibitive basis under the fair lending laws and regulations.

### **Guarantees**

The lending policy should include guidance for guarantees and endorsements. Support from financially responsible endorser/guarantors can be an important factor in assessing the credit risk of a loan.

## **Loan-to-Value Ratios**

An association should establish internal loan-to-value (LTV) ratio limits for all types of secured loans, and apply those standards consistently. Loan performance data has shown that borrowers are more likely to repay their loans when they have equity in the property securing them. OTS has not established LTV ratio limit guidelines for non-real estate lending activities. The absence of such guidance, however, does not reduce the need for an association to follow safe and sound business practices by establishing prudent internal LTV ratio limits.

For real estate lending activities, LTV limits should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (Appendix to 12 CFR § 560.101). [Section 212](#) of the Examination Handbook provides additional guidance on real estate related LTV ratio limits.

## **Exceptions to Lending Standards**

Some approved loans do not comply with an association's written loan standards. Policy exceptions may be appropriate in certain instances; however, the reasons for the exceptions should be well documented in the loan file and approved by the board of directors, its delegates, or a committee thereof. Also, the board of directors is responsible for establishing standards for handling requests that do not meet articulated policy statements but are deemed worthy of consideration. Frequent exceptions to a policy may mean that the policy needs revision or may indicate the more serious problem of management's unwillingness or inability to follow established policy. You should scrutinize policy exceptions to ensure management is not exercising them in a manner inconsistent with sound lending practices, including fair lending laws and regulations. Policy exceptions that thwart or diminish legislative or regulatory mandated consumer protections are never appropriate.

## *Loan Documentation Standards*

An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides standards for the documents needed to approve new credit, renew credit, increase credit to existing borrowers, and change terms in previously approved credits. It is important that an association's loan policies include loan documentation standards to help ensure that underwriters and approving officials have the necessary information to make prudent credit decisions. Furthermore, a properly documented loan file is needed to enable internal loan review staff, external auditors, and examiners to readily ascertain the quality of the loan and whether it was underwritten in compliance with board-approved policies. The inability of an independent third party to ascertain the loan officer's reasoning for approving a loan often indicates poor credit management and may be an unsafe and unsound banking practice.

**Lenders should establish procedures to ensure that adequate documentation, consistent with the size and complexity of each loan transaction, is obtained and maintained.**

Section 560.170 requires that the association establish and maintain loan documentation practices that:

- Ensure that the association can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

Lenders should establish procedures to ensure that it obtains and maintains adequate documentation, consistent with the size and complexity of each loan transaction. The association should tailor the documentation for the various types of loans they originate. Below is a partial list of documents that associations should include in the credit files for various loans. Although the documents listed are generally appropriate for prudent lending, a rigid requirement that all these documents be present for each loan is too restrictive and does not take into account other mitigating factors.

- **Loan application** – should include the purpose of the loan and the identity of any security property. The borrower should sign the loan application. If not, there should be some form of acceptable verification that the borrower requested the loan (e-signature, phone verification etc.). Certain mortgage-related loan applications require the collection of government monitoring information.
- **Promissory note** – evidence of the borrower’s obligation to repay the loan, executed by the borrower or agent.
- **Deed of trust or mortgage for real estate loans** – evidence of the creation of a security interest in the real property for the benefit of the lender, signed by the borrower (or agent).
- **Valuation Report** – a report prepared by a qualified individual or firm independent of the borrower (which may include a bank employee or agent) that discloses an estimate of the market value of the security offered by the borrower as collateral for the loan as of a specific date. For valuations on real estate loans, refer to [Thrift Activities Handbook Section 208](#), Appraisals.
- **Financial Statement and Credit Report** – should include a written credit report prepared by one of the credit reporting agencies and the borrower should sign the financial statement. The documents should be current at the time of application. Up-to-date and accurate financial information on each borrower is essential:



- For individual borrowers seeking personal credit, a credit report and a statement of gross income may be all that is necessary. Financial statements are often requested for larger consumer loans and mortgages. In such cases, the financial information should reflect the borrower's financial condition as of the day of application.
- For individuals or businesses seeking financing for a commercial or business venture:
  - ♦ Audited annual financial statements should be the most current available.
  - ♦ Unaudited financial statements should be signed and dated by the principals as close to the date of commitment as possible, but in all cases, within six months of the application or commitment date.
  - ♦ Tax return statements must be for the most recent tax year.

The board of directors should establish the amount or type of loan that requires audited financial statements. For large loans, the association should require audited financial statements or ensure that staff verifies pertinent information in unaudited financial statements. For example, if a business reports real estate as one of its primary assets, the lender should verify ownership, determine that the value stated on the financial report is reasonable and that there are no undisclosed liens on the property. Likewise, if inventory is a significant business asset reported on the borrower's unaudited financial statement, the lender should perform an inspection of the business premises and ask to see the most recent inventory and monthly inventory reports. The lender should also perform a Uniform Commercial Code (UCC) search to determine whether those assets have already been pledged. Of course, such steps are only necessary where the presence of such assets is an important consideration in the loan decision.

- Associations should review several years of financial statements and compare income and assets between periods. Loan personnel should carefully scrutinize borrowers whose income fluctuates considerably and insist on up-to-date financial information.
- **Approval** – approval sheet or committee minutes showing the officer(s) or committee responsible for reviewing and approving the loan request, and establishing the terms and conditions of the approval.
- **Disbursement** – use of a “proceeds schedule” disclosing date, amount, purpose, and recipient of the loan proceeds.
- **Title Policy/Opinion of Title/Uniform Commercial Code filings/or other filings that are appropriate in the local jurisdictions in order to perfect the security interest** – affirming the description, validity, and priority of the lender's lien on the collateral taken as security for the loan, and any continuing filings required to maintain the association's lien position.

- **Settlement Statement/Disclosure Statement** – evidence proving that the lender provided the borrower, upon closing, an application, a loan settlement statement and disclosure statement(s) (as appropriate) setting forth in detail the charges or fees payable by the borrower to the lender and any legal rights the borrower may have with respect to those charges or fees and the transaction in general.
- **Record of Payment** – showing the status and current payment of taxes, assessments, insurance premiums, other charges on the security of the loan, and documentation for any loss (and subsequent recoveries) on the loan security by an insurance settlement.
- **Evidence of hazard, flood, and other insurance policies** – maintenance of appropriate insurance policies that will protect the association from loss in the event of damage to or destruction of the collateral securing the loan. All applicable policies should list the savings association as a loss payee.
- **Modifications** – evidence of any changes to the loan or original security interest with the appropriate approval of each party.
- **Collateral Release** – evidence of any portion of the collateral pledged to secure the loan, showing the portion released, consideration (if any), documentation that the required pay down has been collected and cleared, and appropriate officer approvals.

With any type of lending, experienced and competent legal assistance is particularly important in developing a lending operation. Likewise, engaging the services of a professional compliance officer at the outset of development of a lending operation will significantly reduce any risk of noncompliance and will enhance the association's ability to adjust loan programs in the future without running afoul of consumer protection laws and regulations.

Properly executed legal documentation is critical in establishing and maintaining collateral liens, endorser/guarantor liability, and in working out problem credits through restructuring, liquidation, or rehabilitation of the credit.

### *Credit Administration*

It is important that an association have a strong loan administration function, particularly when it is engaged in construction, nonresidential, or commercial lending. Loan administration includes loan closing and disbursement, payment processing, collateral administration and control, servicing and participation reports, and the timely receipt, review (both initially and ongoing, as needed), and follow-up of all borrower financial information.

**Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight.**

Loan administration duties are much more involved for business, construction, and multifamily lending, so associations may have a separate loan administration department for these loans. Loan administration includes monitoring the borrower's periodic financial statements, determining ongoing

collateral adequacy, and maintaining contact with the borrower to evaluate his condition and determine additional funding needs.

Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight. It is important that the association establish operating procedures and internal controls for the loan administration function in the following areas:

- Loan closing and disbursement; payment processing; escrow administration; and loan payoffs.
- Collateral administration and control, including type and frequency of collateral evaluations.
- Claims processing.
- Servicing and participation agreements.
- Type and frequency of financials statements reviews, including verification of information where appropriate.
- Segregation of duties (where appropriate).
- Collateral release; site inspections.
- Loan refinancing and modification procedures; collections and foreclosure procedures; and charge off and recovery policies.

## **Portfolio Risk Management: Internal Loan Review, Management Information Systems, and Internal Controls**

Effective portfolio risk management requires managing credit risk across the loan portfolios, not just on a loan-by-loan basis. Effective risk identification starts with the evaluation of individual credits. Rating the risk of individual loans in timely credit evaluations is fundamental to loan portfolio management. The association should implement an internal loan review system to monitor the credit quality of the portfolio and compliance with or conformity to loan policies. The internal asset review (IAR) process should be separate and independent of the lending function. We discuss in detail the objectives and elements of effective internal loan review systems in [Thrift Activities Handbook Section 260](#), Asset Classification, and [Appendix A in Handbook Section 261](#), Allowance for Loan and Lease Losses.

To manage their portfolios, associations must understand not only the risks posed by individual credits but how the risks of individual loans, loan portfolio segments and the entire portfolio interrelate—and manage those risks accordingly. Effective loan portfolio risk management depends in large part on the quality of management information systems (MIS). Credit related MIS helps management and the board to fulfill their respective oversight roles. Considerations in effective management information

systems are whether the right people are receiving the right information at the right time, and whether that information is up-to-date and accurate. Such information might include:

- Total loans and commitments by type, including new extensions, credit renewals and restructured credits.
- Loans in excess of existing credit limits.
- Aggregate exception tracking and reporting.
- Concentration or credit exposure monitoring reports (by type, geographic area, collateral, large employers, etc.).
- Delinquent and nonaccrual loans, and credits adversely graded.
- Stress testing results reports.
- Risk pricing models.
- Internal audit and loan review reports.

You should consider:

- Whether the association's risk monitoring practices and reports address all of its material risks.
- The appropriateness of key assumptions, data sources and procedures used.
- Accuracy and timeliness of reports to management and the board.

Another element of an effective portfolio risk management system is internal controls appropriate to the size and complexity of the association and the level of risk it accepts. The association should ensure that its lending operations are subject to strong internal controls (see discussion of Internal Controls in [Thrift Activities Handbook Section 340](#)).

Finally, an effective self-assessment compliance review program should verify that the association is complying with all applicable consumer protection laws and regulations.

## **SUPERVISORY REVIEW**

You should assess to the extent to which the board of directors and management have in place the policies, processes and systems necessary to identify, measure, monitor, and control risk exposures within the loan portfolio. You should assess the extent to which management and the board of directors are able to evaluate and manage risk of individual credits, individual portfolios by loan type, and across the portfolio as a whole. The analysis of an association's lending operations and portfolio

risk management should include a review of portfolio objectives and risk tolerance levels, portfolio diversification and concentrations, loan policies, loan administration practices, underwriting and documentation requirements, and internal credit portfolio risk systems, including internal asset review function, MIS and internal controls to evaluate the association's asset quality. Under a risk focused examination approach the degree of transactions testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. The maintenance of prudent written lending policies and effective internal systems and controls are essential to quality loan production. If an association has concentrations of credit, management should show a heightened degree of diligence in the review of controls and policies.

In evaluating the quality of an association's assets, follow the sampling guidelines in [Thrift Activities Handbook Section 209](#). If the sampling review indicates significant asset quality concerns, it may be necessary to expand the review for one or more of the loan portfolios. [Section 209](#) provides several sampling methods to limit the number of assets reviewed while mitigating sampling risks.

If further review is deemed necessary for any of the areas of lending, the sections in the Asset Quality chapter of this Handbook will guide you to perform an assessment of each of the association's lending activities, overall loan portfolio performance, and the adequacy of the ALLL.

You should also consider whether management has implemented an internal compliance review program that focuses on systems, monitoring, assessment, accountability, response, and training or a "SMAART" compliance review program. The SMAART framework is the cornerstone to assessing and managing compliance risk associated with an association's lending operations. (Refer to the Self-Assessment Guide and [Examination Handbook Section 1100](#), Compliance Oversight Examination Program.)

## REFERENCES

### United States Code (12 USC)

#### *Home Owners' Loan Act*

§1464(5)(c)(1) Loans or Investments Without Percentage of Assets Limitations

§1464(5)(c)(2) Loans or Investments Limited to a Percentage of Assets or Capital

§1464(5)(c)(3) Loans or Investments Limited to 5 Percent of Assets

#### *Code of Federal Regulations (12 CFR)*

Part 560 Lending and Investment

§ 560.93 Lending Limits

- § 560.100-101 Real Estate Lending Standards
- § 560.160 Asset Classification
- § 560.170 Records for Lending Transactions
- § 561 Definitions
- § 563.41 Transactions with Affiliates
- § 563.43 Loans by Savings Institutions to their Executive Officers, Directors and Principal Shareholders
- § 563.170 Examinations and Audits; Appraisals; Establishment and Maintenance of Records
- Part 564 Appraisals
- § 567.6 Risk-Based Capital

## **OTS CEO Memoranda**

- No. 137, Expanded Guidance for Subprime Lending Programs
- No. 142, Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions
- No. 222, Credit Risk Management Guidance for Home Equity Lending

## **Office of Thrift (OTS) Supervision Bulletins**

- RB 3b Policy Statement on Growth for Federal Savings Institutions
- TB 55a Interagency Appraisal and Evaluation Guidelines
- TB 70 Interagency Statement on Sales of 100% Loan Participations
- TB 78 Classifying Commercial and Other Loans Under the HOLA
- TB 79 Lending Limits Pilot Program

## **OTS Handbook Sections**

- [Examination Handbook Section 1100](#), Compliance Oversight Examination Program

## **FFIEC Interagency Policy Statements**

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (11/7/91)

Interagency Policy Statement on Credit Availability and Fair Lending Initiatives (06/10/93)

Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms (03/30/93)

## **Financial Accounting Standards Board, Statement of Financial Accounting Standards**

- No. 5            Specifies GAAP Accounting for Losses and Contingencies
- No. 34           Capitalization of Interest Cost
- No. 58           Capitalization of Interest Cost in Financial Statements that Included Investments Accounted for by the Equity Method
- No. 66           Accounting for Sales of Real Estate
- No. 67           Accounting for Costs and Initial Rental Operations of Real Estate Projects
- No. 91           Specifies GAAP Accounting for Loan Fees
- No. 114          Accounting by Creditors for Impairment of a Loan
- No. 118          Accounting by Creditors for Impairment of Loans-Income Recognition and Disclosure – an Amendment to SFAS No. 114
- No. 144          Accounting for the Impairment and Disposal of Long-lived Assets

## **American Institute of Certified Public Accountants Pronouncements**

Practice Bulletin 1, Exhibit I, “ADC Arrangement”

AICPA SOP No. 92-3, Accounting for Foreclosed Assets

## **Other References**

Federal National Mortgage Institution Underwriting Guidelines

*Compliance Regulatory References*

**Fair Credit Reporting Act:** 15 USC 1681-1681(u)

**Truth in Lending Act:** 12 CFR Part 226; FRB Reg Z

**Real Estate Settlement Procedures Act:** 12 CFR Part 3500; HUD Reg X

**Homeowners' Protection Act:** 12 USC 4901-4910

**Consumer Leasing Act:** 12 CFR 213; 15 USC 1667

**Flood Disaster Protection Act:** 12 CFR Part 572

**Fair Debt Collection Practices Act:** 15 USC 1692

**Unfair and Deceptive Acts:** 12 CFR Part 535; 15 USC 45

**Homeownership Counseling Procedures:** 12 USC 1701x(c)(5)

**Electronic Banking:** FFIEC Interagency Guidance on Electronic Financial Services and Consumer Compliance

**Advertising:** 12 CFR 563.27; Part 328 FDIC

**Fair Lending and Nondiscrimination:** 12 CFR Part 528

**Equal Credit Opportunity Act:** 12 CFR Part 202; FRB Reg B

**Fair Housing Act:** 42 USC 3601 et. Seq.

**Home Mortgage Disclosure Act:** 12 CFR Part 203; FRB Reg C



# Lending Overview

## Program

### EXAMINATION OBJECTIVES

To identify the savings association's strategic lending plan and risk tolerance levels.

To identify the savings association's loan portfolio diversification strategies, and limitations and guidelines for credit concentrations.

To identify the asset quality programs that you should complete in order to properly evaluate the association's lending function.

To determine the adequacy of policies, practices, procedures, and controls regarding the association's lending activities.

To assess management's and lending personnel's conformance with established policies and procedures.

To assess the adequacy of the association's portfolio risk management practices and systems relative to the size and complexity of the association's lending activities.

To assess the accuracy, timeliness and sufficiency of management and board reports.

To evaluate the overall risk profile of the loan portfolio for credit quality, collectibility, and sufficiency of loan collateral.

To assess the scope and adequacy of the internal asset review function.

To ensure compliance with applicable laws and regulations.

To identify the overall strengths and weaknesses of the lending function(s).

To initiate corrective action when policies, practices, procedures, objectives, and/or internal controls are deficient or when violations of law or regulations are noted.

### EXAMINATION PROCEDURES

The examination procedures in this section help examiners accomplish the above objectives and to guide the asset quality review while avoiding duplication of effort within the various loan related programs by facilitating an exchange of information and examination results between examiner(s) responsible for various asset quality sections.

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	

# Lending Overview

## Program

WKP. REF.

### LEVEL I

1. Review the PERK information, the scoping material, and electronic loan data related to this area.  

---
2. Review the preceding report of examination and all lending-related exceptions noted and determine if management has taken appropriate corrective action.  

---
3. Discuss with management their lending activities, strategies, portfolio diversification and risk tolerance levels; future lending plans; portfolio risk management practices; and portfolio performance and quality, including any problems such as unusual delinquency levels, operating costs, etc., relating to its lending programs or activities.  

---
4. Determine that the savings association's lending policies comply with the following:
  - Are in writing.
  - Are approved by the board of directors.
  - Consistent with the association's strategic plan, risk tolerance, staff expertise and diversification guidelines.
  - Promote safe and sound lending.
  - Are adequate for the type and volume of lending.
  - Where applicable, comply with 12 CFR § 560.100-101.

---
5. Determine that the association's portfolio risk management practices:
  - Provide for timely and accurate board reporting.
  - Ensure that reviews and reports address all of the association's material risks.

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	

# Lending Overview

## Program

WKP. REF.

- Provide for strong internal controls.
  - Rely on appropriate key assumptions, data sources and procedures.
- 
6. In conjunction with the Examiner-In-Charge (EIC) or examiner(s) performing the board and management reviews (Examination Handbook Sections 310 and 330) determine who will review the loan committee minutes and board reports (or equivalent) and report their findings to the examiner(s) responsible for asset quality.
- 
7. Review the association's loan portfolio (including electronic loan data, Uniform Thrift Performance Report (UTPR), board reports, etc.) to determine the type and volume of lending that the association engages in and that the portfolio conforms to regulatory limits including loans to one borrower (LTOB), loan policies and diversification strategies.
- 
8. Be alert to:
- Identified problems within the various portfolios.
  - Portfolios with low credit scores, poor performance, or lax underwriting standards.
  - Concentrations of risk.
  - Internally classified loans.
  - Significant delinquency trends.
  - Any large increase in lending since the preceding examination.
- 

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	

# Lending Overview

## Program

WKP. REF.

9. If the association has a mortgage banking operation, the EIC or assisting examiner(s) responsible for asset quality should coordinate the overlapping loan underwriting policies and procedures with the examiner(s) assigned the review of secondary marketing and servicing to avoid duplication of efforts and ensure an exchange of information.  

---
10. The EIC or assisting examiner(s) responsible for asset quality will coordinate the sampling of loans within each portfolio in accordance with [Section 209](#), Sampling, and the responsibilities of [Section 260](#), Classification of Assets.  

---
11. Determine that management reconciles all loan trial balances, including undisbursed loan proceeds (LIP) and contingency and escrow accounts to the general ledger and reviews reconciling items for reasonableness. Also, determine if there are any unusual or old unreconciled items.  

---
12. Compare electronic loan data balances with balances reported on the Thrift Financial Report. Have association personnel reconcile significant variances.  

---
13. In conjunction with the examiner(s) performing the review of the audit programs (Sections [340](#), [350](#), and [355](#)) and internal loan review system, review the scope and depth of the work performed by the various parties in the various lending areas, with specific emphasis on high-risk areas. Obtain a list of any deficiencies noted in their latest review.  

---

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	

# Lending Overview

## Program

WKP. REF.

14. In conjunction with the examiner's review of the associations compliance management and compliance self-assessment programs, identify any material compliance deficiencies and their impact on the risk or overall quality of the lending operations.

15. Based upon these results, assign the appropriate asset quality programs for review and completion. Specifically, the review should focus on evaluating the association's major areas of risk in order to assign a supportable asset quality rating and render a conclusion regarding the adequacy of loan policies, credit administration, internal asset review, and the allowance for loan and lease losses.

### LEVEL II

1. Based upon Level I examination procedures of the asset quality programs assigned, expand scope when deemed necessary.

2. Coordinate the completion of the various lending questionnaires for each program completed.

3. Ensure that your review meets the Objectives of this and the other assigned asset quality handbook sections. State the findings and conclusions in the Report of Examination.

### EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

**THIS PAGE INTENTIONALLY LEFT BLANK**

---

## Lending Overview

### Questionnaire

---

Yes No

---

#### General Questionnaire

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that accomplish the following:
- Clearly state the board's general credit philosophy?  Yes  No
  - Establish loan authority of committees and individual lending officers?  Yes  No
  - Define the duties and responsibilities of the loan officers and loan committee?  Yes  No
  - Define acceptable types of loans and collateral?  Yes  No
  - Establish maximum loan terms and amortization requirements for various types of loans?  Yes  No
  - Establish loan pricing objectives?  Yes  No
  - Applies loan underwriting standards to loans purchased and participation loans? (The association cannot delegate this responsibility to another lender.)  Yes  No
  - Establish minimum financial information required before the closing of the loan? (The level of data will vary depending on loan type and portfolio.)  Yes  No
  - Establish policies for any automated underwriting and credit scoring standards in use?  Yes  No
  - Establish a written appraisal policy in conformance with 12 CFR § 564 and Section 208 of the Thrift Activities Handbook?  Yes  No
  - Establish documentation standards for underwriting analysis and approval decisions?  Yes  No
  - Establish written collection standards?  Yes  No

---

## Lending Overview

### Questionnaire

---

	Yes	No
2. Does the association review its loan underwriting policies and procedures at least annually and does management determine if the loan underwriting policies and procedures are congruent with changing market conditions?	<input type="checkbox"/>	<input type="checkbox"/>
3. Does the association have review and approval procedures for all reports before submission to the board or its committee?	<input type="checkbox"/>	<input type="checkbox"/>
4. Do management reports include the following items:		
• A recap of new lending by portfolio and type?	<input type="checkbox"/>	<input type="checkbox"/>
• A listing of loan commitments and other contingent liabilities?	<input type="checkbox"/>	<input type="checkbox"/>
• A detailed loan performance and asset classification report?	<input type="checkbox"/>	<input type="checkbox"/>
• A listing of other loans and assets requiring special attention?	<input type="checkbox"/>	<input type="checkbox"/>
• A listing of concentration risks?	<input type="checkbox"/>	<input type="checkbox"/>
5. Has the association established minimum documentation standards for each loan type?	<input type="checkbox"/>	<input type="checkbox"/>
6. Do loans on all borrowers contain the following information:		
• Written applications for all loans that show the purpose of the loan?	<input type="checkbox"/>	<input type="checkbox"/>
• The planned repayment schedule?	<input type="checkbox"/>	<input type="checkbox"/>
• The disposition of the loan proceeds?	<input type="checkbox"/>	<input type="checkbox"/>
• Disbursement authorizations?	<input type="checkbox"/>	<input type="checkbox"/>
• Credit and trade checks on the borrower?	<input type="checkbox"/>	<input type="checkbox"/>
• Signed financial statements (including income statements, W-2, tax returns, and other sources or repayment) for the borrower, guarantor, and significant related parties?	<input type="checkbox"/>	<input type="checkbox"/>



## Lending Overview Questionnaire

	Yes	No
• Collateral evaluations where applicable?	<input type="checkbox"/>	<input type="checkbox"/>
• Lien releases where applicable?	<input type="checkbox"/>	<input type="checkbox"/>
• Written credit memorandum or approval form supporting the loan decision and at-testing that the loan meets the institution’s underwriting guidelines or is an ap-proved exception loan?	<input type="checkbox"/>	<input type="checkbox"/>
• Information on the borrower’s other loan and depository account relationships?	<input type="checkbox"/>	<input type="checkbox"/>
• Other pertinent documents or correspondence relating to the loan?	<input type="checkbox"/>	<input type="checkbox"/>
7. Does the association maintain a system to ensure that it requests and receives current financial information for commercial borrowers whose loan repayment is dependent on business income?	<input type="checkbox"/>	<input type="checkbox"/>
8. Does the association require submission of audited financial statements based on dollar amount of commitment or other criteria?	<input type="checkbox"/>	<input type="checkbox"/>
If so, state the requirement.		
_____		
_____		
9. Does the association perform a credit investigation on proposed and existing borrowers?	<input type="checkbox"/>	<input type="checkbox"/>
10. Does the association require that all loan commitments be in writing?	<input type="checkbox"/>	<input type="checkbox"/>
11. Does the association review and update lines of credit at least annually?	<input type="checkbox"/>	<input type="checkbox"/>
12. Does the association check borrowers’ outstanding liabilities to appropriate lines of credit before granting additional advances?	<input type="checkbox"/>	<input type="checkbox"/>
13. Is the administrative system independent of the lending function (it may be a function of the loan servicing or internal audit department) that covers each department and accom-plishes the following:		

---

## Lending Overview

### Questionnaire

---

- |  | Yes                      | No                       |
|--|--------------------------|--------------------------|
| • Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?   | <input type="checkbox"/> | <input type="checkbox"/> |
| • Determines that loans are in compliance with loan policies and are within the association's lending authority?   | <input type="checkbox"/> | <input type="checkbox"/> |
| • Determines that the loan officer initially approves the loan?  | <input type="checkbox"/> | <input type="checkbox"/> |
| • Ascertains that loans to corporations are within the limitations set for the borrower by corporate resolution?   | <input type="checkbox"/> | <input type="checkbox"/> |
| • Ascertains that loans are within loans to one borrower limits?   | <input type="checkbox"/> | <input type="checkbox"/> |
| • Rechecks the preparations of maturity and interest notices?  | <input type="checkbox"/> | <input type="checkbox"/> |
| • Ensures that personnel follow procedures to protect notes and documents from theft or damage?  | <input type="checkbox"/> | <input type="checkbox"/> |
| • Maintains a tickler file that will give at least 30 days advance notice before expiration of hazard insurance, public liability insurance, flood insurance, and take-out commitments?            | <input type="checkbox"/> | <input type="checkbox"/> |
| • Confirms collateral and loans with customers on a test basis?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 14. Has the association established an adequate system to maintain loan documentation, including a checklist to ensure that the institution received required documents and that they are on file? | <input type="checkbox"/> | <input type="checkbox"/> |
| 15. Does the association ensure that a person who does not handle cash examines and prepares entries to various general ledger and other loan controls?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 16. Does the association prohibit loan officers from processing loan payments?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 17. Does the association segregate and identify records and files for serviced loans?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 18. Does a person who does not issue checks or drafts or handle cash prepare and test loan fee and interest income?  | <input type="checkbox"/> | <input type="checkbox"/> |

---

## Lending Overview

### Questionnaire

---

	Yes	No
19. Does the association reconcile subsidiary loan records daily with the appropriate general ledger accounts?	<input type="checkbox"/>	<input type="checkbox"/>
20. Does a person who does not handle cash investigate reconciling items?	<input type="checkbox"/>	<input type="checkbox"/>
21. Does the association mail to borrowers, at least annually, a detailed statement of account balances and activity?	<input type="checkbox"/>	<input type="checkbox"/>
22. Does the association have a loan review section, or the equivalent?	<input type="checkbox"/>	<input type="checkbox"/>
23. Does the association retain loan records in accordance with their record retention policy and legal requirements?	<input type="checkbox"/>	<input type="checkbox"/>
24. Does the association microfilm, scan, or otherwise record new notes daily?	<input type="checkbox"/>	<input type="checkbox"/>
25. Does the association maintain records in sufficient detail to generate the following information by type of advance:		
• The cost of funding loans?	<input type="checkbox"/>	<input type="checkbox"/>
• The cost of servicing loans, including overhead?	<input type="checkbox"/>	<input type="checkbox"/>
• The cost factor of probable losses?	<input type="checkbox"/>	<input type="checkbox"/>
• Profit margin for each loan program?	<input type="checkbox"/>	<input type="checkbox"/>
26. Overall, are the association's underwriting policies, procedures, and controls adequate to prevent unsafe and unsound lending practices?	<input type="checkbox"/>	<input type="checkbox"/>

### Comments

---



---



---



---

---

**Lending Overview**  
**Questionnaire**

---

---

---

---

---

---

---

---

---

## Portfolio Diversification Questionnaire

---

Yes No

---

### General Questionnaire

1. Does the association have written goals and objectives for loan portfolio diversification?
2. Does the policy include the following items:
- Aggregate limits by type of loan and portfolios?
  - Limits for loans to one borrower?
  - Aggregate limits on loans purchased and sold, including those from a single source?
  - Concentration limits for credit within specific industries?
  - Geographic lending areas?
  - Pricing, term, and collateral requirements for all types of loans?
  - Guidelines for loans to affiliated persons, organizations, and industries?
  - Standards of staff expertise in the various lending areas in which the association is active?
  - Maximum advances as a percentage of collateral value or purchase price?
  - Minimum down payments and/or equity for various loans offered?
3. Is the loan policy compatible with business plan and conditions?
4. If the association does not have a written policy that addresses loan portfolio diversification and/or concentrations, ask management to elaborate upon the following:
- The percentage of loans to assets/deposits that the association strives to maintain.
  - Portfolio composition goals.

---

## Portfolio Diversification Questionnaire

---

	Yes	No
<ul style="list-style-type: none"><li>• The geographic areas where the association originates or purchases loans.</li><li>• Concentrations identified by association personnel.</li></ul>	<input type="checkbox"/>	<input type="checkbox"/>
5. Do these concentrations expose the association to more than acceptable risk? If yes, provide an explanation.	<input type="checkbox"/>	<input type="checkbox"/>
6. What efforts has the association taken to reduce risky concentrations and/or minimize credit concentration risk?		
7. Has management considered the need to employ personnel with specialized experience when needed?	<input type="checkbox"/>	<input type="checkbox"/>
8. Despite written or unwritten policies, has the association instituted controls to monitor the following types of concentrations:		
<ul style="list-style-type: none"><li>• Loans to one borrower?</li><li>• Loans dependent upon one industry?</li><li>• Loans to consumers working for the same employer or the same industry?</li><li>• Loans to commercial companies that are dependent on the same manufacturers or suppliers, or sell to the same customer?</li><li>• Loans dependent on one crop or herd?</li><li>• Loans predicated on the collateral support afforded by a debt equity issue of a corporation?</li><li>• Loans considered out of their normal lending area?</li></ul>	<input type="checkbox"/>	<input type="checkbox"/>

---

## Portfolio Diversification Questionnaire

---

- |  | Yes  | No   |
|--|--|--|
| <ul style="list-style-type: none"><li>• Loans purchased or sold from specific sources?</li><li>• Loan participations purchased and sold from specific sources?</li></ul> | <input type="checkbox"/><br><input type="checkbox"/> | <input type="checkbox"/><br><input type="checkbox"/> |
| 9. What management reports does the association use to monitor these various concentrations of credit?   |  |  |
| 10. Does the board of directors or equivalent committee receive these same reports to review?  | <input type="checkbox"/>                             | <input type="checkbox"/>                             |
| 11. Are there areas of the loan portfolio mix that the institution anticipates changing in the next 12 to 24 months?<br>If yes, state dollar and percentages.            | <input type="checkbox"/>                             | <input type="checkbox"/>                             |
| 12. Does management anticipate introducing a new loan product within the next 12 to 24 months?   | <input type="checkbox"/>                             | <input type="checkbox"/>                             |
| 13. Does management anticipate originating or purchasing loans from any new geographic locations?  | <input type="checkbox"/>                             | <input type="checkbox"/>                             |
| 14. What means does the association use to monitor the economic conditions of loans in territories outside its lending areas?  |  |  |
| 15. List the sources from which the association purchases a significant volume of loans.   |  |  |
| 16. If a concentration exists predicated upon a particular industry, does the association make a periodic review of industry performance and trends?                     | <input type="checkbox"/>                             | <input type="checkbox"/>                             |

---

## Portfolio Diversification Questionnaire

---

Yes No

17. If a concentration exists predicated on a particular crop or herd of livestock, does the association attempt to diversify the inherent potential risk by means of participations or arrangements with government agencies such as guarantees or lending arrangements?
18. Describe any risk reduction efforts and factors besides diversification that the association uses to limit risk from concentrations.

### Comments

---

---

---

---

---

---

---

---

---

---



## Loans To One Borrower

Lenders create a form of concentration risk when they extend a significant amount of credit to any one borrower or to borrowers who are related in a common enterprise. As such, savings associations are subject to regulatory limitations on loans to one borrower (LTOB), as specified in 12 CFR § 560.93. Borrower lending limitations are a critical safety and soundness standard enacted by Congress to prevent federally insured banks and savings associations from placing themselves at risk by concentrating too great a portion of their assets in any single borrower.

A savings association's compliance with the regulatory limitations, however, does not diminish regulatory scrutiny over high risk loans within the legal lending limit nor does it relieve the association's board of directors from exercising due diligence. While the LTOB regulation places a limitation on the aggregate dollar amount of an association's loans to each "borrower," it does not limit the number of loans to any one borrower with that aggregate dollar limitation.

---

### LINKS

 Program

Management must ensure, and examiners should verify, that lending staff is conversant with the lending limitations applicable to savings associations, that the lending limitations are clearly set forth in underwriting guidance, and that management's practices, recordkeeping and internal controls regarding LTOB limits are adequate and provide a high degree of confidence that the association is in compliance with LTOB regulatory requirements.

This Handbook Section provides an overview of the LTOB regulations applicable for federal savings associations and various exceptions that authorize associations to exceed the LTOB limits.

## OVERVIEW

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 revised the LTOB requirements for savings associations (HOLA 5(u)) to parallel the lending limitations applicable to national banks. Section 5200 of the Revised Statutes, (12 USC 84), establishes lending limits measured as a percentage of an institution's capital and surplus. The Office of the Comptroller of the Currency's (OCC) implementing regulations are located at 12 CFR Part 32. OTS codifies these requirements for savings associations in its regulations at 12 CFR § 560.93. These regulations incorporate the loan limits for national banks, providing more stringent rules where necessary.

Section 560.93 of the regulations applies to loans and extensions of credit made by a savings association and its subsidiaries. It does not apply to loans made by a savings association or its GAAP-consolidated subsidiary to subordinate organizations or affiliates of the savings association. The terms *subsidiary*,

*GAAP-consolidated subsidiary, and subordinate organization* have the same meanings as specified in 12 CFR § 559.2. The term *affiliate* has the same meaning as specified in 12 CFR § 563.41.

## General Lending Limit

*Under the general lending limitation an association's total loans and extensions of credit outstanding to one borrower at one time shall not exceed 15 percent of the association's unimpaired capital and unimpaired surplus.* The savings association can have an additional ten percent for loans and extensions of credit fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the funds outstanding. To qualify for the additional ten percent limit, the association must perfect a security interest in the collateral under applicable law, and the collateral must have a market value at all times of at least 100 percent of the loan amount that exceeds the 15 percent general limit.

**Under the general lending limitation an association's total loans and extensions of credit outstanding to one borrower at one time shall not exceed 15 percent of the association's unimpaired capital and unimpaired surplus.**

The Director of OTS may impose more stringent restrictions on a savings association's loans to one borrower if OTS determines that such restrictions are necessary to protect the safety and soundness of the association under the HOLA at 12 USC § 1464(u)(3).

## Calculation of General Lending Limit

To calculate an association's general lending limitation you should utilize the most recent Thrift Financial Report filed with the OTS prior to the date of granting or purchasing the loan (unless there has been a significant change in capital). The general lending limit is 15 percent of unimpaired capital and unimpaired surplus, which are defined as: core capital and supplementary capital included in total capital, plus any Allowance for Loan and Lease Losses (ALLL) not included in supplementary capital, plus the amount of investment in, and advances to, subsidiaries not included in calculating core capital.

## EXCEPTIONS TO GENERAL LENDING LIMIT

### \$500,000 Exception

If a savings association's general lending limitation, as calculated above, is less than \$500,000, such savings association may have total loans and extensions of credit, for any purpose, to one borrower outstanding at one time not to exceed \$500,000.

## Statutory Exceptions

The following exceptions to the lending limits, as set forth in 12 USC 84 and 12 CFR Part 32, are applicable to savings associations in the same manner and to the same extent as they apply to national banks.

### *Loans Subject to Special Lending Limits*

In addition to the amount allowed under the general lending limit, the following loans have special lending limits under 12 CFR § 32.3, subject to the qualifications in that section:

- Loans secured by bills of lading – 35%
- Discount of installment consumer paper – 10%
- Loans secured by documents covering livestock – 10%
- Loans secured by dairy cattle – 10%.

Refer to 12 CFR § 32.3(b) for a full discussion.

### *Loans Not Subject to the Lending Limits*

Section 32.3 also defines loans that are not subject to the lending limits, provided they meet the qualifications in the subsections of 12 CFR § 32.3(c). Refer to 12 CFR § 32.3(c) for a detailed discussion. Such loans are as follows:

- Loans arising from discounts of negotiable commercial paper that evidences an obligation of the person negotiating the paper.
- Banker's acceptances.
- Loans secured by U.S. obligations.
- Loans to or guaranteed by a federal agency.
- Loans to or guaranteed by a general obligation of a State or political subdivision.
- Loans secured by segregated deposit accounts in the lending institution.
- Loans to financial institutions with permission of the OTS Director.
- Loans to the Student Loan Marketing Association.

- Loans to industrial development authorities, which will be deemed a loan to the lessee.
- Loans to leasing companies, where a security interest in the leases are perfected and several other conditions are met.

## **Exception for Loans to Develop Domestic Residential Housing Units**

Pursuant to 12 CFR § 560.93(d)(3), a savings association may make loans to one borrower to develop domestic residential housing units, not to exceed the lesser of \$30,000,000 or 30 percent of the savings association's unimpaired capital and unimpaired surplus, including all loans made under the general lending limit, provided that:

- The purchase price (cash or cash equivalent) of each single-family dwelling unit, the development of which is financed under this exception, may not exceed \$500,000. This requirement is to apply to the actual final sales or purchase price.
- The association must be, and continue to be, in compliance with its capital requirements pursuant to 12 CFR Part 567.
- If the association falls out of compliance with this capital requirement it may no longer avail itself of this exception until it again qualifies and, if eligible, submits a notice or, if ineligible for the notice procedure, applies for and receives approval from the Regional Director. OTS will permit lenders to continue funding a legally binding loan commitment made under this exception if the association should fall out of compliance with its capital requirement, provided such binding commitment to the borrower was made when the association was in capital compliance.
- A savings association eligible under 12 CFR Part 516 for using the notice procedure must submit a notice prior to using the higher limit and must have received a written approval by the Regional Director. An association that is not eligible under 12 CFR Part 516 to file a notice, must submit an application to the Regional Director requesting prior approval to use the exception for domestic residential housing development.
- Such approvals do not constitute a "waiver" of the LTOB limits, but merely permission to use the exception under 12 CFR § 560.93(d)(3), and may contain additional requirements or set forth additional conditions or restrictions governing the exercise of this exception.
- All loans made under this exception are limited in the aggregate to 150 percent of the savings association's unimpaired capital and unimpaired surplus.
- Loans made by an association under this exception must comply with the loan-to-value requirements applicable to federal savings association under 12 CFR § 560.101.

## **Definitions**

“Residential housing unit” has the same meaning as the term *residential real estate* in 12 CFR § 541.23, which means: homes (including condominiums and cooperatives); combinations of homes and business property; other real estate used for primarily residential purposes other than a home (but which may include homes); combinations of such real estate and business property involving only minor business use; farm residences and combinations of farm residences and commercial farm real estate; property to be improved by the construction of such structures; or leasehold interests in the above real estate.

“Single-family dwelling unit” has the meaning set forth in 12 CFR § 541.25.

The term “domestic,” as used in this section, includes units within the fifty states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and the Pacific Islands.

The rule defines the term “to develop” to include the various combinations of phases necessary to produce housing units as an end product. This includes:

- Acquisition, development, and construction
- Development and construction
- Construction
- Rehabilitation
- Conversion.

*Domestic residential housing units must be the end product. The acquisition of real estate for holding or for later developing does not fulfill the requirement of this exception.*

Permanent financing of either individual units within a development or of a multi-unit complex is permissible under this exception provided that the financing is related to any of the five combinations of construction phases.

## **Guidelines for Approval of Use of Exception For Domestic Residential Housing Development**

A Regional Director may provide a blanket approval for an association to use higher LTOB limits for lending to develop domestic residential housing upon determination that the higher limits pose no undue risk to the safety and soundness of the association.

Notices and applications for approval must include sufficient information to permit a thorough evaluation of the merits and risks of approving the higher LTOB limits.

Notices and applications for approval of use of the exception for domestic residential housing development will be processed in accordance with Section 820 of the Applications Processing Handbook, Lending Exceptions - Loans to One Borrower.

## **Special Lending Rule for Residential, Small Business, and Small Farm Loans (12 CFR 32.7)**

A three-year lending limits pilot program, effective September 10, 2001, allows banks and savings associations to request expanded LTOB lending authority up to ten percent of unimpaired capital and unimpaired surplus. The pilot program was due to expire on September 10, 2004, but was extended for another three years, through September 10, 2007. The basic requirements of the program are as follows: (Refer to 12 CFR § 32.7 and Thrift Bulletin 79a for complete details.)

**A three-year lending limits pilot program, allows banks and savings associations to request expanded LTOB lending authority up to ten percent of unimpaired capital and unimpaired surplus.**

- In addition to loans to one borrower extended under the general lending limitation, an eligible savings association may make residential, small business or small farm loans or extensions of credit to one borrower in the lesser of the following two amounts: ten percent of its capital and surplus; or the percent of its capital and surplus, that a State bank is permitted to lend under the State lending limit, in the State where the savings association has its main office. In no cases may the association lend more than \$10 million to one borrower under this authority.
- The association must be well capitalized with a composite rating of 1 or 2 with at least a 2 rating in the asset quality and management components to be eligible for the program.
- The loan or extensions of credit must be secured by residential real estate, or a small business or small farm loan. The residential loan needs to be a first lien and not exceed 80 percent of appraised value. The small business and small farm loans are to be full documentation loans and not to be originated under a low documentation program.
- The association must file an application and receive prior approval from the Regional Director. The application must include a certification that the association is an eligible association, a citation to relevant state authority, and a copy of the board of director's resolution along with the association's policies and procedures governing this lending program.
- This authority is further restricted in that loans and extensions of credit granted under the 12 CFR § 32.2 (a) and (b) exception will be aggregated with loans under this authority and the combined limitation shall not exceed 25 percent of the associations unimpaired capital and unimpaired surplus, or \$10 million. Furthermore, the total loans granted under this additional special lending authority may not exceed 100 percent of the association's unimpaired capital and unimpaired surplus.

