

**NORTH CAROLINA  
OFFICE OF THE COMMISSIONER OF BANKS**

**FINAL GUIDANCE ON  
NONTRADITIONAL MORTGAGE PRODUCT RISKS**

**I. INTRODUCTION**

On October 4, 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) published final guidance in the *Federal Register* (Volume 71, Number 192, Page 58609-58618) on nontraditional mortgage product risks (“interagency guidance”). The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance does not cover a majority of loan originations, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR), developed and issued parallel guidance (the “CSBS/AARMR guidance”) for licensed mortgage brokers and mortgage bankers that are subject to state regulation. The Office of the North Carolina Commissioner of Banks (“OCOB”) participated in the development of the CSBS/AARMR guidance.

On November 29, 2006, OCOB issued proposed guidance (the “proposed guidance”) to promote consistent regulation in the mortgage market and to clarify how mortgage brokers and mortgage bankers (referred to as “providers”) can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume. The proposed guidance was substantially the same as the CSBS/AARMR guidance, which in turn substantially mirrored the interagency guidance, except for the deletion of sections not applicable to non-depository institutions. OCOB requested comments on the proposed guidance through January 29, 2007. In particular, OCOB requested comment on the following questions:

- Are there unique characteristics of non-bank mortgage lenders or mortgage brokers that should be considered in developing and/or applying guidance on nontraditional mortgage loan products?
- Would this guidance affect your operations? What impact would it have on your compliance systems and costs?
- Are nontraditional mortgage loans a significant portion of the mortgage lending business here in North Carolina? Are these loans concentrated in particular segments of the marketplace here in North Carolina (e.g. subprime borrowers, urban areas, etc.)?

- Is the guidance’s definition of nontraditional mortgage loans appropriate? Are there other similar loan products that pose similar risks that should be included in this guidance?

OCOB received 17 comments regarding the proposed guidance, including comments from a number of state and national trade groups representing various lenders. OCOB has decided to finalize its guidance regarding nontraditional mortgage products (the “final guidance”) in substantially the form of the proposed guidance for the reasons discussed below. OCOB has also updated its examination procedures to reflect the final guidance. Updated examination procedures for nontraditional mortgage loans are included in Exhibit A to assist providers in complying with the final guidance.

## **II. BACKGROUND**

The Agencies developed their guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as “nontraditional,” “alternative,” or “exotic” mortgage loans (hereinafter referred to as nontraditional mortgage loans), include “interest-only” mortgages and “payment option” adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

While similar products have been available for many years, the number of institutions and providers offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages. OCOB is concerned that some borrowers may not fully understand the risks of these products. While many of these risks exist in other adjustable-rate mortgage products, the concern of OCOB is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In addition, providers are increasingly combining these loans with other features that may compound risk. These features include simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant’s creditworthiness.

## **III. COMMENTS ON PROPOSED GUIDANCE AND OCOB RESPONSES TO COMMENTS**

The responses to the questions set out in the OCOB proposed guidance and OCOB’s responses are as follows.

### **A. Unique Characteristics of Brokers and Lenders**

The comments received on this question focused primarily on two areas: 1) differences between non-bank mortgage lenders and depository institutions; and 2) the differences between non-bank lenders and mortgage brokers.

Non-bank mortgage lenders vs. depository institutions. Several commenters highlighted that state regulation of non-bank lenders have focused primarily on consumer protection and compliance, whereas the regulation of depository institutions has focused on safety and soundness. One commenter suggested the proposed guidance was particularly meaningful for non-depositories since the non-bank lenders are not subject to the comprehensive level of on-going regulatory scrutiny that is applied to depositories and that non-bank lenders are responsible for the majority of originations. Other commenters suggested that the relevant state interest for non-bank lenders is consumer protection, not safety and soundness, and therefore, this guidance is less relevant for these lenders.

Lenders vs. brokers. Some commenters objected to application of underwriting criteria to mortgage brokers. These commenters suggested that mortgage brokers operate in a consultative and advisory capacity to borrowers and do not themselves underwrite loans. These commenters expressed concern that the guidance could be read to place responsibility on the broker to make sure loans are properly underwritten.

Final Guidance. The final guidance applies to mortgage lenders and mortgage brokers, as OCOB believes that consistent regulation of the mortgage market requires application of this guidance to all non-bank mortgage originators. North Carolina has a strong interest in the economic viability of mortgage lenders doing business in this state, in part to ensure that North Carolina citizens are served by lenders that meet state standards for financial responsibility.<sup>1</sup> The failure of a mortgage lender as the result of its inability to honor “put backs” of defaulted nontraditional mortgage loans may have real and serious consequences for the mortgage market and the borrowing public.<sup>2</sup>

The final guidance applies to brokers in the context of their relationship to the borrower. The guidance applies directly to education of borrowers about the risks of nontraditional mortgages. In addition, North Carolina law requires that a mortgage broker “act with reasonable skill, care, and diligence”<sup>3</sup> and to “make reasonable efforts, with lenders whom the broker regularly does business to secure a loan that is reasonably advantageous to the borrower considering all the circumstances, including the rates, charges, and repayment terms of the loan and the loan options for which the borrower qualifies with such lenders.”<sup>4</sup> Thus, the guidance does not require brokers to re-underwrite nontraditional mortgages offered by providers; however, the Mortgage Lending Act requires brokers to make reasonable efforts to assist their customers in obtaining appropriate loans from providers.

