LOAN WORKSHEET #11 –
NONTRADITIONAL AND SUBPRIME MORTGAGE LENDING

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks. Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements ("reduced documentation") and are increasingly combined with simultaneous second-lien loans. Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectability of the portfolio; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

COVERED TRANSACTIONS

Covered Transactions refers to any product considered or contemplated in the *Interagency Guidance on Nontraditional Mortgage Product Risks* and the *Statement on Subprime Mortgage Lending*, including:

Interest-Only Mortgage Loan—A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower[1] is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM—A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment

[1] The terms "borrower" and "consumer" are used interchangeably throughout this document. Where possible, the term originally used in the Guidance or Statement has been retained.

amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Subprime ARM products: ARM products typically marketed to subprime borrowers with the following characteristics:

- Offering low initial payments based on a fixed introductory or "teaser" rate that expires after a short initial period then adjusts to a variable index rate plus a margin for the remaining term of the loan.[2]
- Loans for which borrowers are approved without considering appropriate documentation of their income.
- Loans with very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") at reset periods, potentially causing a substantial increase in the monthly payment amount "payment shock."
- Loans containing product features likely to result in frequent refinancing to maintain an affordable monthly payment.
- Loans that include substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period.
- Soliciting and transacting loans where borrowers are provided inadequate information relative to product features, material loan terms and product risks, prepayment penalties, and the borrower's obligations for property taxes and insurance.

Subprime "extended amortization" products: Adjustable rate and fixed rate products marketed to subprime borrowers with amortization period longer than the term of the loan, such as to require the payment of a balloon amount at the end of the loan term.[3]

OTHER DEFINITIONS

Reduced Documentation—A loan feature that is commonly referred to as "low doc/no doc," "no income/no asset," "stated income" or "stated assets." For mortgage loans with this feature, a provider sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan—A lending arrangement where either a closed-end second-lien mortgage loan or a home equity line of credit (HELOC) is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment.

SPECIFIC POLICIES and PROCEDURES

The following applies to operations of a mortgage subsidiary of the bank as well as the bank itself.

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[2] For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed rate of interest and the fully indexed interest rate in effect at loan origination may range from 300 (3%) to 600 (6%) basis points.

[3] For example, products known as "50/30" loans feature an amortization period of 50 years with a loan term of 30 years. As a result, at the end of the 30 year term, the borrower is required to make a final balloon payment to repay the remaining principal of the loan.

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Evaluate	Comments
______ **1.** Do written policies and procedures adequately cover (as applicable): **A.** Consumer contact as well as direct and indirect (third party) origination of Covered Transactions? **B.** Underwriting and risk layering? **C.** Internal controls, monitoring and reporting? **D.** Loan Servicing, accounting, and training? **E.** Secondary market activity? **F.** Investment Lending?	

Evaluate	Comments
_____ **2. Consumer Contact/Origination Marketing/Promotional Materials.** **A.** Do promotional materials and other product descriptions, including oral statements or scripts, provide information about the costs, terms, features, and risks of Covered Transactions that can assist consumers in their product selection decisions, including information about payment shock, negative amortization, prepayment penalties, and the cost of reduced documentation? _____ **3. Evaluate Underwriting and Qualifying Borrowers.** **A.** Do qualifying standards evaluate borrower's ability to repay the debt by final maturity at the fully-indexed rate, assuming a fully-amortizing repayment schedule and the need to satisfy monthly or annual payments for taxed, insurance and other similar obligations? (e.g. homeowner association fees)?	

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Evaluate	Comments
B. Does underwriting include reasonable limitation on potential payment shock at expected payment change dates? *Examiner note: Consider whether the institution reviews various scenarios of repricing and the borrower's capacity to service the debt after repricing.*	
C. For loans with negative amortization features, does repayment analysis consider the initial loan amount plus any balance increase that may accrue from negative amortization provision?	
D. Does the institution rely on credit scores or property value as a substitute for capacity to repay based upon income?	
E. Summary: Are underwriting standards appropriate to ensure Covered Transactions are originated in a prudent manner?	
_____ **4. Risk Layering**	
A. Does the institution offer Covered Transactions in conjunction with limited documentation of income? If so, is limited documentation of income the norm or the exception?	

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Evaluate	Comments
B. Does the institution offer Covered Transactions in conjunction with simultaneous second-lien loans? If so, describe how and when second-lien loans are used in conjunction with Covered Transactions. **C.** Does the institution offer Covered Transactions with a negative amortization feature where borrower has provided no or minimal equity in the loan transaction? If so, what mitigating factors are used to manage risk of default? **D.** Does the institution offer Covered Transactions where borrowers have subprime characteristics (e.g., low credit score)? If yes, is the institution in compliance with supervisory policy issuances relating to subprime lending? **E.** Does the institution offer Covered Transactions with extended amortization periods or extended loan terms (e.g. 40 year loans)? _____ **5. Operational Management**	

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Evaluate	Comments
A. Does the quality control function regularly review a sample of Covered Transactions originated by sales staff and a representative sample of processors and underwriters to confirm that policies are being followed? What happens if violations of policies occur?	
B. Does the institution track defaults and foreclosures and report on the reasons for borrower inability to satisfy debt payments as contracted?	
C. Do incentive plans for originators promote sale of Covered Transactions over traditional mortgage loans?	
_____ **6. Evaluate accounting, training, and loan modification**.	
A. Does the institution have strong controls over accruals, customer service and collections?	

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Evaluate	Comments
B. Does institution maintain and execute special policies and procedures to modify or work-out loans that enter into delinquency or default within 1 to 3 payments after funding or after an increase in payment? *Examiner Note: A defaulting loan shortly after funding is commonly known as an "early payment default." Typically, a repurchase of the loan will be automatic for borrowers defaulting at the first payment date; however, the examiner should give special attention to any significant amount of defaults occurring within the first three payments. Further, the examiner should consider the underlying reason for early payment default following a payment reset and not make the assumption that payment increase is the sole trigger of default.* **C.** Are borrowers provided a notice 60 days or more prior to the reset date to refinance without being subject to a prepayment penalty? How are borrowers notified of this reset date and opportunities to avoid application of prepayment penalty?	