## Other LTOB Exceptions

### *Government Sponsored Agency obligations*

The HOLA at 12 USC § 1464(c) authorizes savings associations to invest in debt and equity issues of Fannie Mae, Freddie Mac, Sallie Mae, Ginnie Mae, and the Federal Home Loan Banks, or in the obligations issued by, or fully guaranteed as to principal and interest by, any agency of the United States. Although § 560.93 of the OTS regulations does not specify limitations on such investments, the investments must be prudent and appropriate for the association. OTS may establish individual limits on such investments if an association's concentration presents a safety and soundness concern.

### *Commercial Paper and Corporate Debt*

Commercial paper and corporate debt securities are obligations of commercial entities and are treated as loans or extensions of credit for purposes of the LTOB rules. OTS regulation 12 CFR § 560.40 addresses the requirements for commercial paper and corporate debt securities. It states: A federal association's investment in the commercial paper and corporate debt securities of any one issuer, or issued by any one person or entity affiliated with such issuer, together with other loans (of the issuer), shall not exceed the general lending limit contained in 560.93(c). Notwithstanding the general lending limits, savings associations may invest ten percent of unimpaired capital and unimpaired surplus in the obligations of one issuer evidenced by commercial paper that is rated by at least two nationally recognized investment rating services in the highest category; and corporate debt securities that are rated in the two highest grades by a nationally recognized investment rating service, provided the obligations may be sold with reasonable promptness at a price that reasonably reflects their fair value.

### *Asset-backed Securities, Loan Sales, and Loan Participations*

Typically, OTS considers asset-backed securities, loan sales, and loan participations obligations of the borrowers of the underlying loans that collateralize the security. There are exceptions, however. When the association relies on the credit of the issuer (or seller) for repayment of the obligation, the LTOB limits will apply. This may be demonstrated under the following conditions:

- When the loans, leases, or securities are sold with recourse.
- When the association relies on the seller/issuer (as opposed to a reliable independent third party) to service the underlying loans or leases and remit payments from the borrowers.
- When the association purchases loans or leases or participation interests in pools of loans or leases and the seller services the loans or leases, retains the collateral documents, and the buying association has not perfected a security interest in the assets.

## *Bank Owned Life Insurance (BOLI)*

Savings associations should limit their BOLI investments in any one carrier to the 15 percent of their unimpaired capital and unimpaired reserves. (See TB 84, Interagency Statement on the Purchase and Risk Management of Life Insurance)

## **RECORDKEEPING**

Section 560.93(f) addresses requirements for documenting compliance with the LTOB limitations. When a savings association or its subsidiary makes a loan or loans to any one borrower that, in aggregate, exceed the greater of \$500,000 or 5 percent of the association's unimpaired capital and surplus, it must include documentation showing that such loans were made within the limitations of 12 CFR § 560.93.

## **DEFINITIONS**

For purposes of applying the lending limitations under 12 CFR § 560.93, savings associations shall apply the definitions and interpretations promulgated by the OCC at 12 CFR Part 32 including those discussed below.

### **Borrower**

The term *borrower* has the same meaning as the term *person* set forth in 12 CFR Part 32. For purposes of determining LTOB limitations, a “*borrower*” means a person who is named as a borrower or debtor in a loan or extension of credit, or any other person, including a drawer, endorser, or guarantor, who is deemed to be a borrower under the “direct benefit” or the “common enterprise” tests set forth in 12 CFR § 32.5.

Generally, loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed an individual borrower when:

- The proceeds of a loan or extension of credit are to be used for the direct benefit of the other person. *Direct benefit* will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction.
- A common enterprise will be deemed to exist and loans will be aggregated when:
  - The expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid;
  - Loans or extensions of credit are made:



- ♦ to borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower;
  - ♦ Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues and expenses, inter-company loans, dividends, capital contributions and similar receipts of payments; or
- When separate persons borrow from an association to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the loans.

Loans to partnerships are always attributed to the general partners, but the direct benefit test or common enterprise test must be met for partnership loans to be attributed to limited partners. Refer to 12 CFR § 32.5(d) for a discussion of special rules for loans to a corporate group and loans to partnerships, joint ventures and associations.

Debt guaranteed by a person is attributed to the guarantor if the guarantor becomes an obligor under the terms of the guarantee.

## Loans

Loans and extensions of credit mean an association's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds. Loans and extensions of credit include all of the following:

- A contractual commitment to advance funds.
- A maker or endorser's obligation arising from an association's discount of commercial paper.
- An association's purchase of securities subject to a repurchase agreement.
- An association's purchase of third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period.
- An overdraft but not an intra-day overdraft for which payment is received before the close of business.
- Fed Funds sold with a maturity of more than one business day.

Refer to 12 CFR § 32.2(k) for further explanation of these definitions.

## Contractual Commitment

The limitation on loans and extensions of credit includes all obligations where the savings association has a contractual commitment to advance funds. This includes the savings association's obligation to:

- Make payment (directly or indirectly) to a third person contingent upon the default of the association's customer in performance of their obligations.
- Guarantee or act as surety for the benefit of a person.
- Advance funds under a standby letter of credit or similar arrangement.
- Advance funds under a qualifying commitment to lend.

A *qualifying* commitment to lend means a legally binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to the borrower was within the association's lending limits when entered into, and has not been disqualified. If the association subsequently chooses to grant a loan to the borrower, which when added together with all outstanding loans and commitments exceeds the LTOB limit, then those commitments in excess of the limit become permanently disqualified. The association can advance funds only to the extent that with the advancement of new funds the

**The limitation on loans and extensions of credit includes all obligations where the savings association has a contractual commitment to advance funds.**

association remains in compliance with regulatory limitations. Refer to 12 CFR § 32.2(f) for additional details.

association remains in compliance with regulatory limitations. Refer to 12 CFR § 32.2(f) for additional details.

Savings associations often grant construction or other loan commitments that are scheduled to repay within a certain timeframe. The association may then grant a subsequent loan to the same borrower that, combined with the first, would exceed its LTOB limit, if it were funded prior to the repayment of the first loan. In order to avoid a lending limit violation and as a prudent business practice, savings associations should include in all appropriate loan commitments a clause that releases them from the obligation to fund the commitment if funding would cause an LTOB violation.

## Loans to Facilitate Sales

OTS's policy concerning sale financing for any asset is identical to that of the OCC. A purchase money note with no advance of funds is not a "loan" for lending limit purposes. In sales financing, only advances of new funds are "loans" subject to the limits of 12 CFR § 560.93. OTS does not object to sale financings that do not involve an advance of funds or place the lender in a more risky situation, provided the sale is not to the borrower who defaulted on a loan that resulted in the lender owning the asset in question.

## Renewals

The lender's renewal of a loan does not constitute a new loan for lending limit purposes provided the lender does not advance new funds to the borrower and does not substitute a new borrower for the original obligor. When the lender renews a nonconforming loan, he or she has an opportunity to bring the loan into conformance with the lending limits. This includes attempting to have the debtor partially repay the nonconforming loan or obtain another institution's nonrecourse participation in the loan to bring it into lending limit compliance. Thus, the lender must make and document best efforts to bring the loan into conformance prior to renewal. If these efforts are unsuccessful, however, the lender may renew, restructure, or modify the nonconforming loan, provided that there is no substitution of borrowers or additional advance of funds.

Upon the expiration of a partially funded loan commitment, the association may renew only the funded portion if this amount exceeds the association's lending limit and only if best efforts were first made to bring it into compliance. The association will then treat this renewed portion as a legal, although nonconforming, term loan. If the borrower subsequently repays a portion of the outstanding balance owed to the lender, the lender may not advance new funds to the borrower until the outstanding balance of the loan is brought within the association's lending limits.

## Other Exclusions

The following items do not constitute loans or extensions of credit for LTOB purposes (see 12 CFR § 32.2(k)(2)):

- Additional funds advanced for the benefit of a borrower by a savings association for payment of taxes, insurance, utilities, security, and maintenance and operating expenses necessary to preserve the value of real property securing the loan, consistent with safe and sound banking practices.
- Accrued and discounted interest on an existing loan or extensions of credit.
- Amounts paid against uncollected funds in the normal process of collecting.
- That portion of a loan or extension of credit sold as a participation on a nonrecourse basis, provided that the participation results in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders.

## **USE OF SALVAGE POWERS**

Traditionally, salvage powers have provided the legal justification for federal savings associations to hold, operate (if necessary), and invest additional funds (when necessary) in property acquired as a result of, or in lieu of, foreclosure prior to resale of that property.

It has long been the position of the OTS and its predecessor that a federal savings association has inherent or implied authority to take whatever steps may be necessary to salvage an investment, provided that the steps taken:

- Are an integral part of a reasonable and *bona fide* salvage plan; and
- Do not contravene a specific legal prohibition. (The OTS does not consider the LTOB limitation to be a specific legal prohibition within the meaning of the salvage powers doctrine.)

Accordingly, a savings association may use its salvage powers to exceed the LTOB limitation provided it is able to demonstrate that it is making excess investments pursuant to a reasonable and *bona fide* salvage plan. Excess investments that are not made pursuant to such a plan are illegal and could trigger enforcement action by the OTS.

The board of directors should expressly approve the salvage plan. State-chartered savings associations have similar authority under state law.

**A federal savings association that intends to make a salvage powers investment in excess of its LTOB limitation must first contact its OTS regional office to ensure that the Regional Director does not object to the association's judgment that the proposed salvage plan is necessary and appropriate.**

A federal savings association that intends to make a salvage powers investment in excess of its LTOB limitation must first contact its OTS regional office to ensure that the Regional Director does not object to the association's judgment that the proposed salvage plan is necessary and appropriate. (An association need not contact its regional director before making reasonable delinquent tax or insurance payments necessary to protect the association's security interest in the property. However, it should still document that such action is necessary and appropriate.)

Regional Directors will take into consideration the risks posed by proposed salvage plans, an association's past history of salvage operations, the financial condition of the association and its ability to undertake the risks attendant to salvage operations. The level of scrutiny given to a salvage plan will also vary depending on the foreclosure status of the asset being salvaged.

## **Assets Acquired as a Result of, or in Lieu of, Foreclosure**

Once an asset has been acquired as a result of, or in lieu of, foreclosure, the LTOB limitation no longer applies directly to subsequent investments in that asset. In such situations, however, OTS uses the LTOB limitation as a prudential standard to identify significant salvage operations that may require special scrutiny to ensure that they are being prudently conducted. This includes salvage operations on foreclosed assets held in the insured institution and those held in subsidiaries. (For purposes of measuring whether an association has exceeded its LTOB limit, OTS will aggregate all of a federal savings association's investments in the property in question regardless of whether those investments occurred before or after foreclosure.)

The OTS recognizes that the payment of normal operating expenses (such as taxes and insurance or expenses to prevent deterioration of the investment) may be prudent steps necessary to minimize the

potential for loss pending the disposition of repossessed assets. Some capital expenditures, such as those necessary to put collateral property in final form for occupancy or sale, may also be prudent. However, the burden of demonstrating that capital expenditures are reasonable is greater than for operating expenditures, since capital expenditures are likely to be much more substantial.

When reviewing a proposed salvage plan, regional staff will consider whether the plan meets the following criteria:

- Is necessary to enable the association to salvage its existing investment.
- Is necessary to protect the value of the foreclosed property (e.g., the additional investments will result in a more marketable property).
- Is in the best interest of the association.
- Will reduce the risks associated with the foreclosed property.

### **Loans in the Process of Foreclosure**

A loan will be deemed to be in the process of foreclosure if a federal savings association has begun the process necessary to foreclose or to take a deed in lieu of foreclosure and is actively pursuing that process, but has not yet acquired title to the property securing the loan.

Although you will use the same standards outlined in the section above to review salvage plans that call for investments in excess of LTOB limits in loans in the process of foreclosure, you will also take account of the additional risks associated with investing funds in a property that has not yet been acquired by the association. Under these circumstances, a federal savings association should also demonstrate that the timing of its proposed investment (i.e., before foreclosure) is reasonable.

### **Troubled Loans Not in the Process of Foreclosure**

Although a federal savings association may also use its salvage powers to invest funds in excess of its LTOB limits in a troubled loan that is not in the process of foreclosure, the burden of demonstrating that this type of salvage operation is prudent is high. You should assess whether a federal savings association can demonstrate it has met the standards outlined in the section titled “Assets Acquired as a Result of, or in Lieu of, Foreclosure” and that its decision to delay or forego foreclosure is consistent with safe and sound operations.

## REFERENCES

### United States Code (12 USC)

#### *Chapter 2: National Banks*

§ 84            Lending Limits

#### *Chapter 3: Federal Reserve System*

§ 371c        Banking Affiliates

§ 371c-1     Restrictions on Transactions with Affiliates

§ 375b        Loans to Insiders

#### *Home Owners' Loan Act*

§ 1464 (c)    Investment Authority

§ 1464(u)    Limits on Loans to One Borrower

§ 1467a       Holding Companies

§ 1467a(m)   Qualified Thrift Lender Test

§ 1468        Transactions with Affiliates and Loans to Insiders

#### *Federal Deposit Insurance Act*

§ 1813        Definitions

§ 1831e      Activities of Thrifts

### Code of Federal Regulations (12 CFR)

#### *Chapter I: Comptroller of the Currency*

#### *Part 3: Minimum Capital (for National Banks)*

§ 3.3            Transitional Rule (Intangible Assets)

§ 3.100        Capital and Surplus

§ 3.100        Components of Capital, Appendix A

## *Part 32: Lending Limits (for National Banks)*

- § 32.2 Definitions
- § 32.3 Lending Limits
- § 32.4 Calculation
- § 32.5 Combination Rules
- § 32.6 Nonconforming Loans
- § 32.7 Lending Limits Pilot Program
- § 32.102 Federal Funds Sold
- § 32.108 Interest and Discount

## *Chapter III: Federal Deposit Insurance Corporation Subchapter A: Procedures and Rules of Practice*

- § 303.13 Applications by Thrifts

## *Chapter V: Office of Thrift Supervision*

- Part 541 Definitions
- Part 560 Lending and Investment
  - § 560.30 General Lending and Investment Powers
  - § 560.93 Lending Limitations
  - § 560.101 Real Estate Lending Standards
  - § 561.19 Financial Institution
  - § 563.41 Transactions with Affiliates
- Part 567 Capital Requirements

## **OTS Bulletins**

- TB 79a Lending Limits Pilot Program
- TB 84 Interagency Statement on the Purchase and Risk Management of Life Insurance

**THIS PAGE INTENTIONALLY LEFT BLANK**



# Loan To One Borrower

## Program

### EXAMINATION OBJECTIVES

To determine the adequacy of an association's risk management practices and controls regarding loans to one borrower (LTOB) limits.

To ensure the adequacy of the association's recordkeeping with respect to LTOB.

To assess management's and lending personnel's conformance with established guidelines.

To ensure compliance with applicable laws and regulations.

### EXAMINATION PROCEDURES

WKP. REF.

You should conduct the following Level I examination procedures in conjunction with Examination Handbook Section 201, Lending Overview, to bring together a review of the entire lending function(s) of an association. As such, the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality should take added precautions to avoid duplication of efforts by ensuring an exchange of information and results from each examiner responsible for the asset quality sections.

### LEVEL I

1. Review the PERK information and the scoping material related to this area.

---

2. Determine whether management has taken appropriate corrective action to address any deficiencies noted during the prior examination.

---

3. Participate in the appropriate Level I procedures of Section 201 or discuss the findings with the EIC and/or his representative.

---

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# Loans to One Borrower

## Program

WKP. REF.

4. Review board and management reports used to monitor high dollar loans and concentrations among affiliated borrowers.  

---
5. Assess the adequacy of the association's documentation for loans in excess of five percent of its unimpaired capital and surplus. (This may be done during the review of large loans.)  

---
6. Determine if the association is in compliance with applicable regulatory LTOB limits and any board imposed "house" limits.  

---
7. Determine the adequacy of reporting to the board and management on LTOB limitations and exceptions.  

---
8. Review the association's large loans and commitments to determine if any approach the legal lending limit and assess management's monitoring of such loans.  

---
9. Determine whether the combination rule of 12 CFR § 32.5 applies to any of the association's borrowers.  

---
10. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.  

---

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# Loans To One Borrower

## Program

WKP. REF.

### LEVEL II

1. Review any loans made under the exceptions for domestic residential housing development or the lending limits applicable to the Lending Limit Pilot Program. Determine that appropriate notice or application was provided and approval received.  

---
2. Determine whether loans originated under such programs were made in accordance with applicable policy and regulation.  

---
3. In situations where the association has exercised its salvage powers to exceed the LTOB limitations, ensure that the association has adequate justification and appropriately notified the OTS regional office.  

---
4. Summarize findings, comment on any violations, obtain management responses, and update programs and the continuing examination file (CEF) and/or electronic CEF (ECEP) with any information that will facilitate future examinations.  

---
5. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate workpapers and report pages.  

---

### EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	







**THIS PAGE INTENTIONALLY LEFT BLANK**

## One- to Four-Family Residential Real Estate Lending

The primary business of the thrift industry is residential real estate lending. Section 5(c)(1)(B) of the Home Owner's Loan Act (HOLA) authorizes federal savings associations to invest in loans secured by "residential real estate" — subject to safety and soundness considerations. Residential real estate loans include permanent mortgage loans, construction loans, or other loans secured by single- and multi-family residential dwellings. This Handbook Section focuses on permanent mortgage lending secured by one- to four (1-4) family residential properties. We discuss construction and multifamily loans in Handbook Section 213.

The single-family residential mortgage market is a highly competitive market and one that offers a wide variety of loan products to meet consumer demand. Loan products are, on the one hand, highly standardized as a result of the secondary market, along with innovations in automated underwriting and credit scoring. On the other hand, competition and demand have produced an array of mortgage loan product options for consumers ranging from fixed-rate to variable-rate loans, interest-only loans, negatively amortizing loans, subprime loans, and reverse mortgages. Each of these products brings different underwriting, risk, and portfolio management considerations.

---

LINKS	
	<a href="#">Program</a>
	<a href="#">Appendix A</a>
	<a href="#">Appendix B</a>
	<a href="#">Appendix C</a>
	<a href="#">Appendix D</a>
	<a href="#">Appendix E</a>

From a credit risk perspective, well-underwritten loans to creditworthy individuals secured by their personal residences are among the safest loans in a savings association's portfolio<sup>1</sup>. While annual loan loss rates for prime 1-4 family permanent loans fluctuate over time, they are typically below 20 basis points, which is generally lower than the loss rates for any other class of loans. Portfolios of such loans generally present much less credit risk than commercial real estate loan portfolios because:

- The risk of default is spread over many moderately sized loans rather than a few large loans.
- Savings associations generally use standardized underwriting criteria, which makes overall performance more predictable.
- Default risk is low and diversified. It is generally not dependent on the success of a particular business or industry.

---

<sup>1</sup> Initially, we will focus our discussion on prime mortgage loans with loan-to-value (LTV) ratios of less than 90 percent or with private mortgage insurance. Subprime mortgage lending and high LTV lending will be discussed later in this section.

- The amount of loss given default is generally lower because the loans are well secured by the borrower's home.

Single-family mortgage loans do entail risks. These risks include interest-rate risk, an increased default risk if underwriting standards are weak or are not followed, and the risk that properties in a particular community or during an economic downturn may experience price declines. Price declines may lead to both higher defaults and greater losses in each default. The risks inherent in a real estate mortgage loan depend on:

- The borrower's creditworthiness (or ability and willingness to pay) over the loan term.
- The loan amount relative to the value of the security property (LTV) over the life of the loan.
- The loan's terms and interest rate over the loan term.

Lenders can mitigate risk by establishing and adhering to sound lending standards and portfolio diversification strategies; maintaining high quality loan servicing and collections departments; regularly assessing portfolio risk and monitoring portfolio performance; and making changes or taking remedial action as necessary.

This Handbook Section has two parts:

- **Real Estate Lending Policies and Operations:** an overview of real estate lending standards, loan portfolio risk management, and other underwriting considerations.
- **Underwriting Considerations for Specific Loan Products:** subprime mortgage lending, adjustable rate mortgages including negatively amortizing loans, interest-only loans, home equity loans, manufactured housing loans, and reverse mortgage loans.

## REAL ESTATE LENDING POLICIES AND OPERATIONS

### Real Estate Lending Standards

As indicated in Handbook Section 201, one of the first steps in creating a sound lending program is the establishment of safe and sound lending policies and prudent underwriting criteria. On December 31, 1992, OTS, in concert with the other federal banking agencies, adopted the *Real Estate Lending Standards Rule (RELS)*, 12 CFR § 560.100-101. The rule requires each insured depository institution to adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or are made for the purpose of financing the construction of a building or other improvements to real estate. Such policies must be consistent with safe and sound banking practices, appropriate to the size of the institution and the nature and scope of its operations, and reviewed and approved by the board of directors. The rule also requires that the lending policies must establish:

- Loan portfolio diversification standards.
- Prudent underwriting standards, including LTV limits, that are clear and measurable.
- Loan administration procedures.
- Documentation, approval, and reporting requirements to monitor compliance with the savings association's lending standards.

In addition, savings associations must monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions. The rule also requires that the real estate lending policies reflect consideration of the *Interagency Guidelines for Real Estate Lending Policies* (Interagency Guidelines). The Interagency Guidelines in Appendix A to § 560.101 state that an institution's written lending policy should contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made. In particular, the institution's policies should address the following:

- Geographic lending areas.
- Loan portfolio diversification strategies.
- Prudent underwriting standards that are clear and measurable.
- Appropriate terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Loan review and approval procedures for loan exceptions.
- Loan administration procedures.
- Monitoring and reporting procedures.
- Appraisal and evaluation program.