---

<sup>1</sup> See N.C.G.S. §53-243.05(i)(requiring that the Commissioner determine that an applicant for licensure has financial responsibility).

<sup>2</sup> In *Skinner v. Preferred Credit*, 361 N.C. 114; 638 S.E.2d 203 (2006), *rehearing denied*, 2007 N.C. LEXIS 195 (N.C., Feb. 15, 2007), the North Carolina Supreme Court determined that North Carolina courts do not have jurisdiction over certain types of real estate trusts holding mortgage loans. This limitation on the state’s jurisdiction over investors makes the financial responsibility of originators a key to ensuring the borrowing public will have adequate remedies for violations of North Carolina law.

<sup>3</sup> N.C.G.S. §53-243.10(3).

<sup>4</sup> N.C.G.S. §53-243.10(4).

Accordingly, brokers should develop policies and procedures to ensure they do business with providers that comply with the guidance or the Agency guidance as applicable.

To assist providers with compliance with this guidance, OCOB has attached, as Exhibit A, its examination procedures to ascertain compliance with this guidance.

## **B. Operational Burden**

Most commenters do not anticipate this guidance will impact their operations or compliance costs. Many originators noted that the guidance calls for sound underwriting practices and that they have already updated their compliance systems to manage the risks of nontraditional mortgage loans. Some commenters expressed concern that vague terms or rigid implementation of the guidance could lead to significant impact on their operations.

Final Guidance. The final guidance includes, as Exhibit A, OCOB's examination procedures to ascertain compliance with this guidance. This checklist should assist providers in developing sensible compliance systems that do not create unnecessary operational burdens.

## **C. Prevalence of Nontraditional Mortgage Loans in North Carolina**

Commenters provided a range of opinions on the prevalence of nontraditional mortgage loans in North Carolina. Most commenters noted that they offered nontraditional mortgage loans primarily to astute or sophisticated borrowers, who tended to have high credit scores and high incomes, for the purchase of homes with sales prices above the median home price in the relevant market. Some commenters suggested that nontraditional mortgage loans were more common in higher-cost areas, such as coastal communities. Many commenters concurred with the proposed guidance's concern with nontraditional mortgages being marketed to borrowers with subprime credit or to those families on fixed income. One commenter conducted courthouse research to determine the prevalence of subprime ARMs in the marketplace, finding nearly 10% of loans surveyed to be subprime ARMs.

Final Guidance. While North Carolina may have fewer nontraditional mortgage loans than some other high cost areas, the evidence indicates that these loan products are marketed in the state. While many commenters noted that these products have been available for many years, the marketing to the general public, and the subprime market in particular, is relatively new. This data supports the implementation of the proposed guidance at this time.

## **D. Hybrid ARMs and other products**

Many national and state organizations submitted comments on the question of whether or not subprime hybrid ARMs should be included in the final guidance. One comment

avored expansion of the guidance to include subprime hybrid ARMs, asserting that subprime hybrid ARMs are the predominant product in the subprime marketplace, have the type of payment shock found in the nontraditional mortgage loans covered in the proposed guidance, and are associated with high foreclosures. This comment noted that some federal regulators and members of Congress had expressed concern that the Agencies' guidance did not appear to cover hybrid ARMs that had similar payment shock to other nontraditional mortgage loans.

The majority of commenters favored retaining the current scope of the guidance and specifically encouraged OCOB to avoid expanding the guidance to cover hybrid ARMs. These commenters offered a number of reasons to avoid expansion of the guidance, including: 1) the need for uniform and consistent application of the guidance across providers; 2) the benefits of hybrid ARMs to consumers; and 3) a desire for a more comprehensive notice and comment period in the event that OCOB intended to expand the scope of the guidance.

Final Guidance. The final guidance retains the scope of the proposed guidance and does not expand the guidance specifically to cover subprime hybrid ARMs at this time. The benefits of uniform application and consistency among the states and Agencies outweigh the benefits of including a particular product within the scope of the guidance. In addition, as noted above, the Agencies have issued a proposed statement on subprime mortgage lending that addresses underwriting concerns with subprime hybrid ARMs.<sup>5</sup> CSBS/AARMR have announced their intent to issue a parallel statement on subprime mortgage lending in the near future.<sup>6</sup> OCOB intends to continue to work with AARMR, CSBS, and the Agencies to augment this guidance as necessary.