**The institution should consider both internal and external factors in the formulation of its loan policies.**

The institution should consider both internal and external factors in the formulation of its loan policies, including the expertise and size of its lending staff, market conditions, and compliance with real estate related laws and regulations.

Appendix A to this Handbook section contains answers to commonly asked questions about the RELS and Interagency Guidelines. While the Interagency Guidelines apply to all real estate loans, not just 1-4

family residential real estate loans, we incorporate the guidance relevant to single-family mortgage lending in the following discussion.

## *Underwriting Standards*

Prudently underwritten real estate loans should reflect all relevant credit factors including:

- The capacity and creditworthiness of the borrower.
- The value of the security property.
- Borrower equity.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (guarantees, private mortgage insurance, etc.).

The underwriting standards should also address:

- Maximum loan amounts.
- Maximum loan maturities.
- Amortization schedules.
- LTV limits.
- Pricing structures.
- Credit scores.
- Debt-to-income requirements for loans originated, loans purchased and loans sold in the secondary market.
- The use of automated underwriting and credit scoring systems in the underwriting process.

## *Documentation Standards*

OTS expects savings associations to document loans to establish a record of each transaction, demonstrate loan quality, and secure its interest in any collateral pledged for the loan. OTS designed its documentation requirements to be flexible and based on the size and complexity of the savings association's lending operations. Pursuant to 12 CFR § 560.170, each savings association, including its operating subsidiaries and service corporations, should establish and maintain loan documentation practices that:



- Ensure the association can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose of and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate the appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

The purpose of this rule is not to mandate a list of required loan documents, but to ensure that the association maintains the necessary documents to protect its interest in the loan and verify management's determination that each borrower has the willingness and ability to repay their obligations in accordance with the loan's contractual terms. OTS modeled these documentation requirements after the *Interagency Guidelines Establishing Standards for Safety and Soundness*. (See 12 CFR Part 570.)

## **Typical Documentation**

For residential real estate lending, savings associations typically obtain the following documentation:

- A signed loan application.
- A signed and dated promissory note and mortgage (or deed of trust).
- A title insurance policy or opinion of title to evidence the recording of the loan and the lender's security interest in the property.
- An appraisal or evaluation, in accordance with 12 CFR Part 564, evidencing the value of the security property.
- Evidence that the borrower obtained adequate hazard insurance, and a certification that the borrower will retain such insurance for the life of the loan.
- A credit report or financial statement evidencing the borrower's other credit obligations and payment history.
- Verification of the source of down payment, and a verification of borrower income and employment.

- Debt-to-income ratio calculation, to document the borrower's ability to repay the loan.
- An underwriting or approval memorandum or form (signed off by the person(s) or committee authorized to approve the loan) that documents the loan's compliance with the savings association's underwriting requirements, rules, and regulations.

Some savings associations may require additional documentation such as bank statements, pay stubs and income tax returns.

### **Documentation for Loans to be Sold**

When lenders originate loans for resale, they will typically document loans in accordance with the needs or requirements of the intended purchaser. For example, when a savings association originates loans for sale to Freddie Mac or Fannie Mae, the lender may use the underwriting requirements and documentation required by those organizations. Such underwriting and documentation requirements may be less stringent than what the lender requires for loans it plans to hold in its portfolio. Savings associations may use loan underwriting and documentation requirements of the purchaser provided the association sells the loans quickly and has a written loan purchase agreement with the purchaser. Where there is no such agreement and savings associations originate loans with the "intention" of selling them in the secondary mortgage market, savings associations should use their own prudent underwriting and documentation standards.

### **Reduced Loan Documentation**

In recent years, some savings associations reduced loan documentation requirements to expedite loan approval and reduce administrative costs. Savings associations and examiners have raised questions about whether "low-doc" and "no-doc" loans meet OTS's documentation requirements.

The following definitions are useful in the discussions of this issue:

*Well-documented loans.* A well-documented loan has the documentation necessary to: record the loan and secure the lender's interest in the collateral, support the borrower's willingness and ability to repay the loan, and establish the sufficiency of the collateral to liquidate the loan, if it should become necessary.

*Low-doc loans.* A "low-doc" loan has the documentation necessary to record the loan and secure the lender's interest in the collateral. However, it may not have all of the documentation lenders typically require to support the borrower's willingness and ability to repay the loan, and the sufficiency of the collateral to liquidate the loan, if necessary. For example, a lender may ask borrowers to state their income rather than require full verification and tax returns.

*No-doc loans.* A "no-doc" loan generally has the documentation necessary to record the loan and the lender's interest in the collateral, but has no documentation to support the borrower's willingness and ability to repay the loan or the sufficiency of the collateral to liquidate the loan, if necessary (e.g., no income verification, credit report, or appraisal.)

Regardless of the savings association's name for such programs, you should focus on the actual documents required and the credit risks involved. OTS has long held that no-doc residential real estate lending, as defined above, is unsafe and unsound. Low-doc lending programs, as defined herein, vary greatly and require careful scrutiny.

**OTS has long held that no-doc residential real estate lending, as defined above, is unsafe and unsound.**

Savings associations that make low-doc loans should demonstrate that such loans are prudently underwritten and meet OTS's documentation requirements. Well-managed low-doc residential lending programs typically offset the higher risk undertaken by not fully evaluating the borrower's source of repayment with other mitigating credit factors. For example, if the association does not ask for or verify the borrower's income, it should use other means to demonstrate the borrower's willingness and ability to make timely loan payments, such as higher borrower down payments (lower LTV ratios) and higher credit scores. Some lenders may determine ability to repay a mortgage by comparing the applicant's new mortgage payments with his or her current rent or mortgage payments, or they may ask for two or three months of the applicant's checking account statements and review the activity.

While there can be much debate over which documents are needed to support the loan decision, the ultimate proof of whether the association's loans are adequately underwritten lies in the performance of its portfolio relative to similar but well-documented portfolios. If an association offers a low-doc loan product, it should ensure appropriate risk-based pricing and regular monitoring of loan performance, and limit the volume of production until it has experience with the product and it demonstrates adequate performance.

### *Supervisory Loan-to-Value Limits*

As set forth in the *Interagency Guidelines*, permanent mortgage or home equity loans on owner-occupied, 1-4 family residential property whose LTV ratio equals or exceeds 90 percent at origination should have appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral. On a case-by-case basis, associations may make loans in excess of supervisory LTV limits based on the support provided by other credit factors and documented in the loan file.

On October 8, 1999, the banking agencies issued *Interagency Guidance on High LTV Residential Real Estate Lending*. (See Appendix D.) High LTV loans are defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied, 1-4 family residential property that equals or exceeds 90 percent of the real estate's appraised value. The exception is a loan that has appropriate credit support such as mortgage insurance, readily marketable collateral, or other acceptable collateral, that reduces the LTV ratio below 90 percent. Through this policy statement the agencies clarified that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support, should be considered an exception to the Guidelines and included in the association's calculation of loans subject to the 100 percent of capital limitation. (See 12 CFR § 560.101, and Appendices A and D of this section for additional information).

## *Exceptions to the General Lending Policy*

Lending policies may provide for prudently underwritten loan approvals that are exceptions to its standard lending policies. The board of directors is responsible for establishing standards for review and approval of such exceptions. A written justification that clearly sets forth all the relevant credit factors that support the underwriting decision should support the loan approval. Tracking of the aggregate level of exceptions helps detect shifts in the risk characteristics of the loan portfolio. When viewed individually, underwriting exceptions may not appear to increase risk significantly; however, when aggregated, even well-mitigated exceptions can increase portfolio risk. Management should regularly analyze aggregate exception levels and report them to the board. An excessive volume or a pattern of exceptions may signal an unintended or unwarranted relaxation of the association's underwriting standards.

## *Loan Administration*

The loan administration function is responsible for receiving and recording payments, recording security agreements, retaining loan documentation, and maintaining escrow accounts. Associations should establish procedures to monitor the payment of real estate taxes and insurance and to arrange for interim or blanket hazard insurance policies to cover any lapse in coverage. This becomes more important with seriously delinquent loans because borrowers may have less incentive and ability to make such tax or insurance payments. Loan administration procedures for real estate lending should address:

- Documentation requirements.
- Collateral administration, including the type and frequency of collateral evaluations.
- Loan closing and disbursements; payment processing; and loan payoffs.
- Escrow monitoring and administration.
- Collection procedures and timing, including foreclosure procedures.
- Claims processing.
- Servicing and participation agreements.

Timely collection of delinquent loans is a critical factor in portfolio performance. An association's written policies should provide for enhanced collection efforts as delinquency problems become more serious.

You should look for indications of delinquency problems where staff and management are:

- Unaware of delinquency problems.

- Inaccurately reporting such problems to the board.
- Not taking appropriate action to collect on the loan or foreclose, where appropriate.

## *Real Estate Appraisal and Evaluation*

Experience has shown that the lower the LTV, the lower the likelihood of default and the lower the amount of loss in the event of default. While the sale of collateral is not an acceptable *primary* source of repayment, the borrower's equity in the home is an important factor in borrower motivation and should be integrated into the lending decision. Real property provides protection to the lender should the borrower's circumstances change and he or she is unable to service the debt.

Thus, an adequate system of collateral appraisal or evaluation and review in accordance with 12 CFR Part 564 is an essential element in sound real estate lending. A real estate appraiser should base the market value estimate contained in the real estate appraisal or evaluation on the conveyed interest in real estate on a cash or cash equivalent basis. Handbook Section 208 provides guidance and examination procedures on real estate appraisals and evaluations.

## **Portfolio Risk Management**

### *Loan Review and Monitoring*

A sound real estate lending policy should be augmented by strong and effective internal controls. These controls should emphasize proper segregation and independence of duties between:

- Loan officers who assist the customer and facilitate the application process.
- Loan administration personnel who disburse funds, collect payments, and provide for the timely receipt, review, and follow-up of all necessary mortgage loan documentation.
- Accounting staff that record loan transactions.
- Loan review and internal audit staff.

**A sound real estate lending policy should be augmented by strong and effective internal controls.**

To monitor credit quality and compliance with board established policies and procedures, the savings association should implement a system of internal loan review commensurate with its size, risk, and the complexity of its lending and investment activities. Management's inadequate response to problem loans or lending practices can often be traced to an inadequate loan review function, or one that is poorly structured or that is not sufficiently independent of the officers who made the loans. Unfortunately, such weaknesses surface when credit problems emerge that an effective Internal Asset Review (IAR) system could prevent.

The *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)* contains an attachment on loan review systems. Refer to Appendix A in Handbook Section 261 for the ALLL policy statement. The loan review section sets forth guidelines for establishing a prudent internal loan review program that:

- Promptly identifies loans with potential credit weaknesses so that timely corrective action can be taken to minimize losses.
- Assesses relevant trends that may affect collectability.
- Provides information to assess the adequacy of the ALLL.
- Assesses the adequacy of and adherence to internal loan policies.
- Evaluates the activities of lending personnel.
- Provides management and the board of directors with objective, accurate, and timely information on the portfolio's quality.
- Includes all loans, whether originated or purchased.
- Includes sample coverage that is statistically valid and includes periodic reviews of high-dollar, high-risk loans.

The purpose of the internal loan review or IAR is to assess overall asset quality, and identify specific problem assets so that association management may implement corrective action. An effective IAR should enable management to identify weaknesses in the loan portfolio and take appropriate corrective actions when necessary, both with respect to individual loans and any weaknesses in the association's loan policies and procedures.

The guidelines list several important elements to an effective loan review system. These are:

- Qualifications and independence of loan review personnel.
- Frequency, scope, and depth of reviews.
- Management review of findings and follow-up corrective action.
- Report distribution to appropriate staff, management, and the board of directors.

While each of these elements is important to an effective loan review function, one of the most critical elements is independence. Often, the initial loan review function is given to loan officers because they are the most familiar with their loans and can spot weaknesses early. This is acceptable as a first line of review. However, associations should avoid over-reliance on loan officers and their line supervisors for

identification of problem loans. Senior management and the board of directors should ensure that loans are also reviewed by individuals who do not have control over the loans they review and are not part of, or influenced by, anyone in the approval process.

Please refer to Appendix A in Handbook Section 261 for a further discussion of an effective internal loan review system.

## *Management Information Systems*

Accurate and timely management information reports are key to a successful lending operation. Management information systems (MIS) reports should enable management and the board of directors to assess the performance of each loan product type (LTV, credit score, originating office, loan officer, geographic location, and profitability); and the performance of the portfolio as a whole. This will enable management to make changes to poorly performing, or unprofitable programs.

MIS reports may include:

- Summary reports showing trends in outstanding loans, new loan volume, delinquencies, and portfolio yield by different product types and LTV.
- Credit scoring distribution reports by portfolio, new volume, delinquency, and losses.
- Past due, nonaccrual, trial balance, and collections reports.
- Extension and renewal reports.
- Reports on the volume and significance of underwriting exceptions.

You should ensure that MIS reports are:

- Used to monitor loan performance or improve the portfolio.
- Timely, accurate and appropriate to the size and complexity of the association's operations.
- Provided to both management and the board.

## **Automated Underwriting Considerations**

Some savings associations use automatic underwriting programs when they plan on selling loans in the secondary mortgage market. Automated underwriting uses historical loan performance, statistical models, and known risk factors to evaluate whether a loan can be sold into the secondary market. The most widely used automated underwriting services are Freddie Mac's Loan Prospector® and Fannie Mae's Desktop Underwriter®.

**Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time.**

Mortgage lenders use automated underwriting to help them:

- Determine the terms under which the loan can be sold into the secondary market.
- Evaluate the credit, collateral and capacity of borrowers to make their monthly mortgage payments.
- Identify the appropriate type of loan for the borrower.

Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time. It also helps lenders weigh all the strengths and weaknesses of the loan appropriately, in accordance with historical experience so that worthy borrowers with minor weakness are not unjustly rejected.

OTS has determined that the use of external underwriting programs, whether automated or not, is acceptable, provided the loan is sold, without recourse, in the secondary market to a purchaser who has agreed in writing to accept the loans approved using the automated underwriting program. When loans do not qualify for sale, when they may be rejected after sale, or when they are held in portfolio, a savings association must perform its own underwriting and grant loans only if they meet the association's underwriting criteria.

When a savings association designs and uses its own automated underwriting program, it should test and validate the program prior to placing it in use and regularly thereafter.

## Interest Rate Risk Considerations

In addition to credit risk, mortgage lending, particularly long-term fixed rate loans, expose the savings association to interest rate risk; that is the risk that the savings association's liabilities will reprice faster than its assets as interest rates rise, causing net interest margins and thus earnings to decline. In addition to establishing sound lending policies, the association can mitigate other portfolio risks such as interest rate and market risk, by hedging, by expanding its loan products to include adjustable-rate mortgage (ARM) loans and 15-year mortgages, and by selling some or all of its most interest-rate sensitive mortgages. Moreover, many savings associations sell residential mortgage loans in the secondary market to reduce the interest-rate risk associated with funding long-term, fixed-rate assets with short-term liabilities. This can also provide future fee income if the loans are sold with servicing retained. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Handbook.

## Compliance Considerations

As part of a sound lending program, the association must ensure that all loans are made in accordance with federal laws governing credit transactions. OTS regulation 12 CFR § 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of loans originated. Loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair



Housing Act, the Equal Credit Opportunity Act, Regulation B, or OTS Nondiscrimination regulations. The Truth-In-Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are subject to specific restrictions. Loans are also subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community. (See the Compliance Sections of the Handbook for further discussion.)

## Capital Considerations

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines a qualifying mortgage loan as a loan that:

- Is fully secured by a first lien on a 1-4 family residential property.
- Is underwritten in accordance with prudent underwriting standards, including standards relating to the ratio of the loan amount to the value of the property (LTV ratio). See Appendix to 12 CFR § 560.101.
- Maintains an appropriate LTV ratio based on the amortized principal balance of the loan.
- Is performing and is not more than 90 days past due.

If a savings association holds both the first and junior liens on a residential property, and no other party holds an intervening lien, the transaction is treated as a single first lien loan for purposes of determining the LTV and appropriate risk weighting under § 567.6(a).

In essence, 1-4 family residential mortgages that are performing, are prudently underwritten, and have loan-to-value ratios at origination of less than 90 percent, or are covered by private mortgage insurance, may qualify for the 50 percent risk weighting. OTS has not specifically defined the term "prudently underwritten" for purposes of determining compliance with 12 CFR § 567.1; however, OTS has long held that to be prudently underwritten, a loan must be made in a safe and sound manner to ensure that the borrower has the ability and willingness to repay the loan in a timely manner.

OTS allows savings associations flexibility in underwriting their loans, based on many factors, including borrower equity or LTV, the borrower's credit standing (as evidenced by a credit report and credit score), sufficient cash flows to service the debt (as evidenced by an acceptable debt-to-income ratio or other appropriate information), combined with other factors, such as a guarantee from a financially responsible third party, private mortgage insurance, or evidence of other borrower assets that could be used to liquidate the loan.

## *Low-doc Residential Loans*

OTS will consider low-doc residential mortgage loans prudently underwritten for purposes of meeting the 50 percent capital risk weighting requirements for qualifying residential mortgages, provided the following conditions are met:

- The loans otherwise meet the requirements of § 567.1.
- The association adequately documents the value of the security property pursuant to the requirements of 12 CFR Part 564.
- The association adequately documents its analysis of each borrower's credit history (as evidenced by a credit report or credit score, for example).
- OTS has no major safety and soundness criticisms of the association's lending program.

To retain the 50 percent risk weighting, the loans should perform as well as well-documented qualifying mortgages, given their risk profile, loss variance, and profitability. Should the performance on a portfolio of low-doc mortgage loans decline to a level that presents safety and soundness concerns, OTS may direct the savings association to risk weight some or all of the low-doc mortgages at 100 percent or higher.

## *Subprime Mortgage Loans*

The interagency policy statement *Expanded Guidance for Subprime Lending Programs* addresses the capital requirements for subprime mortgage loans. (OTS CEO Memo 137, issued February 2, 2001.) The guidance states: "Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an association would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type." Therefore, if such programs otherwise meet the above requirements, OTS expects associations to hold capital of one and a half to three times the 50 percent risk weighting for qualifying 1-4 family mortgages (or more, depending on the overall risks involved).

## **UNDERWRITING CONSIDERATIONS FOR SPECIFIC LOAN PRODUCTS**

### **Subprime Mortgage Lending**

The term *subprime* refers to the credit characteristics of the individual borrower. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

**Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies.**

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.
- Bankruptcy in the last 5 years.
- Relatively high default probability as evidenced by, for example, a credit bureau score of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default probability likelihood.
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

*Subprime loans* are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.

With subprime lending programs, financial institutions target subprime borrowers and offer them loans at higher interest rates and loan fees than that offered to prime borrowers, based on the risk of the loan. Since lenders charge a premium for the added risk of default, subprime loans can be more profitable than standard risk loans, provided that the lender has accurately estimated default and loss rates and has adequately priced the loans.

The banking agencies believe that responsible subprime lending can expand credit access for consumers and offer attractive returns. However, the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital. A savings association that is or plans to become engaged in subprime mortgage lending (or the purchase of such loans) must consider the additional risks inherent in this activity. It must determine if these risks are acceptable and can be controlled, given its staff, financial condition, size, and level of capital support. If management and the board decide to enter the subprime lending business, they must establish board-approved policies and procedures, and internal controls to identify, measure, monitor, and control the additional risks.

In March 1999, the OTS, together with the other banking agencies issued *Interagency Guidance on Subprime Lending*, which provides detailed guidance to examiners on subprime lending activities. (See Appendix A of Handbook Section 217.)

On February 2, 2001, the Agencies issued the *Expanded Guidance for Subprime Lending Programs (CEO Memo 137)*. This expanded guidance discusses supervisory expectations for the ALLL regulatory capital, examination review of subprime activities, classification of risk, and documentation for re-aging, renewing, or extending delinquent accounts. This guidance also discusses regulatory expectations for the review and treatment of certain potentially abusive lending practices.

## Adjustable-Rate Mortgage (ARM) Loans

Unlike fixed-rate mortgages, where the interest rate does not change over the life of the loan, the interest rate on an ARM is based on the movement of a predetermined index. The rate is usually set as the function of the predetermined index plus an incremental amount established at the initiation of the loan. This incremental amount is commonly referred to as the margin. The combination of the index rate and the margin is referred to as the fully indexed rate. Depending on the type of index the ARM is based on, the interest accrual rate can change monthly (11th District Cost of Funds Index [COFI]) or annually (Constant Maturity Treasury Index [CMTI]). Some ARMs are structured such that there are limits on the amount of the increases and decreases in the interest accrual rate as the result of changes in the underlying rate index. These are called interest rate “caps,” “ceilings,” and “floors.”

For most ARM loans, the borrower’s monthly payment amount is recalculated at predetermined dates to assure full amortization of the loan over its remaining life at the current fully indexed interest rate. This date is referred to as the payment-adjustment date.

### *Pricing of ARMs*

The pricing of products and services offered by savings associations should be competitive, provide sufficient yield to cover the operating expenses, funding costs, expected losses, and a reasonable risk adjusted return on invested funds. The pricing of products and services should foster safe and sound lending.

Some lenders may incorrectly price ARMs because of a lack of understanding of the “options” or risks associated with ARMs. Lenders should price “promotional” mortgage loans, such as adjustable “teaser” rate mortgages, to yield a sufficient return over the life of the loan. Mortgage documents should state precisely which index is used and when the rate may be adjusted.

**Some lenders may incorrectly price ARMs because of a lack of understanding of the “options” or risks associated with ARMs.**

One method to determine if lenders are appropriately pricing ARMs is to compare the expected returns on originated ARMs with yields on comparable ARMs in the secondary market. Specifically, you can compare secondary market data to determine whether the points the association receives for originating the ARM compensate it for the discount that the secondary market requires to accept the risks of that ARM. If the required discount is larger than the fees the association receives for originating the ARM, you might conclude the association is not pricing its ARMs appropriately.

### *Qualifying ARM Borrowers*

Adjustments to higher interest rates may lead to steep increases in payment burdens and subsequent delinquencies if borrowers were originally qualified at low introductory rates with high debt-to-income payment burdens. It is important that associations assess a borrower’s ability to qualify for the loan by measuring current income against projected payments that will result from a fully indexed or current market interest rate. Lenders may, however, consider the potential for increase in a borrower’s income

and compare that figure against anticipated higher payments. For example, some fixed/adjustable loans adjust after 3 or more years (e.g., 3-1, 5-1, or 7-1 ARMS) providing more opportunity that the borrower's income will catch up to the expected increase in payment.

### *Teaser Rates and Interest Rate Buy Downs*

One feature commonly associated with the ARM product (fixed-rate products also) is the “teaser” or low introductory interest rate. This includes situations where borrowers receive a short-term subsidy or “buy down” of the loan rate from the seller. Teaser rates are used to attract borrowers to do business with the lender (or seller) versus the competition. Teaser rates reduce the initial interest accrual and monthly payment during the period that the teaser is in effect, usually 12 to 36 months. At the expiration of the teaser-rate term, the borrower's monthly interest accrual is calculated at the fully indexed rate.

OTS regulations place no restrictions on ARM loans. The adjustable rate mortgage provisions of 12 CFR § 560.35 do not set limitations on periodic and lifetime interest-rate adjustments. Thus, management has the flexibility to develop a buy down program provided it underwrite and structure the program in a safe and sound manner.

Using the deep teaser rates to qualify a borrower will cause some borrowers to qualify for loans that they would not qualify for under normal circumstances, under the assumption that their ability to pay will increase with time. OTS is concerned about the potential for increased credit risk, particularly when the LTV ratio is high (90 percent or higher). Associations should generally qualify borrowers at the fully indexed or market mortgage rate as of the date of commitment. A possible exception to this policy is when a savings association engages in a program of immediately selling such loans, without recourse, to nonthrift third parties, thereby removing the credit risk from its own portfolio.

As stated above, savings associations may consider the potential for an increase in a borrower's income and compare that figure against anticipated higher payments as the teaser rate term expires.

### *Accounting Treatment*

Where the buy down payment is in the form of a single, lump sum representing a portion of the interest due during the buy down period, the association should include the payment with other deferred fees and loan costs to determine the net deferred fees for the loan. The association should amortize such net deferred fees over the life of the loan using the interest (level yield) method pursuant to SFAS No. 91. Such accounting is required for any type of loan, whether fixed-rate or adjustable-rate, in connection with making a buy down payment.

Savings associations should take into consideration the existence of any buy down arrangement in determining the value of the property. If the amount of the buy down is reflected through an increase in the property's sale price to a level higher than on an identical property in the local market on which no buy down is offered, then the appraisal should reflect this fact.

## *Negative Amortization*

Lenders may structure some ARM products such that they negatively amortize under certain interest rate scenarios. With conventional fixed-rate mortgages, the interest accrual rate and annual payment are held constant over the life of the loan, and a portion of each monthly payment reduces the outstanding principal balance of the loan. With negatively amortizing or “NegAm” ARMs, the minimum required payment remains constant for a specified period of time. If rates increase during that time, any unpaid interest is added to the principal balance so the loan balance would increase, while the borrower’s minimum required monthly payments would remain fixed. Borrowers, however, have the flexibility to make up the difference between the interest charged and their minimum monthly payments.

The advantage of negatively amortizing loans is that they allow borrowers payment flexibility and do not create a payment shock for the borrower until the loan is recast (see Appendix C). The disadvantage is the risk that the borrower’s equity may decrease during periods when interest rates are high. Loan performance data has shown that prudently underwritten ARM mortgages with a NegAm feature in the contract generally perform as well as fixed-rate mortgages. In fact, during periods when such loans would negatively amortize, many borrowers typically pay additional principal to minimize their loss of equity. It is important, however, that savings associations establish proper underwriting and property valuation standards, as well as controls to monitor and manage the additional risks from negatively amortizing ARM lending.

You should focus your attention on loans where borrowers are only making the minimum required payments. Such borrowers may be at risk should rates increase or they experience financial difficulties. You should also determine the amount of mortgages in the portfolio that are actually negatively amortizing as opposed to those where the loan contract merely allows it.

NegAm loans should not be considered high LTV loans (pursuant to 12 CFR §§ 560.100-101) just because of a commitment by the lender to allow the loan balance to negatively amortize to a level that exceeds the supervisory LTV limits. Because the NegAm commitment is conditional and because the borrower may elect to pay a higher payment so that negative amortization does not occur or would be limited, the loan would only become a high LTV loan if the loan balance actually increases to 90 percent or higher of the real estate’s value at origination.

See Appendix C for a more detailed discussion of negatively amortizing loans.

## **Interest-only Mortgage Loans**

Interest-only (I/O) mortgages are becoming increasingly popular. With a typical 30-year fixed-rate mortgage, a portion of the borrower’s monthly payment pays the interest accrued each month, and a portion of the payment reduces the principal amount of the loan. Over the term of the loan, the principal balance is repaid in full. In comparison, with an I/O mortgage, the borrower’s monthly payments are structured to repay the interest accrued each month, with no portion to reduce the principal. Thus, the

**It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans.**

loan balance does not decrease during the interest-only period. Most I/O mortgages have an interest-only period and an amortization period. Typically the I/O period is five years, and the amortization period is 25 years. I/O loans often have a 5-year fixed interest rate, which is lower than the interest rate on a typical 30-year fixed-rate mortgage. The loan then has a 25-year adjustable-rate, fully amortizing period.

Advantages of I/O mortgages are that they allow borrowers to reduce their monthly payments, often allowing them to borrow more than they could otherwise afford, or to free up their income for other purposes. The disadvantage of I/O loans is that the monthly payment will inevitably increase fairly significantly after the interest-only period expires and the amortization period begins. This may place borrowers in danger of default if they cannot afford the higher monthly payments. Thus, I/O loans are best suited for borrowers who plan to resell their homes in a few years, those who expect their incomes to increase significantly in the years ahead, or high income/net worth borrowers who would not be in danger of losing their homes when the payment increases.

I/O loans are also less liquid than fully amortizing loans, because the borrower pays no principal for the first five years. This may be an advantage or a disadvantage, depending on the association's liquidity needs and its other investment alternatives.

It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans. The primary factor to consider is the borrower's ability to make higher payments after the expiration of the I/O period.

### *Qualifying I/O Borrowers*

It is important that associations assess an I/O borrower's ability to qualify for the loan by measuring current income against projected larger, amortizing payments after the interest rate and the I/O period expires. As with ARM loans, savings associations may consider the potential for increase in a borrower's income and compare that figure against anticipated higher amortizing payments.

As with any lending program, OTS expects savings associations to identify, measure, monitor, and control the risks of their lending activities. Therefore, a prudent strategy may be to limit the association's investment or sell most I/O production until management fully understands and can control the risks involved with this product.

You should review I/O programs and assess whether management is conducting the program in a safe and sound manner, identifying and controlling the risks, and monitoring the performance of the I/O portfolio. Appropriate MIS and performance reporting to management and the board of directors is an essential element in this process.

### **Home Equity and Second Mortgage Loans**

For years, savings associations accommodated homeowners' needs by allowing them to take out second mortgages to make improvements to their homes, finance education, consolidate bills, start a business, or other purposes. Typically, a lender offers second mortgage or home equity loans for shorter terms and higher rates than they offer for their first mortgage loan products. When home equity and second

mortgage loans originally were offered in the market-place, the maximum amount financed would typically be 80 percent of the value of the home, less the amount of the borrower's first mortgage. Savings associations have generally had excellent performance experience with these loans.

Over the past few years, lenders have offered various higher risk home equity products, such as subprime home equity loans and home equity lines of credit up to 100 percent of the value of the home, when combined with the first mortgage. Some lenders (many of them unregulated) offer home equity loans up to 125 percent of the value of the borrower's home. The higher risks associated with this lending is discussed in the *Interagency Guidance on High LTV Residential Real Estate Lending*. (See Appendix D.)

Because of the higher risk associated with subprime and high LTV home equity loans, savings associations should consider the *Credit Risk Management Guidance for Home Equity Lending* issued by the OTS together with the other banking agencies on May 16, 2005. (See Appendix E.) The guidance outlines OTS's expectations for savings associations with home equity lending programs to implement sound risk management practices. Savings associations should also adhere to the Interagency Guidelines and the REELS Rule, as well as other applicable rules and guidelines. The association should determine whether such a program is appropriate taking into account its staff resources, capital levels, and other risk exposures inherent in the association's asset structure. Savings associations should establish prudent lending standards, credit management, servicing and collections procedures to identify, measure, monitor, and control the risks associated with such lending.

- **Lending Standards.** Savings association lending policies relating to its home lending program should be appropriate given the size and financial condition of the association, the expertise and size of the lending staff, the need to avoid undue concentrations of risk, market conditions, and compliance with real estate laws and regulations. The policy should also clearly state the goals of the association's home lending program.

Some high LTV home equity lenders offset the higher credit risks inherent in low security or unsecured lending by requiring higher credit bureau scores. Lenders may also use other strategies such as setting maximum debt to income ratios that limit a borrower's total monthly debt burden to prudent levels, and establishing maximum loan amounts and length of employment standards. Since these products are often ARMs with no caps, it is also appropriate to consider the guidance on ARM lending in this Handbook Section.

- **Credit Management.** Once loans are on the books, a savings association should perform periodic risk assessments through loan review and portfolio monitoring. Monitoring should include the evaluation of trends in loan volume, delinquencies, nonperforming and classified loans, as well as losses and the adequacy of the ALLL. At a minimum, associations should segregate portfolios by LTV ratio (such as 80 to 89 percent, 90 to 99 percent, and 100 to 109 percent) and analyze them separately. When the first mortgage is with another lender, associations should include the mortgage balance with the other lender in calculating LTV. It is not necessary that an exact first mortgage balance be obtained for this purpose; associations may use the balance of the first mortgage at origination or a reasonable approximation based on expected amortization. If an association approves loans using credit scores, it should track



performance by periodic credit score updates. The association should make adjustments to underwriting standards and loan administration and collection procedures when performance does not meet expectations or economic cycles dictate added concern.

- **Servicing and Collections.** Because foreclosure is seldom a cost effective option, lenders that engage in high LTV home equity lending often need to make special efforts to develop and maintain effective servicing and collection procedures. Lenders involved in subprime lending stress that their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary. Associations need to ensure they can absorb the costs associated with a more intensive loan servicing and collection function.
- **Other Strategies to Minimize Risk.** To further minimize risk, associations may want to adopt strategies more pertinent to the unique nature of subprime or high LTV home equity loans. For example, when a borrower uses the loan to consolidate other debts, borrowers may reload on credit card debt after taking out the home equity loan. Lenders might design procedures to prevent this, such as paying off other creditors directly from the loan proceeds and limiting “cash out” funds. Lenders may also monitor subsequent charge account activity by updating credit bureau reports on a regular basis. When credit report data indicates a decline in the borrower’s credit standing, lenders should consider taking action to limit their exposure, such as curtailing further advances on open-end lines of credit.

## Manufactured Home Financing

Congress designated the term “manufactured housing” to describe homes built to Housing and Urban Development (HUD) building code (HUD code) established in the Manufactured Home Construction and Safety Standards Act of 1976. HUD code pre-empts local building codes. Manufactured homes have a permanent chassis. Modular, panelized, kit and other homes without a permanent chassis are not considered to be manufactured homes. Modern manufactured homes have evolved from their distant origins as travel trailers or mobile homes, and are almost never moved from their original site. Today, about three-fourths of new unit sales are multi-section homes, and two-thirds are placed on the buyer’s land.

In most states, manufactured homes are originally titled as personal property or chattel. To be considered real estate, the home’s wheels, axles, and hitch must be removed and the home must be permanently attached to the land. In such cases, personal property title is surrendered and the home converted to real property in accordance with state and local requirements.

Pursuant to section 5(c)(1)(J) of the HOLA, a federal savings association may invest in manufactured home chattel paper<sup>2</sup> and interests therein without limitation as to percentage of assets. This authority includes dealer inventory and retail financing.

---

<sup>2</sup> The term “manufactured home chattel paper” means a document evidencing an installment sales contract or a loan or interest in a loan secured by a lien on one or more manufactured homes and equipment installed or to be installed therein.

Additionally, a savings association may invest in manufactured homes secured by a combination of the manufactured home and real estate. If the manufactured home is permanently affixed to a foundation, a savings association may treat a loan secured by a combination of manufactured home and lot on which it sits as a home loan and report it as such on its Thrift Financial Reports. Such loans are subject to the LTV and other requirements of the Interagency Guidelines, at 12 CFR § 560.101.

Lenders engaged in manufactured housing finance must carefully manage the risk of collateral depreciation. Savings associations should establish conservative underwriting standards, prudent LTV limits and amortization schedules, and rigorous appraisal standards for manufactured home lending. Professional appraisers with specific experience in valuing manufactured homes should conduct the appraisals. Fannie Mae and Freddie Mac purchase mortgages secured by manufactured homes, subject to specific underwriting guidelines. Mortgage insurance is available from private mortgage insurers and Federal Housing Administration (FHA) for loans secured by manufactured homes.

## Reverse Mortgage Loans

Over two-thirds of this country's senior citizens own their homes. While almost 80 percent of the homes are owned free of any liens or encumbrances, many seniors find themselves in the position of being "house rich but cash poor." In response to this problem, some lenders have developed loan products referred to as reverse mortgage loans.

Reverse mortgage loans are a form of credit extension secured by first mortgages on single-family residences. As the term implies, reverse mortgage loans are the reverse of traditional mortgage loans. Instead of borrowing a lump sum and repaying it over time, borrowers receive loan proceeds either in the form of a line of credit (typically about 30 percent to 40 percent of the property's value, which they can draw on when they need it) or in regular monthly advances. The advances may either be for a specified number of months ("term" loans) or may be paid as long as the borrower lives in the home ("tenure" loans). Regardless of the advance feature of the loan (term, tenure, or line of credit), reverse mortgage loans do not have fixed maturity dates. They mature when the borrower either dies or moves. If there are two borrowers, the loan matures when the survivor dies or moves. At that time, lenders are repaid out of the proceeds from the sale of the home, and the lender's recovery from the borrower or the estate will be limited to the proceeds from the sale of the home. As with conventional mortgage loans, the lender accrues interest on the outstanding balance until the loan is repaid.

For a typical mortgage loan, the loan amount is based on a percentage of the appraised value or sales price, and is repaid by the borrower(s) through monthly payments over a fixed loan term, so that the loan amount in relation to the property's value typically decreases over time. Reverse mortgages, on the other hand, start out with a low LTV ratio that typically increases over time as the lender makes advances to the borrower(s) and interest accrues on the unpaid balance.

The amount of the monthly payments or advances the borrower(s) receive for either term or tenure reverse mortgage loans depends on the estimated loan maturity, the interest rate, and the value of the home. Lenders use mortality and relocation tables to estimate the loan maturity. For tenure loans, the number of months to maturity equates to the number of payments the lender will have to make to the borrower(s). For example, under the FHA reverse mortgage program, a 65-year-old woman, with

\$100,000 in home equity, might receive \$234 per month for life. An 85-year-old woman with \$100,000 in home equity might receive \$604 per month. The reason for the increase in payment amounts to the 85-year old borrower is that the number of payments the lender expects to pay is much lower than for the 65-year old borrower.

Other factors that affect monthly payments are the expected appreciation or depreciation of the home and whether the borrower receives an up-front advance in addition to monthly payments. The FHA program uses very conservative life expectancy assumptions in its payment model, so monthly payments are often lower than with private programs that use standard life insurance mortality tables.

Reverse mortgage loans are attractive from a consumer standpoint in that they enable borrowers to use the equity in their homes to produce monthly cash income while they remain in their homes. OTS encourages associations to engage in lending programs that meet identified community credit needs, provided the association conducts them in a safe and sound manner. While reverse mortgage loans may be responsive to a particular community's credit needs, their structure presents several challenges to lenders, including the management of risks associated with changes in the value and condition of the property over the life of the loan, the uncertainty over the loan term and the number of payments that will be made to the borrower, and the general lack of experience among savings associations with reverse mortgage products. Therefore, it is incumbent on management and the board of directors to carefully assess all risks associated with any proposed reverse mortgage-lending program and determine to what degree the association can offset or tolerate such risks.

Furthermore, as with all new lending programs, savings associations should limit their reverse mortgage investments until they gain sufficient experience in dealing with the unusual characteristics of the product. As reverse mortgage loans are secured by real estate, they are subject to the REELS regulation and Interagency Guidelines discussed in this section.

Appendix B contains a more detailed discussion of the risks associated with reverse mortgage loans, as well as accounting and other policy issues.

## REFERENCES

### United States Code (12 USC)

*Home Owners' Loan Act*

§ 1464(5)(c)(1) Loans or Investments without Percentage of Assets Limitations

§ 1464(5)(c)(2) Loans or Investments Limited to a Percentage of Assets or Capital

### Code of Federal Regulations (12 CFR)

Part 528      Nondiscrimination Requirements

Part 535	Prohibited Consumer Credit Policies
Part 560	Lending and Investment
§ 560.170	Establishment and Maintenance of Records
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
Part 564	Appraisals
§ 567.1	Qualifying Mortgage Loan
§ 567.6	Risk-based Capital Credit Risk-weight Categories
Part 570	Safety and Soundness Standards
§ 590.3	Operations (Preemption)
§ 590.4	Consumer Protection Rules for Federally Related Loans, Mortgages, Credit Sales and Advances Secured by First Liens on Residential Manufactured Housing Loans

## Office of Thrift Supervision Guidance

### *CEO Memos*

CEO 103	Uniform Retail Credit and Account Management Policy
CEO 137	Expanded Guidance for Subprime Lending Programs

### *Regulatory and Thrift Bulletins*

RB 3b	Policy Statement on Growth for Federal Savings Associations
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
TB 55a	Interagency Appraisal and Evaluation Guidelines

### *Handbook Sections*

Section 208	Appraisals
Section 217	Consumer Lending, Appendix A, Interagency Guidance on Subprime Lending
Section 261	Adequacy of Valuation Allowances, Appendix A, Effective Internal Asset Review Systems

- Section 410 Financial Reports and Records
- Section 1100 Compliance Examination Oversight Program
- Section 1200 Fair Lending
- Section 1300 Consumer Loans and Regulations
- Section 1400 Compliance Laws and Regulations

## **Financial Accounting Standards Board, Statement of Financial Accounting Standards**

- No. 5 Specifies GAAP Accounting for Losses and Contingencies
- No. 34 Capitalization of Interest Cost
- No. 67 Accounting for Costs and Initial Rental Operations of Real Estate Projects
- No. 91 Specifies GAAP Accounting for Loan Fees
- No. 133 Accounting for Derivatives

## **Other References**

- Fannie Mae and Freddie Mac Underwriting Guidelines
- FHA Underwriting Guidelines

**THIS PAGE INTENTIONALLY LEFT BLANK**

# One- to Four-Family Residential Real Estate Lending Program

---

## EXAMINATION OBJECTIVES

To evaluate the one- to four- (1-4) family residential loan portfolio for credit quality and risk.

To determine if a savings association's lending policies regarding real estate lending activities are adequate, in conformance with the Real Estate Lending Standards (RELS), and appropriate to the size and complexity of the association's lending operations.

To assess management's and lending personnel's conformance with established policies and guidelines, and compliance with applicable laws and regulations.

To determine if a savings association's risk management practices and internal controls regarding residential real estate lending activities are adequate.

To initiate corrective action as appropriate.

## EXAMINATION PROCEDURES

You should conduct the following examination procedures in conjunction with the Examination Handbook, Section 201, Overview procedures to bring together a review of the entire lending function(s) of an association. Where a savings association has multiple loan departments (e.g., segregated by lending type(s)) the examiner team will use the aggregate findings to arrive at an overall assessment of the lending function and the credit risk and quality of the entire loan portfolio. As such, the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality should avoid duplication of efforts by ensuring an exchange of information and results from each examiner responsible for the different asset quality sections.

### LEVEL I

WKP, REF

This section expands on the general lending discussion in Section 201 to address additional policy guidelines specific to 1-4 family residential mortgage lending.

1. Review Section 201 Level I findings to determine whether the loan policies and procedures include guidance related to the types of 1-4 family residential lending programs the association offers, and whether the portfolio risk management practices and internal controls adequately address these programs.

---

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

---

WKP. REF.

2. Verify that the lending policies and practices are consistent with the REELS (12 CFR §§ 560.100-101) and the Interagency Guidelines for Real Estate Lending Policies and the Interagency Guidance on High LTV Residential Real Estate Lending (Interagency LTV Guidance) (Appendix D to this Handbook Section), and appropriate for the nature and risk of the real estate lending activities conducted.

---

3. Review loan portfolio performance, identify performance concerns, and determine whether additional review is needed to assess any performance concerns.

---

4. Identify any new lending activities, programs or strategies to evaluate as part of this review.

---

5. Review the audit reports and preceding report of examination and all lending related exceptions noted, and determine if management took appropriate corrective action.

---

6. In conjunction with the board and management report reviews in Sections 260, 310, and 330, ascertain if any problems or concerns regarding real estate lending were noted.