While the nontraditional guidance does not specifically address subprime hybrid ARMs, providers should be cognizant of the prohibited practices under the Mortgage Lending Act. In particular, North Carolina law prohibits providers from engaging in “any transaction, practice, or course of business that is not in good faith or fair dealing [...] in connection with the brokering or making of [...] any mortgage loan.”<sup>7</sup> By its terms, this duty applies prior to the consummation of the mortgage loan. Providers should engage in sound and prudent underwriting practices to ensure they are not making or brokering loans without a reasonable consideration of the borrower's ability to repay the loan. Mortgage brokers are also reminded of their particular duties to consumers discussed above in Section III.A.

---

<sup>5</sup> See FDIC Press Release PR-18-2007, Proposed Statement on Subprime Mortgage Lending (Mar 1, 2007) at [www.fdic.gov/news/news/press/2007/pr07018a.html](http://www.fdic.gov/news/news/press/2007/pr07018a.html).

<sup>6</sup> CSBS AND AARMR Support Interagency Statement on Subprime Lending, CSBS/AARMR joint press release (Mar. 2, 2007) at [http://www.csbs.org/AM/Template.cfm?Section=Press\\_Releases&CONTENTID=10185&TEMPLATE=/CM/ContentDisplay.cfm](http://www.csbs.org/AM/Template.cfm?Section=Press_Releases&CONTENTID=10185&TEMPLATE=/CM/ContentDisplay.cfm)

<sup>7</sup> N.C.G.S. §53-243.11(8).

#### IV. FINAL GUIDANCE

The text of the final Guidance on Nontraditional Mortgage Product Risks follows:

##### **GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS**

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as “interest-only” mortgages where a borrower pays no loan principal for the first few years of the loan and “payment option” adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.<sup>8</sup>

While some mortgage bankers and mortgage brokers (referred to as “providers”) have offered nontraditional mortgages for many years with appropriate risk management, the market for these products and the number of providers 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.<sup>9</sup> Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes providers 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; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

---

<sup>8</sup> Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (“HELOCs”), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

<sup>9</sup> Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

The Office of the Commissioner of Banks (OCOB) expects providers to effectively assess and manage the risks associated with nontraditional mortgage loan products.

Providers should use this guidance to ensure that risk management practices adequately address these risks. OCOB will carefully scrutinize risk management processes, policies, and procedures in this area. Providers that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Providers with sound underwriting, and adequate risk management will not be subject to criticism merely for offering such products.

### **Loan Terms and Underwriting Standards**

When a provider offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins.

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Providers are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

**Qualifying Borrowers**—Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some providers manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, a provider's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that a provider's underwriting criteria are based on multiple factors, a provider should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, a provider's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final

maturity at the fully indexed rate,<sup>10</sup> assuming a fully amortizing repayment schedule.<sup>11</sup> In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.<sup>12</sup>

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

**Collateral-Dependent Loans**—Providers should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged may be unfair and abusive.<sup>13</sup> Providers that originate collateral-dependent mortgage loans may be subject to criticism and corrective action.

**Risk Layering**—Providers that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, a provider should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit

---

<sup>10</sup> The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11<sup>th</sup> District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

<sup>11</sup> The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

<sup>12</sup> The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

<sup>13</sup> A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

**Reduced Documentation**—Providers increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower’s repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, it is expected that a provider will more diligently verify and document a borrower’s income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, providers generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

**Simultaneous Second-Lien Loans**—Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

**Introductory Interest Rates**—Many providers offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing nontraditional mortgage product terms, a provider should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Providers should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

**Lending to Subprime Borrowers**—Providers of mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should ensure that such programs do not feature terms that could become predatory or abusive. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the provider and the borrower.

**Non-Owner-Occupied Investor Loans**—Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the

borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

### **Risk Management Practices**

Providers should ensure that risk management practices keep pace with the growth of nontraditional mortgage products and changes in the market. Providers that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, providers should:

- Develop written policies that specify acceptable product attributes, production, sales and securitization practices, and risk management expectations; and
- Design enhanced performance measures and management reporting that provide early warning for increasing risk.

**Policies**—A provider’s policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, a provider should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

**Concentrations**—Providers with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Further, providers should consider the effect of employee and third party incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

**Controls**—A provider’s quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

**Third-Party Originations**—Providers often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Providers should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the provider’s lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help providers identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the provider should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.

**Secondary Market Activity**—The sophistication of a provider’s secondary market risk management practices should be commensurate with the nature and volume of activity. Providers with significant secondary market activities should have comprehensive, formal strategies for managing risks. Contingency planning should include how the provider will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, a provider remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, a provider may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets.