---

7. Review MIS reports related to 1-4 family residential lending to identify potential areas of concern and to assess the adequacy of reporting to the board of directors and management on the performance of the real estate portfolio (trends, delinquencies, exceptions, losses, collections, etc.).

---

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	



# One- to Four-Family Residential Real Estate Lending Program

WKP. REF.

8. Verify that the association is properly classifying past due 1-4 family mortgages and home equity loans in accordance with the Uniform Retail Credit and Account Management Policy.

9. Participate in the Level I review of Section 208 or discuss findings with the EIC to ensure that the association's appraisal practices are sound and do not otherwise impact the risk of the association's lending operations.

10. Coordinate with examiners reviewing compliance management to ensure that the association adequately covers the 1-4 family residential lending within the scope of the compliance management oversight, and that there are no material violations of consumer lending laws or deficiencies in the compliance management function that could impact the risk profile of the real estate loan portfolio.

11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures. Where you determine that the association has sound underwriting policies and practices, and strong internal controls and risk management practices, you might limit your review to higher risk lending activities (e.g., subprime lending), areas with identified performance concerns, or newer lending activities or programs (e.g., interest-only loan programs) where the association's track record is limited.

12. Based on your Level I review, determine the need for sampling of homogeneous assets.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

WKP. REF.

## LEVEL II

### One- to Four-Family Residential Lending

1. Determine whether the association has established procedures to verify borrower provided information (such as sending out verification of deposit letters and verification of income letters).

---

2. Determine whether the association has established procedures to perfect its interest in the security property.

---

3. Verify that the association adequately prices mortgage loans to provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit.

---

4. If applicable, determine whether the association has appropriate controls, oversight, and underwriting policies and procedures to address low-doc loan programs.

---

5. For FHA-insured and VA-guaranteed loans:
  - Determine that a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by test checking a representative sample of such loans.
  - Determine that required delinquency reports are being submitted.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

WKP. REF.

## *Adjustable Rate Mortgages*

6. Verify that the points the association receives for originating the ARM loans compensate the association for the discount that the secondary market would demand to accept the risks of that ARM product.

---
7. Determine which index (Treasury bill rate quoted on a discount basis or on the constant-maturity yield rate) the association uses for adjustable rate mortgages (including interest-only mortgages). Verify that association's mortgage documents state precisely which index is used.

---
8. For discounted or "teaser" ARMs:
  - Determine if the association's current pricing structure or policy is sufficient to cover the association's operation expenses, funding costs, and risk premium. If not, determine the soundness of management's strategy, such that:
    - Deeply discounted ARMs, even in periods of stable or falling interest rates, may not reach profitability until at least two or three repricings occur.
    - Any interest-rate movement above the yearly interest-rate cap must be absorbed by the association.
    - Refinancing existing ARMs at lower rates offered on new ARMs reduces the opportunity to recoup initial losses in subsequent repricings.
  - Determine if the association's lending policies and procedures and underwriting guidelines adequately address the increased default risk by qualifying borrowers at or near fully indexed rates.

---
9. Verify that the association properly accounts for interest rate buy downs according to SFAS No. 91.

---

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

---

WKP. REF.

## *Home Equity Lending*

10. If the association originates home equity loans, verify that the association:
- Adheres to the guidance set forth in the Interagency LTV Guidance regarding high LTV loans.
  - Has adequate underwriting procedures.
  - Has an adequate servicing and collection department and staffing.
  - Has adequate monitoring and reporting systems.
- 

## *Negative Amortization Loans*

11. If applicable, determine whether the association has underwriting policies and procedures that adequately address negatively amortizing loans, including limits on the amount of negative amortization allowed on a loan compared with its current market value.
- 

## *Interest Only Loans*

12. If applicable, determine whether the association has underwriting policies and procedures that adequately address interest-only loans.
- 

## *Subprime Mortgage Lending*

13. If the association is engaging in subprime mortgage lending, verify that the association:
- Segregates its subprime loans to manage risks and monitor performance.
  - Follows the Interagency Subprime Lending Guidance and the Expanded Subprime Lending Guidance.

<b>Exam Date:</b>	
<b>Prepared By:</b>	
<b>Reviewed By:</b>	
<b>Docket #:</b>	

# One- to Four-Family Residential Real Estate Lending Program

WKP. REF.

- Has sufficient staff training and resources to manage any additional collection burden.
- Has sufficient ALLL and capital to cover the additional risks inherent in its subprime lending operation.

As appropriate, conduct additional subprime lending examination procedures detailed in Appendix B of Handbook Section 217.

- 
14. Select a sample of subprime loans for review and analyses. **Sampling is mandatory for associations with subprime lending programs.**
- 

## *Reverse Mortgage Loans*

15. Determine if the association engages in reverse mortgage lending. If so, verify that the association:
- Calculates the risk-based capital requirement separately for each reverse mortgage loan.
  - Assesses each borrower's life expectancy for each reverse mortgage loan.
  - Performs a sensitivity analysis on the reverse mortgage loan program's profitability for:
    - A range of alternative mortality rates.
    - A variety of possible appreciation and depreciation scenarios.
- 

16. Determine whether the association structures reverse mortgage loan contracts to withhold the appreciation portion of payment until appreciation actually occurs.
- 

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

---

WKP. REF.

## *Manufactured Home Financing*

17. Determine whether the association engages in manufactured home financing. If so, determine whether the association:
- Is originating residential real estate loans secured by permanently affixed manufactured homes; or investing in retail manufactured home chattel paper that is insured or guaranteed.
  - Has adequate policies and procedures specific to manufactured home financing.
  - Has staff with expertise in this area.
  - Uses professional appraisers experienced in manufactured home valuation.
  - Sells manufactured home chattel paper without recourse.
- 

## *Sampling*

18. If concerns are noted in reviews, select for review a sample of 1-4 family mortgages. You should base this decision on the performance of those portfolios, whether the association offers new loan programs, and the adequacy of the association's lending policies, practices, oversight, and controls. Focus transactional testing on the higher risk areas. Use transactional testing to provide reasonable confidence that the conclusions regarding 1-4 family residential lending are valid.
- 

## **CONCLUSIONS**

1. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.
- 
2. Ensure that your review meets the objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

# One- to Four-Family Residential Real Estate Lending Program

---

WKP. REF.

corrective measures, on the appropriate work papers and report pages.

---

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

**THIS PAGE INTENTIONALLY LEFT BLANK**



**Questions and Answers on Real Estate Lending Standards (RELS)  
Regulation and Guidelines**

1. **What is the private mortgage insurance (PMI) requirement for owner-occupied, one-to four- (1-4) family residential and home equity mortgage loans?**

Owner-occupied, 1-4 family residential and home equity mortgage loans of 90 percent LTV ratio or greater have “appropriate” PMI or readily marketable collateral. There is no requirement to have PMI coverage that would bring the effective LTV ratio down to 80 percent. If an association makes a 95 percent LTV loan and requires PMI that insures losses down below 90 percent, the loan would not be considered a high LTV loan for purposes of the real estate lending standards policy.

2. **Can a savings association originate 100 percent LTV ratio loans without PMI?**

A savings association can originate 100 percent LTV home mortgage loans without PMI, though they would be included in the “Loans in excess of the supervisory LTV limits” category, which must be reported to the board of directors and limited, in aggregate, to 100 percent of capital. While examiners would not take exception to a moderate amount of such loans, they may criticize the association if the loans are underwritten in an unsafe and unsound manner.

3. **What is the loan category for a loan to purchase a developed residential lot where the roads and sewers, etc., are in place, but there are no immediate plans to build a home?**

The association should treat the loan as a land development loan. Although the purpose of the loan is not to develop the lots, the end product is the same. OTS expects savings associations that make higher-risk loans to do so at lower LTV ratios. Those with lower risk, such as loans to purchase finished lots, could be made at the maximum LTV ratio.

4. **Do uninsured deposits that are in excess of the FDIC insurance limit (currently \$100,000) count as “financial instruments” for “readily marketable collateral?”**

Yes.

5. How would the maximum supervisory LTV ratio limit be calculated for loans fully cross-collateralized by two or more properties or secured by a collateral pool of two or more properties?

For cross-collateralized loans, the maximum loan that the association can make within the supervisory LTV ratio limits is based on the following formula: [(Value of each property X appropriate maximum LTV ratio) less any senior liens].

6. What is the loan category of a loan to construct a single-family home, where the borrower has a take-out commitment (made by either the same lender or a different lender) for permanent financing when completed?

A construction-permanent loan secured by a single-family residence to the owner-occupant is treated as a permanent mortgage loan for purposes of categorizing the loan in the supervisory LTV ratio limits. In other words, if the LTV ratio equals or exceeds 90 percent, the loan should have credit enhancement in the form of PMI or readily marketable collateral. A construction loan by one lender with the permanent take-out by a second lender is treated as a 1-4 family construction loan (with an 85 percent supervisory LTV ratio limit) until construction is complete and the permanent lender refinances the loan. If the permanent lender is a closely held affiliate of the construction lender, then the loan can be treated as a permanent loan. Of course, as in all construction loans, a lender should always maintain appropriate disbursement controls during the construction period.

7. Are unsecured loans (with loan proceeds used to purchase or improve real estate) subject to the rule?

Yes. In drafting the statutory language that required the banking agencies to draft regulations requiring federally insured depository institutions to issue regulations on real estate lending standards, Congress was concerned that, without a requirement to include unsecured loans used to finance real estate transactions, some institutions would be tempted to make unsecured loans to avoid having to comply with the rule.

8. Are loans underwritten as “unsecured” loans where the lender takes a security interest in real estate at borrower’s request (i.e., for tax purposes) subject to the RELS rule?

Yes. The “abundance of caution” exception only applies when a loan is otherwise well collateralized, such as a loan to purchase an automobile that is collateralized by the vehicle, and the underwriting criteria and loan terms were more indicative of an auto loan.

9. How should associations categorize, for supervisory LTV ratio limit purposes, mortgage loans that are not principal residences?

Unless such residences meet the Internal Revenue Service (IRS) test of residency, the loans are considered improved property loans (85 percent LTV ratio limit) since they are not owner-occupied, 1-4 family residences. (The definition of owner-occupied requires that the

home be the borrower's principal residence.) If the loan is made with an LTV ratio higher than 85 percent, it is placed in the larger 100 percent of capital "bucket" (which does not have a principal residence requirement).

Loans that meet the IRS test of residency are treated as owner-occupied, 1-4 family residences.

**10. How should loans under the FHA Title I program be treated?**

Similar to the OTS capital rule treatment of such loans, FHA Title I program loans are not considered guaranteed loans, so if the association makes loans with LTV ratios of 90 percent or higher without PMI, they would go in the loans in excess of the supervisory limits "bucket."

**11. Does the REELS rule cover manufactured homes?**

The rule applies to real estate loans. Loans secured by "manufactured homes" that are not affixed to real property are not real estate loans and the REELS rule does not apply to them. Other "similar" personal property – mobile homes, RVs, etc. – are chattel and are not considered home loans under the rule. If a mobile home and a lot secure the loan, the security property is categorized as chattel and land, and the lot loan would be subject to the REELS rule. If a manufactured loan is permanently attached to the property, it is a home loan and covered by the rule.

**12. How should loans guaranteed by the Federal government or state governments be treated for purposes of the supervisory LTV ratio limit if the guarantee is less than the loan amount?**

All loans, or portion of loans, guaranteed by the U.S. Government or its agencies, and all loans backed by the full faith and credit of a state government, are excluded from the supervisory LTV ratio limit guidelines. Consequently, any portion of a loan that is so guaranteed should not be categorized as a high LTV loan.

**13. Do we include non-owner-occupied, 1-4 family loans in the 100 percent of capital exception bucket?**

Yes. Non-owner-occupied 1-4 family loans are subject to the 85 percent LTV ratio for improved property loans; such loans with LTV ratios greater than 85 percent are placed in the 100 percent exception bucket.

14. Are loans in excess of the supervisory LTV limit secured by developed lots for 1-4 family residential homes placed in the 100 percent of capital exception bucket?

Yes. All loans related to 1-4 family residential properties go into the 100 percent exception bucket. For developed lots, the lots should be in a 1-4 family residential subdivision and properly zoned to be treated as 1-4 family residential properties.

15. Should home improvement loans be treated like permanent mortgages or construction loans?

Yes, home improvement loans should be treated like permanent mortgages for purposes of determining the maximum supervisory LTV.

16. If an association has a firm take-out commitment on a construction loan, can it be treated as an excluded transaction under the fourth exclusion (loans to be sold)?

No, because the borrower has not met the conditions of the ultimate lender (complete construction, obtain an occupancy permit, etc.).

17. How do you determine the supervisory LTV ratio limits for multi-stage projects?

The maximum LTV ratio for multi-stage projects is ultimately limited by the LTV ratio applicable to the final stage of the loan. Associations should establish, as part of their loan administration policies, procedures on loan disbursements, based on the value of the project less the cost to complete it less a completion reserve, during the entire construction process. In general, prudent loan disbursement means that funding of the initial acquisition of raw land should not exceed 65 percent of the cost of the land and funding the development stage should not exceed 75 percent of the costs of development, etc.

18. For cross-collateralized loans, we calculate the maximum LTV ratio based on a weighted average method. If one loan in the pool is over the LTV ratio limits, what goes into the high LTV ratio “bucket?”

If the weighted-average LTV ratio of the pool is over the maximum supervisory LTV ratio, the whole pool goes into the bucket. If the weighted-average LTV ratio is less than the supervisory maximum, nothing goes into the bucket, even if one loan is above the maximum supervisory LTV ratio. This is in recognition that with cross-collateralization, the association has “excess LTV ratio cushion” in one loan to “cover” another loan’s lack of LTV ratio cushion. Conversely, if the entire excess cushion is used, then the whole pool presents a higher degree of risk. This will give associations an incentive to structure pools to exclude any loans that might cause the pool to be put in the bucket, but that is acceptable. We can review any individual loan for safety and soundness, and associations should only be making prudent loans.

19. If a bank makes a loan to a borrower to purchase a property and make improvements that will enhance the value over the original cost, on what value should the LTV be based?

In general, the LTV should be based on the original cost plus the improvements, however, use the fair market value (per the appraisal or evaluation) as completed after the improvements are made.

**THIS PAGE INTENTIONALLY LEFT BLANK**

## **RISKS AND POLICY ISSUES ASSOCIATED WITH REVERSE MORTGAGE LOANS**

### **Accounting for Reverse Mortgages**

The accounting for reverse mortgages, including the recognition of interest and fee income, should be in accordance with instructions provided by the staff of the Securities and Exchange Commission (SEC), in an October 1992 paper, “Accounting for Pools of Uninsured Residential Reverse Mortgage Contracts.” In general, the SEC instructions require the grouping of individual reverse mortgages into pools, and then adjusting the carrying value of, and recognizing income on the pools based on the retrospective yield. The retrospective yield is the effective yield from inception of the mortgages, which reflects both actual cash flows to date and expected future cash flows.

The SEC instructions require that estimates of future cash flows incorporate actuarial projections of mortgage terminations, including assumptions about life expectancy, prepayments, and borrower relocation, and projections of collateral values. At each reporting date, the analysis of actual cash flows to date and expected future cash flows is to be updated, and the retrospective yield is to be recomputed. The carrying value of each pool of reverse mortgage loans represents the recorded investment in the loans, adjusted on a cumulative basis for income recognized based on the retrospective yield. Considering the complex accounting issues involved with reverse mortgage lending, savings associations are cautioned against engaging in such programs unless their accounting staffs have the knowledge and experience to deal with such issues.

### **Classification of Reverse Mortgage Loans**

Savings associations should classify reverse mortgage loans in accordance with the OTS Classification of Assets regulation 12 CFR § 560.160 and OTS bulletins and policy statements. The OTS regulation directs federal savings associations to classify assets based on well-defined weaknesses. Assets are classified Substandard, Doubtful, or Loss based on the degree and likelihood that the association would sustain a loss on the assets.

Unlike standard mortgage loans, reverse mortgage loans are repaid from the proceeds of the sale of collateral, not monthly borrower payments. As such, reverse mortgage loans that are not insured by an agency of the federal government should be classified based on the ability of the collateral to support the loan. A loan should be adversely classified if the recorded investment in the loan (including accumulated advances to borrowers, accrued fees, accrued interest, deferred net fees, and any unamortized purchase premium or discount<sup>1</sup>) exceeds the estimated net proceeds from the sale of the

---

<sup>1</sup> The contra account resulting from the application of the retrospective yield approach, if determined on a pool basis, should not be deducted in arriving at the recorded investment. (Specific valuation allowances, however, can be deducted from the loan balance in arriving at the recorded investment.) This is because the classification decision is made on a loan-by-loan basis. Also, because this contra account is not available to absorb losses in the association’s entire portfolio, it cannot be included in the association’s allowance for loan and lease losses (ALLL) for purposes of the risk-based capital regulation.

security property, based on the most current value of the property (based on an appraisal or evaluation). Disposition costs, such as real estate commissions, attorney's fees, settlement costs, etc., reduce the amount realized from the sale of the property. Therefore, unless an association can show that its disposition costs will likely be less than 10 percent, it should classify loans with a loan-to-value (LTV) ratio (based on the current appraised value of the property) greater than 90 percent as no less severe than Substandard.<sup>2</sup> It should be noted that loan amounts greater than the expected net disposition value of the property should be netted from the loan by additions to the retrospective yield contra account. Therefore, classifying such amounts Loss is not necessary.

### **Risk-Based Capital Rule Treatment**

Reverse mortgages are treated as follows under the risk-based capital rule:

*On-balance-sheet amounts* are treated like other mortgage loans. Reverse mortgage loans that meet the requirements for "qualifying mortgage loans" (including LTV ratio and performance requirements) are risk-weighted at 50 percent. Once the loan no longer qualifies as a "qualifying mortgage loan" (such as when the LTV ratio is 90 percent or higher), the loan should be risk-weighted at 100 percent. (The LTV ratio, for the capital rule purposes, is computed using the recorded investment in the loan as the numerator and the original property value as the denominator.)

*The off-balance-sheet commitment amount* is first converted to an on-balance-sheet credit equivalent amount and then risk-weighted in the same fashion as the on-balance-sheet asset. Savings associations should use the 50 percent credit conversion factor for the off-balance-sheet commitment. (The 50 percent credit conversion factor assumes that the commitment is not cancelable by the association. Unconditionally cancelable commitments do not have to be included in the calculation of risk-weighted assets.) The amount of the off-balance-sheet commitment is determined by multiplying the number of remaining payments<sup>3</sup> by the amount of the advance to be paid each period. The off-balance-sheet commitment amount must be recalculated annually. For line of credit loans, which contain a cap on the dollar amount to be provided to the borrower, the off-balance-sheet commitment is the undisbursed line of credit amount.

Although pool accounting may be used to determine an association's yield on its reverse mortgage investment, the risk-based capital requirement must be calculated separately for each loan.

---

<sup>2</sup> Because reverse mortgage loans are accounted for using the retrospective yield method, which requires a contra account for uncollectible amounts, it is not necessary that uncollectible amounts be classified Loss. An ALLL is not automatically required on reverse mortgage loans classified Substandard. However, general allowances should be established for reverse mortgage loans if the association is likely to experience losses on the disposition of the security property that are not reflected in the recorded investment. The level of any required ALLL on reverse mortgage loans should be based on the association's historical net loss experience for reverse mortgage loans, adjusted for current conditions and trends.

<sup>3</sup> For tenure loans, the number of remaining payments is usually equal to the estimated number of remaining months of a borrower's life, based on a third-party, independent actuarial table.



### **Mortality/Relocation Estimates**

In order to estimate how long a savings association will have to make payments under the tenure reverse mortgage loan contracts, it must assess each borrower's life expectancy. Such estimates are generally made using mortality rates, published by the U.S. Bureau of the Census, or actuarial tables available from life insurance companies.<sup>4</sup> It is important that an association use current actuarial tables from a reliable and independent source (preferably from a major life insurance company or some other entity that has proven expertise and reliability). Also, consideration should be given to whether national mortality norms can be expected to hold for the association's particular area and mix of borrowers. There is the risk that a particular population will not behave as predicted by national mortality and relocation norms. Persons who apply for reverse mortgages may not be representative of the general population, so there is the potential for the mortality rates of an association's borrowers to deviate significantly from published tables. Therefore, an association should perform a sensitivity analysis on the effect a range of alternative mortality rates would have on the program's profitability.

Some reverse mortgage lenders use both mortality and relocation rates to estimate when the reverse mortgage contract will terminate. Typically, a reverse mortgage loan is expected to terminate when the borrower either moves or dies. Since senior citizens often relocate before they die, the use of relocation rates allow for contract term estimates to be shorter and allow lenders to justify larger payments to the borrower. Federal savings associations are urged to use caution when adopting relocation rates for the general elderly population, because reverse mortgage borrowers may alter their relocation patterns in light of the fact that they will continue to receive monthly payments from the lender as long as they remain in their homes.

### **Appraisals and the Requirement for Reappraisals**

As with other real estate loans, the provisions of 12 CFR Part 564 establish when an appraisal or evaluation is required for a reverse mortgage loan. There are no specific requirements for reappraisals or reevaluations after a loan is made; however, as with other types of real estate loans, the association should periodically assess the value of the collateral supporting its loans. This is particularly important for reverse mortgage loans because the loan balance increases over time and the collateral is the primary source of repayment.

As stated in Thrift Bulletin 55, Real Estate Appraisal and Evaluation Guidelines, the useful life of an appraisal or evaluation will vary depending on the property and the market place. Management should determine if there have been material changes to the appraisal's or evaluation's underlying assumptions that affect the original estimate of value. Factors that could cause material changes in property values include:

- Passage of time.

---

<sup>4</sup> Insurance companies use actuarial tables (also referred to as annuity tables) to determine the monthly amount they can profitably pay to a purchaser of their annuity products. Actuarial tables differ from mortality tables in that they have built-in assumptions that annuitants will die at a slower rate (generally 65 percent to 85 percent) than indicated by mortality tables. This assumption serves two purposes: (1) it protects the insurance company in the event that annuitants live longer than projected by mortality tables, and (2) it allows the insurance company to build a profit into the annuity product.

- Market volatility.
- Availability of financing.
- The inventory of unsold homes in the marketplace.
- New improvements to, or lack of maintenance on the security property or surrounding properties.
- Zoning changes.
- Changes in the local economy.

If the useful life of an appraisal or evaluation becomes suspect, management should determine whether there is a need for a reappraisal or reevaluation. Where property values have changed significantly from when the loan was originated, a new appraisal or evaluation may be warranted.

This is particularly important if property values have declined or if the loan balance of an individual loan approaches the anticipated market value of the security property. A significant change in property value will result in a corresponding increase or decrease in the estimated net collateral proceeds at contract termination and, therefore, an adjustment to the association's effective yield on the loan.

### **Property Appreciation Assumptions**

Reverse mortgage loan programs often assume that the security property will appreciate over the life of the loan. Integrating property appreciation assumptions into the loan contract allows lenders to offer higher payments to borrowers because the lender would ostensibly receive more funds from the sale of the property when the borrower dies or relocates. While appreciation assumptions may seem reasonable and supported by historical experience, in some markets the anticipated appreciation may not materialize, and, in other markets, properties that have experienced high appreciation rates over the past decade could experience substantial depreciation in the future.

Savings associations should analyze the characteristics and profitability of their reverse mortgage loans under a variety of appreciation and depreciation scenarios, including a "worst case" scenario of property depreciation such as those experienced in parts of California and Boston in the early 1990s. When estimating cash flows for accounting purposes, associations should adjust any appreciation or depreciation assumptions periodically during the life of the loan.

Finally, association management is encouraged to take a very conservative stance toward property appreciation and depreciation assumptions. It may be useful to structure contracts to withhold the appreciation portion of the payment until appreciation actually occurs. The benefit of this structure is that, if appreciation actually occurs, the association could justify higher payments to borrowers later in the contract, which, in effect, would provide borrowers with a hedge against inflation.

### **Interest-Rate Risk**

Interest-rate risk is potentially high for fixed-rate reverse mortgage loans. Because of their negative amortization feature, fixed-rate reverse mortgage loans could have substantially greater interest-rate sensitivity than standard 30-year fixed-rate mortgage loans. The Thrift Financial Report's Consolidated Maturity and Rate Schedule (Schedule CMR) does not have a separate category for reverse mortgages, so they must be reported as they are on Schedule SC. For purposes of Schedule CMR, the savings association should report the outstanding balance of reverse mortgages similar to the manner in which it reports other home mortgage loans, that is, the current outstanding balance (not the estimated future disbursements). The weighted average maturity should be based on the expected life of the loan, given mortality calculations.

Because Schedule CMR may not reflect the interest-rate sensitivity of reverse mortgages, savings associations that plan a significant investment in reverse mortgage loans should conduct an interest-rate sensitivity analysis. Such investment may require associations to undertake an internal interest-rate risk analysis required by Thrift Bulletin 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Activities.

### **Taxes and Insurance**

To protect the collateral value of the security property, savings associations should ensure that real estate taxes are paid and that adequate hazard insurance is maintained. This becomes critically important as the borrower's equity diminishes, because they may have less incentive to pay real estate taxes. Savings associations are advised to monitor the payment of real estate taxes and insurance and to hold blanket hazard insurance policies to cover any lapse in coverage.

### **Property Maintenance**

Adequate maintenance of the security property is critical to a reverse mortgage program. Although most reverse mortgage loan documents oblige borrowers to keep their property in good repair and otherwise maintain the value of the property, the borrowers may have little incentive or ability to do so. While typical reverse mortgage loan documents grant the lender the authority to make needed repairs and add the costs to the loan balance, such additions to the loan balance only increase the risks that there will be insufficient value in the home upon sale to cover the amount due. While the lender could conceivably declare default if the borrower fails to maintain the property, public relations considerations may preclude such action. Also, there are costs associated with property inspections to ensure that the borrower properly maintains the property. Therefore, lenders should consider the effect of deferred maintenance (or lender funded repairs) on the value of their investment.

### **Legal Requirements and Legal Risks**

While reverse mortgage loans have been available for some time, the product is not in widespread use. Therefore, federal savings associations may not be thoroughly familiar with the statutory and regulatory requirements that will apply if they offer a reverse mortgage program. In addition, the contractual rights and obligations of borrowers and lenders in these transactions will differ significantly from those under, for example, purchase-money mortgage loan contracts. For these reasons, a savings association that

offers, or intends to offer, a reverse mortgage program should consult its legal counsel to ensure that the program complies with applicable requirements and that any legal risks associated with these loans are adequately addressed. In this regard, the association should, at a minimum, consider the following laws and statutes:

### *Basic Authority*

Federal savings associations have express authority, under the Home Owners' Loan Act (HOLA) and OTS regulations, to originate or purchase reverse mortgages, notwithstanding any contrary state laws. By virtue of the Alternative Mortgage Transaction Parity Act ("Parity Act"), 12 USC §§ 3801 et seq., state savings associations are also authorized to originate and purchase reverse mortgages even when state law purports to prohibit reverse mortgages, unless the state in question expressly "opted out" of the Parity Act within the three year period beginning on October 15, 1982, and ending on October 14, 1985. In "opt out" states, state law governs the permissibility of reverse mortgages for state savings associations. Federal savings associations are not subject to state law even in states that have exercised their "opt out" option.

Notwithstanding the foregoing, a special rule applies in the state of Texas. The HOLA provides deference to the specific provision in the Texas constitution that prohibits most non-purchase money liens against homesteads.

### *State Usury Laws*

Some reverse mortgage loans have an annual premium feature designed to offset the risks that some borrowers may live longer than the mortality tables predict. If the annual loan fee is significant, the earlier the borrower repays the loan, the higher the effective cost of financing. For example, OTS is aware of some private programs that include an annual loan fee based on the value of the home, not the loan balance. A program with a 5 percent annual loan fee and a 10.5 percent interest rate would result in an effective interest rate of greater than 20 percent should the loan repay within the first 6 years.<sup>5</sup> Therefore, savings associations should determine whether state usury laws apply. Although federal law generally pre-empts the application of state usury laws to mortgage loans (including reverse mortgage loans) that are secured by first liens on residences, 12 USC § 1735f-7a, states were permitted to "opt out" of this pre-emption provision within the three year period beginning on April 1, 1980, and ending on March 31, 1983. Maximum interest rates in "opt out" states will either be governed by state law or the federal Most Favored Lender provision. 12 USC § 1463(g).

### *Disclosure Laws*

Disclosures made to borrowers about reverse mortgage loans must comply with the Truth in Lending Act (TILA) and with the implementing regulation – Regulation Z – promulgated by the Federal Reserve Board. Lenders must provide reverse mortgage borrowers with full and accurate disclosures including, where appropriate, the loan's annual percentage rate and total finance charges. Borrowers must also be notified of their right to rescind the transaction. Also, savings associations should consider

---

<sup>5</sup> The OTS would look unfavorably on such aggressive pricing, which may have a negative effect on the association's CRA rating.

making annual percentage rate and finance charge disclosures under varying scenarios of property appreciation and borrower mortality.

In addition, the Community Development Banking Act amends the TILA to require that lenders make certain new disclosures regarding the projected total cost of a reverse mortgage loan to the borrower.

### **Contractual Provisions**

Circumstances unique to reverse mortgage transactions may affect both the borrower's ability to comply with the terms of the reverse mortgage loan contract and the association's ability to recover possession of the security property at the appropriate time. For example, an elderly borrower receiving a modest fixed income may lack the resources to maintain the security property as called for under the reverse mortgage loan contract. A borrower's heirs may be unaware that he or she has taken out a reverse mortgage and may, upon the borrower's death, challenge the association's right to take possession of the property. While no contractual provision can eliminate the possibility that these problems will arise, foresight and careful drafting of the reverse mortgage loan documents may mitigate the legal risk they present for the association. Savings associations may also reduce their legal risk by ensuring that borrowers understand the practical consequences of the rights and obligations that the reverse mortgage loan contract creates. Savings associations should therefore consider encouraging borrowers to seek independent credit counseling as part of their reverse mortgage programs.

### **Government Guaranteed Reverse Mortgage Programs**

The Department of Housing and Urban Development (HUD), through the Federal Housing Association (FHA), offers a reverse mortgage guarantee program that lenders may participate in. The FHA program is similar to reverse mortgage programs discussed above, except that FHA guarantees payment to the borrower (in the event the lender should become unable to meet its payment obligations to the borrower) and guarantees the lender's investment. Under the program, borrowers pay FHA a mortgage insurance premium (MIP), consisting of an up-front fee of two percent of the maximum claim amount, plus an annual premium of one-half of one percent of the outstanding loan balance. Under the FHA program, the maximum claim amount is the maximum dollar amount that the FHA can insure for a particular geographical area. The MIP, which can be financed, provides a fund to absorb losses in the event that the mortgage balance on some loans exceeds the value of the property at the time the loan becomes due and payable.

The FHA guarantee is structured so that once the balance of a guaranteed loan reaches 98 percent of the maximum claim amount, the lender has the option of assigning the mortgage to FHA, thus eliminating the likelihood of loss to the lender. FHA's loan guarantee is limited to a maximum of the lesser of the appraised value of the house or the maximum dollar amount that the FHA can insure for single-family residences in a geographical area (currently \$67,500 to \$227,550). As mentioned above, the FHA program bases payments on the assumption that a borrower will live to age 100, so monthly payments to a typical FHA program borrower may be lower than payments under programs that use

actuarial life expectancies.<sup>6</sup> Also, interest rates on the FHA reverse mortgage program are often lower than the rates charged by private programs.

As with other FHA guaranteed loans, the guaranteed portion of these loans is risk-weighted at 20 percent for the risk-based capital rule.

Another positive aspect of the FHA program is that Fannie Mae will purchase an association's reverse mortgage loans made under the FHA program. Because of the federal guarantee, an association's participation in this or similar government guaranteed reverse mortgage loan programs alleviate many of the safety and soundness concerns discussed above.

---

<sup>6</sup> The fact that an association's reverse mortgage loan program may have specific features that are very conservative does not ensure that the program as a whole is prudent. Similarly, the fact that the association bases expected loan terms on current actuarial tables, rather than the very conservative mortality assumptions used by the FHA, does not mean that, taken as a whole, the lender's reverse mortgage lending program is imprudent.

## **NEGATIVELY AMORTIZING MORTGAGES**

### **Introduction**

A conventional fixed-rate mortgage holds the interest accrual rate and the payments constant over the life of the loan. A portion of each monthly payment reduces the outstanding principal of the loan. Negative amortization (NegAm) adjustable rate mortgages (ARMs) are structured such that the outstanding principal balance may increase, even though payments are current. Negative amortization occurs when the borrower makes a payment at an interest rate that is lower than the accrual rate; therefore, the monthly payment is insufficient to cover the interest expense, and the difference is added to the principal amount.

If lenders carefully underwrite NegAm loans with prudent loan to value (LTV) percentages and monitor the loans closely, the added credit risk may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns. In addition, the credit performance of NegAm loans is particularly vulnerable in an economic environment of rapidly rising interest rates and stagnant or falling property values.

### **NegAm Products/Features**

Most NegAm loans have the following common features:

- Begin with an introductory teaser rate
- Borrower choice of payment amount
- A lagging aggregate interest rate index
- A cap on annual payment increases
- Contain maximum principal accrual limits
- Mandatory recast dates.

**Teaser rate** . Typically, a savings association originates a NegAm loan with a low introductory “teaser” rate. This may be more than 200 basis points below the fully indexed loan rate. This teaser rate is generally in effect for a period of one to three months. During the teaser rate period, the borrower’s payment rate is the same as the lender’s accrual rate (interest rate). At the expiration of the teaser rate period, the loan’s interest rate immediately rises to the fully indexed rate; however, the minimum required loan payment remains the same until the next payment adjustment. During this period, the loan is typically negatively amortizing.

The lender determines the interest rate by adding a margin, stated in the mortgage, to the underlying index rate. This margin over the index varies with competitive pricing pressures, but is usually in the range of 200 to 300 basis points.

**Payment amount.** Borrowers typically have four payment options available with these loans:

- An amount sufficient to amortize the loan over 30 years.
- An amount sufficient to amortize the loan over 15 years.
- Interest only.
- A minimum payment that permits negative amortization.

**Index.** The NegAm loan's interest rate typically adjusts either every month, six months, once a year, every three years, or every five years. Historically, most NegAm interest rates were based on the 11th District Cost of Funds Index (COFI). However, in the last few years, lenders have shifted away from COFI and now use other indexes such as the 12-Month Treasury Average (MTA). Both COFI and MTA have a delayed response to interest rate changes compared with the constant maturity Treasury (CMT) index. This lagged response reduces the potential for borrower payment shock. It also, to the extent that an association's liabilities more closely resemble the COFI than the CMT, reduces that association's basis risk from an asset/liability management perspective. However, if the spread between an association's cost of funds and COFI widens for whatever reason, the association may face substantial income compression.

**Payment caps.** Payment increases or decreases on NegAm loans are typically capped at 7.50 percent per year. If the capped payment is not sufficient to fully amortize the loan, the shortfall is added to the loan balance. A shortfall occurs when the payment rate is less than the accrual rate.

**Accrual limits and recast dates.** NegAm loans typically recast at the earlier of: (1) every five years, or (2) when the loan balance increases to more than 110 percent (sometimes 125 percent) of the original loan amount, known as the principal accrual limit. When recast, the loan payment will adjust to a level to fully amortize the loan over the remaining 25 years and is not subject to the 7.50 percent annual payment cap. For a \$200,000 loan with a 110 percent accrual limit, the recast would occur if the principal balance increased to \$220,000. If the initial LTV were 80 percent, the LTV would have increased to 88 percent at the recast date (assuming no documented increase in property value). Other maximum principal accrual limits may also be encountered.

## **NegAm Risks**

ARM lending involves a transfer of interest rate risk from the lender to the borrower. As a tradeoff, the lender must assume the additional credit risk associated with a borrower's potential inability to service the loan if interest rates rise. NegAm loan products were developed, in part, to help prevent payment default from occurring because of interest rate spikes. They have proven able to mitigate some of the risk associated with payment shock and prepayment.



**Underwriting standards.** Lenders do not directly hedge the option or credit risk associated with NegAm loans, but control the risks with appropriate underwriting standards, caps, and limits. The combination of deep teaser rates, aggressively qualifying borrowers at below fully indexed rates, high principal accrual limits, and the lack of initial LTV controls increase the credit risk to the lender.

**Payment shock.** NegAm borrowers may face recast payment shock, where the loan payment adjusts upward to fully amortize the principle balance over the remaining life of the loan without the protection of interest rate or payment caps. Borrowers may not be able to continue to make the higher payments. This is especially true where lenders make NegAm loans to subprime borrowers or there are inadequate underwriting controls. As a group, subprime borrowers are more likely to utilize the NegAm option, lessening future payment shock protection.

**Capitalized interest.** Lenders may record negative amortization as income in the form of capitalized interest. The lender does not actually receive the negative amortization amount as a payment from the borrower. Under generally accepted accounting principles (GAAP) the lender capitalizes (adds to the loan balance) the negative amortization interest amount and recognizes the amount as income as long as the capitalized interest is considered collectible. The collectibility of the interest depends on the borrower's ability and willingness to pay, which itself can be influenced by the size of the loan relative to the property value. An increasing capitalized interest balance may indicate increasing credit risk, as it might indicate declining borrower equity and less available payment shock protection for the portfolio. A high level of capitalized interest may also create cash flow or liquidity concerns for the lender.

**Credit risk.** LTVs can increase over time (if property values decline or the borrower chooses to make the minimum payment), which increases the credit risk to the association. However, recast requirements should prevent runaway LTVs. If property values do not appreciate and interest rates rise, all lenders may be adversely affected, but NegAm lenders more so because of escalating LTVs. Additionally, the reported earnings sometimes mask credit risk in a NegAm portfolio, where the association is accruing income at a higher rate than the borrower is paying on the loan. Traditional credit quality monitoring reports of point-in-time delinquency and default data may lag as indicators of asset quality problems because borrowers facing payment problems can opt to reduce their monthly payments without causing the loan to go delinquent or disrupting the income accrual on the loan.

### NegAm Compliance Requirements

Promotion of NegAm loans must comply with OTS and other federal regulatory requirements. Section 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of NegAm loans originated. NegAm loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B or OTS Nondiscrimination regulations. The Truth in Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to NegAm loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are prohibited from having negative amortization features. Moreover, NegAm loans are subject to evaluation under the Community Reinvestment Act and

implementing regulation as part of the association's performance in meeting the credit needs of its community.

### NegAm Risk Management

Not all NegAm loan portfolios are structured the same or have higher credit risk. If lenders carefully underwrite NegAm loans with prudent LTVs and monitor the loans closely, the added credit risk they face may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns.

Lenders engaged in a NegAm lending program should monitor the quality of the NegAm portfolios closely. Specifically, lenders should track and monitor all loans with the NegAm option and quantify the borrowers' preferences regarding NegAm loan payments. The choice of making the fully amortizing versus the minimum payment is a borrower option, the exercise of which is a revealing indicator of a borrower's ability to service the loan. Additionally, lenders should:

- **Use appropriate underwriting standards.** Underwriting standards for NegAm loans should meet the real estate lending standards set forth in 12 CFR §560.101. Poor underwriting can create loans where the potential risk from negative amortization is excessive.
- **Identify the percentage of borrowers utilizing negative amortization and the associated capitalized interest.** Because capitalized interest may have accumulated over several years, lenders should report balances by loan vintage. If capitalized interest is substantial, its impact on the association's income levels should be analyzed to evaluate the quality of earnings. Excess capitalized interest may also create possible cash flow or liquidity concerns.
- **Track NegAm loan performance by program and origination year.** Point-in-time delinquency reports for NegAm loans can be misleading and mask immediate problems not reflected in delinquency rates. NegAm delinquency rates are generally only meaningful when combined with an analysis of borrower utilization and capitalized interest levels. If NegAm utilization and capitalized interest levels are increasing, future credit problems may arise.
- **Track performance by credit scores.** If warranted, segment the portfolio into different credit score groups to better track performance and risk exposure.
- **Monitor the impact of its use of NegAm loans on its record of meeting the credit needs of its community, including low- and moderate-income markets.** While many NegAm loan programs offer expanded credit opportunities to communities, a few may have the effect of unduly eroding borrowers' equity and thus adversely affecting the communities.

### Qualifying for the 50 Percent Risk-Based Capital Treatment

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines qualifying mortgage loans as one- to four-family residential first mortgage loans that are performing, are prudently underwritten, and have LTV ratios at origination of 90 percent or

less, or are covered by private mortgage insurance. To qualify for a 50 percent risk weighting, NegAm loans should meet the above requirements. Should a portfolio of NegAm mortgages present safety and soundness concerns, OTS may direct the association to risk weight some or all of the NegAm mortgages and any future production at 100 percent or more.

### **Examination of NegAm Lenders**

You should carefully analyze NegAm lending programs and determine if the association has appropriate underwriting controls and standards as described throughout this Appendix. As with all loan types, you will evaluate the level of credit risk in the association's portfolio and ensure that loan loss reserves and capital are sufficient to support the level of risk.

**THIS PAGE INTENTIONALLY LEFT BLANK**

---

Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
Office of Thrift Supervision

---

October 8, 1999

**INTERAGENCY GUIDANCE ON HIGH LTV RESIDENTIAL  
REAL ESTATE LENDING**

**PURPOSE**

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are jointly issuing this statement to address some of the inherent risks of high loan-to-value (LTV) residential real estate lending. This statement clarifies that the real estate lending standards jointly adopted by the agencies in 1992 apply to these transactions.<sup>1</sup> This statement also outlines other controls the agencies expect institutions to have in place when engaged in this type of lending.

**Background and Scope**

Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 required the agencies to adopt uniform regulations prescribing real estate lending standards. The agencies' regulations and the appended Guidelines require institutions to adopt and maintain comprehensive, written real estate lending policies. The Guidelines describe the criteria, specific factors, and supervisory LTV limits that institutions should consider when establishing their real estate lending policies.

---

<sup>1</sup> The agencies adopted uniform rules on real estate lending and issued the *Interagency Guidelines for Real Estate Lending Policies* (Guidelines), dated December 1992. See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS).

For the purpose of applying the Guidelines to high LTV residential real estate loans, a high LTV residential real estate loan is defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied 1- to 4-family residential property that equals or exceeds 90 percent of the real estate's appraised value, unless the loan has appropriate credit support. Appropriate credit support may include mortgage insurance, readily marketable collateral or other acceptable collateral that reduces the LTV ratio below 90 percent.<sup>2</sup>

Insured depository institutions have traditionally avoided originating residential real estate loans in amounts exceeding 80 percent of the appraised value of the underlying property unless the amount above 80 percent was supported by private mortgage insurance, a government guarantee or other credit support. However, this trend is changing. Consumers are increasingly using the equity in their homes to refinance and consolidate other debts or finance purchases. By doing so, they can generally obtain favorable repayment terms, lower interest rates, and tax advantages relative to other forms of consumer debt, such as unsecured credit cards. These and other factors have stimulated strong consumer demand for these loans.

#### *Credit Risks Associated with High LTV Loans*

High LTV lending can be profitable when risks are effectively managed and loans are priced based on risk. High LTV lending poses higher risk for lenders than traditional mortgage lending. A summary of the primary credit risks associated with this type of lending follows:

- **Increased Default Risk and Losses.** Recent studies indicate that the frequency of default and the severity of losses on high LTV loans far surpass those associated with traditional mortgages and home equity loans.<sup>3</sup> The higher frequency of default may indicate weaknesses in credit risk selection and/or credit underwriting practices, while the increased severity of loss results from deficient collateral protection. In addition, the performance of high LTV borrowers has not been tested during an economic downturn when defaults and losses may increase.
- **Inadequate Collateral.** High LTV loans are typically secured by junior liens on owner-occupied single-family residences where the combined loans frequently exceed the market value of the home, sometimes by as much as 25 to 50 percent. When such a loan defaults and the combined LTV exceeds 90 percent, it is unlikely that the net sales proceeds will be sufficient to repay the outstanding debt because of foreclosure, repair, and selling expenses. Therefore, high LTV lenders are exposed to a significant amount of loss in the event of default.

---

<sup>2</sup> Examples of readily marketable collateral and other acceptable collateral are contained in the Guidelines.

<sup>3</sup> Moody's Investor Service. "Moody's Home Equity Index Update, Special Report," pp 2, 6 - 8, dated October 2, 1998; "Home Equity Index Update: 3Q98," pp 7-8, dated January 22, 1999; and 1Q99, pp 1-2, 9, dated May 21, 1999; OTS Research and Analysis, "National Mortgage Default Rates and the Vintage Effect," May 19, 1997, p 5.

- **Longer Term/Longer Exposure.** High LTV loans generally have long maturities (up to 30 years). The lender's funds are therefore at risk for the many years it takes the loan to amortize and the borrower to accumulate equity. This leaves lenders vulnerable to future adverse events beyond their control, such as the death, divorce, sickness or job loss of a borrower. Finally, high LTV loans are often underwritten using credit-scoring models. The predictive value of these models is less reliable beyond a two-year horizon and across different economic cycles.
- **Limited Default Remedies.** Traditional mortgage servicing and collection procedures are not as effective when engaging in high LTV lending because the sale of collateral and customer refinancing are generally eliminated as ways to collect these loans. A delinquent borrower with little or no equity in a property may not have the incentive to work with the lender to bring the loan current to avoid foreclosure. The borrower also may not have the ability to fund closing costs to sell the property as an alternative source of repayment. Therefore, high LTV lenders must intervene early to reduce the risk of default and loss.

### *Effective Risk Management Programs*

Institutions involved in high LTV lending should implement risk management programs that identify, measure, monitor, and control the inherent risks. At a minimum, an institution's program should reflect the existing Guidelines for real estate lending, as well as the other risk management issues discussed within this statement. The following represents a partial summary of the Guidelines. Institutions should refer to the Guidelines for additional guidance on loan portfolio management considerations, underwriting standards, and credit administration.

### **Loan-to-Value Limits**

The Guidelines direct institutions to develop their own internal LTV limits for real estate loans, subject to the supervisory LTV limits. The Guidelines permit institutions to grant or purchase loans with LTV ratios in excess of the supervisory LTV limits provided that such exceptions are supported by documentation maintained in the permanent credit file that clearly sets forth the relevant credit factors justifying the underwriting decisions. These credit factors may include a debt-to-income ratio or credit score. The Guidelines further specify that all loans in excess of the supervisory LTV limits should be identified in the institution's records and should not exceed 100 percent of the institution's total capital.<sup>4</sup>

The Guidelines state that first lien mortgages or home equity loans on owner-occupied, 1- to- 4- family residential property loans whose LTV ratios equal or exceed 90 percent should have appropriate credit support, such as mortgage insurance, readily marketable collateral, or other acceptable collateral. Through this policy statement, the agencies clarify that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support,

---

<sup>4</sup> Moreover, within the aggregate limit, total LTV exceptions for all commercial, agricultural, multifamily, or other non-1- to 4-family residential properties should not exceed 30 percent of total capital.

should be considered an exception to the Guidelines and included in the institution's calculation of loans subject to the 100 percent of capital limit.

### **CALCULATING THE LOAN-TO-VALUE RATIO**

For the purpose of determining the loans subject to the 100 percent of capital limitation, institutions should include loans that are secured by the same property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should include the recourse obligation of any loan in excess of the supervisory LTV limits that is sold with recourse.

The LTV ratio for a single loan and property is calculated by dividing the total (committed) loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. The following guidance is provided for those situations involving multiple loans and more than one lender. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.
- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the Guidelines and may be excluded from the institution's 100 percent of capital limitation.

### **Transactions Excluded from Supervisory Guidelines**

The Guidelines describe nine lending situations that are excluded from the supervisory LTV limits, reporting requirements, and aggregate capital limitations. The agencies have received numerous questions from bankers and examiners regarding two of these excluded transactions. These are:



- 
- **Abundance of Caution.** The Guidelines indicate that any loan for which a lien on or interest in real property is taken as additional collateral through an abundance of caution may be excluded from the supervisory LTV and capital limits. The Guidelines specifically state that “abundance of caution” exists when an institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral. Because real estate is typically the only form of collateral on a high LTV loan, the abundance of caution exclusion would not apply to these transactions.
  - **Loans Sold Promptly, Without Recourse, to a Financially Responsible Third Party.** The Guidelines state that loans that are to be sold promptly after origination, without recourse, to a financially responsible third party may be excluded from supervisory LTV limits. The agencies have received several inquiries requesting a definition of the word “promptly.”

This exclusion provides flexibility to institutions engaged in mortgage banking operations. Institutions engaged in mortgage banking normally sell or securitize their high LTV loans within 90 days of origination. Accordingly, the agencies will generally find that when a lender sells a newly originated loan within 90 days it has demonstrated its intent to sell the loan “promptly” after origination. Conversely, when a lender holds a loan for more than 90 days, the agencies believe that the intent to sell “promptly” has not been demonstrated. Such loans will be included among the loans subject to the overall capital limit. The agencies may also determine that this exclusion is not available for institutions that have consistently demonstrated significant weaknesses in their mortgage banking operations.

## **BOARD REPORTING AND SUPERVISORY OVERSIGHT**

All exceptions to the Guidelines should be identified in the institution’s records, and the aggregate amount, along with performance experience of the portfolio, should be reported to the board at least quarterly. Examiners will review board or committee minutes to verify adherence to this standard.

An institution will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, its regulatory agency will determine if it has a supervisory concern and take action accordingly. Such action may include directing the institution to reduce its loans in excess of the supervisory LTV limits to an appropriate level, raise additional capital, or submit a plan to achieve compliance. The agencies will consider, among other things, the institution’s capital level and overall risk profile, as well as the adequacy of its controls and operations, when determining whether these or other actions are necessary.

## **OTHER RISK MANAGEMENT ISSUES**

**Loan Review and Monitoring.** Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a

minimum, institutions should segment their high LTV loan portfolio by their vintage (age) and analyze the portfolios' performance for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. Institutions should monitor the ongoing performance of their high LTV loans by periodically re-scoring accounts, or by periodically obtaining updated credit bureau reports or financial information on their borrowers.

On February 10, 1999, the Federal Financial Institutions Examination Council (FFIEC) issued the *Uniform Retail Credit Classification and Account Management Policy*. That FFIEC policy statement established the minimum uniform classification standards for retail credit. Institutions involved in high LTV lending should adopt the standards contained in this policy as part of their loan review program.

**Sales of High LTV Loans.** When institutions securitize and sell high LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high LTV loans must implement procedures to control the risks inherent in that activity. Institutions should enter into written counterparty agreements that specify the duties and responsibilities of each party and include a regular schedule for loan sales.

Institutions should also develop a contingency plan that designates back-up purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, institutions should also establish maximum commitment limits for the amount of pipeline and warehoused loans, as well as designate alternate funding sources.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for the subsequent quarterly revaluations.

**Compliance Risk.** Institutions that originate or purchase high LTV loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to high LTV products for reasons other than the borrower's creditworthiness. Such practices could, for example, violate the Fair Housing Act, Equal Credit Opportunity Act, the Truth in Lending Act (including its special rules and restrictions under the Home Ownership and Equity Protection Act for loans with high rates or closing costs), or the Real Estate Settlement Procedures Act. An adequate compliance management program must identify, monitor, and control the consumer compliance risks associated with high LTV lending.

## **Appendix D: One- to Four-Family Residential Real Estate Lending Secti**

**on 212**

---

---

Emory W. Rushton     Richard  
Senior Deputy Comptroller for  
Bank Supervision Policy  
Office of the Comptroller of the Currency

---

Spillenkothen  
Director, Division of Banking  
Supervision and Regulation  
Board of Governors of the Federal Reserve System

---

James L. Sexton     Richard  
Director, Division of Supervision  
Federal Deposit Insurance Corporation

---

M. Riccobono  
Deputy Director  
Office of Thrift Supervision

**THIS PAGE INTENTIONALLY LEFT BLANK**

---

Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
Office of Thrift Supervision  
National Credit Union Administration

---

May 17, 2005

## **CREDIT RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING**

### **PURPOSE**

In response to the exceptionally strong growth in home equity lending over the past few years, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (collectively, the agencies) are issuing this guidance to promote sound risk management practices at financial institutions with home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). The agencies have found that, in many cases, institutions' credit risk management practices for home equity lending have not kept pace with the product's rapid growth and easing of underwriting standards.

### **Overview**

The rise in home values coupled with low interest rates and favorable tax treatment has made home equity loans and lines attractive to consumers. To date, delinquency and loss rates for home equity loans and lines have been low, due at least in part to the modest repayment requirements and relaxed structures that are characteristic of much of this lending. The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that financial institutions may not be fully recognizing the risk embedded in these portfolios. Specific product, risk management, and underwriting risk factors and trends that have attracted scrutiny are:

- Interest-only features that require no amortization of principal for a protracted period;
- Limited or no documentation of a borrower's assets, employment, and income (known as "low doc" or "no doc" lending);
- Higher loan-to-value (LTV) and debt-to-income (DTI) ratios;
- Lower credit risk scores for underwriting home equity loans;

- Greater use of automated valuation models (AVMs) and other collateral evaluation tools for the development of appraisals and evaluations; and
- An increase in the number of transactions generated through a loan broker or other third party.

Like most other lending, home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral valuation management, individual account and portfolio management, and servicing.

Financial institutions should ensure that risk management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for financial institutions that project or have already experienced significant growth or concentrations, particularly in higher risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party generated loans. This guidance describes sound credit risk management systems for:

- Product Development and Marketing
- Origination and Underwriting
- Third-Party Originations
- Collateral Valuation Management
- Account Management
- Portfolio Management
- Operations, Servicing, and Collections
- Secondary Market Activities
- Portfolio Classifications, Allowance for Loan and Lease Losses (ALLL), and Capital

### **Credit Risk Management Systems**

#### *Product Development and Marketing*

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the

---

institution's internal policies and applicable laws and regulations<sup>1</sup> and to evaluate the credit, interest rate, operational, compliance, reputation, and legal risks. In particular, risk management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, financial institutions should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, refer to the "Third-Party Originations" Section.) Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

### *Origination and Underwriting*

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the agencies' regulations on real estate lending standards,<sup>2</sup> prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.<sup>3</sup> Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.<sup>4</sup> Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's

---

<sup>1</sup> Applicable laws include Federal Trade Commission Act; Equal Credit Opportunity Act (ECOA); Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); Fair Housing Act; Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

<sup>2</sup> In 1992, the agencies adopted uniform rules on real estate lending standards and issued the "Interagency Guidelines for Real Estate Lending Policies." See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC) and 12 CFR 560.100-101 (OTS).

<sup>3</sup> The OCC also addressed national banks' need to assess a borrower's repayment capacity in 12 CFR 34.3(b). This safety and soundness-derived anti-predatory lending standard states that national banks should not make consumer real estate loans based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. See also Regulation Z (Truth in Lending – 12 CFR 226.34(a)(4)).

<sup>4</sup> "Interagency Guidelines Establishing Standards for Safety and Soundness" also call for documenting source of repayment and assessing ability of the borrower to repay the debt in a timely manner. See 12 CFR 30, Appendix A, II.C.2 (OCC); 12 CFR 208, Appendix D-1 (FRB); 12 CFR Part 364, Appendix A (FDIC); and 12 CFR Part 570, Appendix A (OTS).

income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

HELOCs generally do not have interest rate caps that limit rate increases.<sup>5</sup> Rising interest rates could subject a borrower to significant payment increases, particularly in a low interest rate environment. Therefore, underwriting standards for interest-only and variable rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

### *Third-Party Originations*

Financial institutions often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, an institution should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

**Brokers** are firms or individuals, acting on behalf of either the financial institution or the borrower, who match the borrower's needs with institutions' mortgage origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the financial institution and the broker. For control purposes, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

**Correspondents** are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Financial institutions commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating financial institution should have systems and controls to provide assurance that the correspondent is appropriately managed, financially sound, and provides mortgages that meet the institution's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality control unit or function in the delegating financial institution should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio performance management activities.

Both brokers and correspondents are compensated based upon mortgage origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, financial institutions should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the institution should have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or

---

<sup>5</sup> While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 CFR 226.30(b).



---

fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.<sup>6</sup> Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the institution should take appropriate action against the third party, which could include terminating its relationship with the third party.

### *Collateral Valuation Management*

Competition, cost pressures, and advancements in technology have prompted financial institutions to streamline their appraisal and evaluation processes. These changes, coupled with institutions underwriting to higher LTVs, have heightened the importance of strong collateral valuation management policies, procedures, and processes.

Financial institutions should have appropriate collateral valuation policies and procedures that ensure compliance with the agencies' appraisal regulations<sup>7</sup> and the "Interagency Appraisal and Evaluation Guidelines" (guidelines).<sup>8</sup> In addition, the institution should:

- Establish criteria for determining the appropriate valuation methodology for a particular transaction based on the risk in the transaction and loan portfolio. For example, higher risk transactions or non-homogeneous property types should be supported by more thorough valuations. The institution should also set criteria for determining the extent to which an inspection of the collateral is necessary.
- Ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation.
- Implement policies and controls to preclude "value shopping." Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the institution should adhere to a policy for selecting the most reliable method, rather than the highest value.

---

<sup>6</sup> In addition, a financial institution that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the institution can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

<sup>7</sup> 12 CFR 34, subpart C (OCC); 12 CFR 208 subpart E and 12 CFR 225 subpart G (FRB); 12 CFR 323 (FDIC); 12 CFR Part 564 (OTS); and 12 CFR 722 (NCUA).

<sup>8</sup> Comptroller's Handbook for *Commercial Real Estate and Construction Lending*; SR letter 94-55 (FRB); FDIC (Financial Institution Letter (FIL-74-94), dated November 11, 1994; Thrift Bulletin 55a (OTS); and LTCU 03-CU-17 (NCUA).

- Require sufficient documentation to support the collateral valuation in the appraisal/evaluation.

*AVMs*—When AVMs are used to support evaluations or appraisals, the financial institution should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. As part of the validation process, the institution should document the validation’s analysis, assumptions, and conclusions.<sup>9</sup> The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a “confidence score” which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Financial institutions that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Institutions should also establish the confidence levels that are appropriate for the risk in a given transaction or group of transactions.

When tax assessment valuations are used as a basis for the collateral valuation, the financial institution should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property’s market value as part of the validation process.

### *Account Management*

Since HELOCs often have long-term, interest-only payment features, financial institutions should have risk management techniques that identify higher risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, an institution should have risk management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account management practices for large portfolios or portfolios with high-risk characteristics include:

- Periodically refreshing credit risk scores on all customers;
- Using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- Periodically assessing utilization rates;
- Periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;

---

<sup>9</sup> National banks should refer to OCC Bulletin 2000-16, “Risk Modeling – Model Validation.”

- 
- Monitoring home values by geographic area; and
  - Obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.<sup>10</sup>

Where appropriate, financial institutions should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.<sup>11</sup> In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances, and (2) as a result of this change, the institution has a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A financial institution's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

### *Portfolio Management*

Financial institutions should implement an effective portfolio credit risk management process for their home equity portfolios that includes:

*Policies* - The agencies' real estate lending standards regulations require that an institution's real estate lending policies be consistent with safe and sound banking practices and that an institution's board of

---

<sup>10</sup> Under the agencies' risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the institution conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See Appendix A to 12 CFR 3, Section 3(b)(4)(ii) for OCC; 12 CFR 208, Appendix A, III.D.4 and 12 CFR 225, Appendix A, III.D.4 for FRB; Appendix A to 12 CFR 325, II(D)(4) (FDIC); and 12 CFR 567.6 (OTS).

<sup>11</sup> Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 CFR 226.5b(f)(3)(vi)(A) – (F).

directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the institution's overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

*Portfolio objectives and risk diversification* - Effective portfolio management should clearly communicate portfolio objectives such as growth targets, utilization, rate of return hurdles, and default and loss expectations. For institutions with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the institution should analyze the situation sufficiently to enable the institution's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, an institution should analyze the portfolio by segment using criteria such as product type, credit risk score, DTI, LTV, property type, geographic area, collateral valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

*Management information systems* - By maintaining adequate credit MIS, a financial institution can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Financial institutions should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For institutions with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

- Production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type;
- Delinquency and loss distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI);
- Vintage tracking;
- The performance of third-party originators (brokers and correspondents); and
- Market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values.

*Policy and underwriting exception systems* - Financial institutions should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track

---

information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

*High LTV Monitoring* - To clarify the agencies' real estate lending standards regulations and interagency guidelines, the agencies issued "Interagency Guidance on High LTV Residential Real Estate Lending" (HLTV guidance) in October 1999. The HLTV guidance clarified the "Interagency Real Estate Lending Guidelines" and the supervisory loan-to-value limits for loans on one- to four-family residential properties. This statement also outlined controls that the agencies expect financial institutions to have in place when engaging in HLTV lending. In recent examinations, supervisory staff has noted several instances of noncompliance with the supervisory loan-to-value limits of the "Interagency Real Estate Lending Guidelines." Financial institutions should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the institution's board of directors. Specifically, financial institutions are reminded that:

- Loans in excess of the supervisory LTV limits should be identified in the institution's records. The aggregate of high LTV one- to four-family residential loans should not exceed 100 percent of the institution's total capital.<sup>12</sup> Within that limit, high LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.
- In calculating the LTV and determining compliance with the supervisory LTVs, the financial institution should consider all senior liens. All loans secured by the property and held by the institution are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property **equals** or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
- For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the financial institution is legally committed to lend over the life of the loan).
- All real estate secured loans in excess of supervisory LTV limits should be aggregated and reported quarterly to the institution's board of directors.

---

<sup>12</sup> For purposes of the "Interagency Real Estate Lending Standards Guidelines," high LTV one-to four-family residential property loans include: (i) a loan for raw land zoned for one-to four-family residential use with a LTV ratio greater than 65 percent; (ii) residential land development loan or improved lot loan with a LTV greater than 75 percent; (iii) a residential construction loan with a LTV ratio greater than 85 percent; (iv) a loan on non-owner occupied one-to four-family residential property with a LTV greater than 85 percent; and (v) a permanent mortgage or home equity loan on an owner-occupied residential property with a LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

Over the past few years, new insurance products have been introduced to help financial institutions mitigate the credit risks of HLTV residential loans. Insurance policies that cover a “pool” of loans can be an efficient and effective credit risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The agencies will consider pool insurance as a sufficient credit enhancement to remove the HLTV designation in the following circumstances: 1) the policy is issued by an acceptable mortgage insurance company, 2) it reduces the LTV for each loan to less than 90 percent, and 3) it is effective over the life of each loan in the pool.

*Stress testing for portfolios* - Financial institutions with home equity concentrations as well as higher risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Institutions should consider stress tests that incorporate interest rates increases and declines in home values. Since these events often occur simultaneously, the agencies recommend testing for these events together. Institutions should also periodically analyze markets in key geographic areas, including identified “soft” markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

#### *Operations, Servicing, and Collections*

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit risk management should oversee these support functions to ensure that operational risks are properly controlled.

*Lien Recording* - Institutions should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

*Problem Loan Workouts and Loss Mitigation Strategies* - Financial institutions should have established policies and procedures for problem loan workouts and loss mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's “Uniform Retail Credit Classification and Account Management Policy,” issued June 2000, and should, at a minimum, address the following:

- Circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes. Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms;
- Circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure; and

- Appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans. For large portfolios, vintage delinquency and loss tracking also should be included.

While the agencies encourage financial institutions to work with borrowers on a case-by-case basis, an institution should not use workout strategies to defer losses. Financial institutions should ensure that credits in workout programs are evaluated separately for the ALLL, because such credits tend to have higher loss rates than other portfolio segments.

### *Secondary Market Activities*

More financial institutions are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary market activities can enhance credit availability and an institution's profitability, they also pose certain risk management challenges. An institution's risk management systems should address the risks of HELOC securitizations.<sup>13</sup>

### *Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital*

The FFIEC's "Uniform Retail Credit Classification and Account Management Policy" governs the classification of consumer loans and establishes general classification thresholds based on delinquency. Financial institutions and the agencies' examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Financial institutions should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for its HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.<sup>14</sup>

## **CONCLUSION**

---

<sup>13</sup> Refer to "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (May 23, 2002), OCC Bulletin 2002-22 (OCC); SR letter 02-16 (FRB); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, dated November 1997. The Federal Reserve also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21.

<sup>14</sup> See the "Interagency Expanded Guidance for Subprime Lending Programs" issued in January 2001 for supervisory expectations regarding risk management processes, allowance for loan and lease losses, and capital adequacy for institutions engaging in subprime lending programs.

## **Appendix E: One- to Four-Family Residential Real Estate Lending Secti**

**on 212**

---

Home equity lending is an attractive product for many homeowners and lenders. The quality of these portfolios, however, is subject to increased risk if interest rates rise and home values decline. Sound underwriting practices and effective risk management systems are essential to mitigate this risk.