### **Consumer Protection Issues**

While nontraditional mortgage loans provide flexibility for consumers, OCOB is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, providers should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

**Concerns and Objectives**—More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the “recast” of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices

that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the provider.

**Legal Risks**—Providers that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that providers must provide for closed-end mortgages in advertisements, with an application,<sup>14</sup> before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the sale or securitization of a loan may not affect a provider's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan.

In addition to federal law, various North Carolina laws apply to these transactions, including laws regarding unfair or deceptive acts or practices (Chapter 75 of the North Carolina General Statutes), requirements under the Mortgage Lending Act (Article 19A of Chapter 53 of the North Carolina General Statutes), and requirements of Chapter 24 of the North Carolina General Statutes regarding usury.

### **Recommended Practices**

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:<sup>15</sup>

---

<sup>14</sup> These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

<sup>15</sup> Providers also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

**Communications with Consumers**—When promoting or describing nontraditional mortgage products, providers should give consumers information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, providers should give consumers information at a time that will help consumers select products and choose among payment options. For example, providers should offer clear and balanced product descriptions when a consumer is shopping for a mortgage—such as when the consumer makes an inquiry to the provider about a mortgage product and receives information about nontraditional products, or when marketing relating to nontraditional mortgage products is given by the provider to the consumer—not just upon the submission of an application or at consummation.<sup>16</sup> The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.<sup>17</sup>

- *Promotional Materials and Product Descriptions*  
Promotional Materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.
  - *Payment Shock*. Providers should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.<sup>18</sup> Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

---

<sup>16</sup> Providers also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

<sup>17</sup> Providers may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, providers should provide clear and balanced information about the risks of these products in all forms of advertising.

<sup>18</sup> Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

- *Negative Amortization.* When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)
- *Prepayment Penalties.* If the provider may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.
- *Cost of Reduced Documentation Loans.* If a provider offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.
- *Monthly Statements on Payment Option ARMs*  
 Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Providers should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).
- *Practices to Avoid*  
 Providers also should avoid practices that obscure significant risks to the consumer. For example, if a provider advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the provider also should give clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, providers should avoid promoting payment patterns that

are structurally unlikely to occur.<sup>19</sup> Such practices could raise legal and other risks for providers.

Providers also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

**Control Systems**—Providers should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Providers should design control systems to address compliance and consumer information concerns as well as the risk management considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about the product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Providers should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that a provider makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the provider should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, policies, or laws.

## **Appendix**

---

<sup>19</sup> For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

**Interest-Only Mortgage Loan**—A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower 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 amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

**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 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.

## Exhibit A: Examination Guidelines for Nontraditional Mortgages

The following procedures are intended to guide Mortgage Division examiners in the implementation of OCOB's Nontraditional Mortgage Guidance, as finalized on March 12, 2007. This manual is subject to change based on changes in examination techniques, relevant statutes, rules, and guidance. These procedures are also intended to assist licensees in complying with the Nontraditional Mortgage Guidance.

1. **Management Questionnaire:** All licensees must answer the following questions regarding their making or brokering of nontraditional mortgage loans:

1. Provide information regarding nontraditional mortgage loans offered (either brokered or made) by licensee in past year in table below:

*Prime Mortgage Loans* (residential, non-investment)

Loan Type	Number	Volume/Total Amount of Loans (in thousands)	Pct that involve reduced documentation	Pct of Originations
Interest-only first mortgages				
Option-pay ARMs				
Other first-lien mortgages that permit negative amortization				

*Subprime Mortgage Loans* (residential, non-investment)

Loan Type	Number	Volume/Total Amount of Loans (in thousands)	Pct that involve reduced documentation	Pct of Originations
Interest-only first mortgages				
Option-pay ARMs				
Other first-lien mortgages that permit negative amortization				

2. Applicable to *Mortgage Bankers*:
  - i. Provide a copy of underwriting policies and procedures used to qualify customers for nontraditional mortgage loans, including procedures used to determine borrower's ability to repay the debt by final maturity at the fully-indexed rate.
  - ii. Provide a copy of underwriting policies related to the use of reduced documentation in conjunction with nontraditional mortgage loans.
  - iii. Does licensee offer simultaneous second-lien loans in conjunction with nontraditional mortgage loans? If so, please identify policies used to determine borrower's ability to manage second-lien debt service under expected payment schedule.
  - iv. Provide a list of nontraditional mortgage loans made that required an exception to written underwriting policies.
  - v. Do you have risk management policies and procedures in place to manage the risks of nontraditional mortgage loans (e.g. volume limits, performance measures)? If so, please describe and provide a copy of relevant policies.
  - vi. Do you have any policies and procedures in place to monitor the quality of nontraditional mortgage loans originated through third-party originators

- (brokers, correspondents)? If so, please describe and provide a copy of relevant policies.
- vii. Describe licensee's policies and procedures for informing borrowers of the risks of nontraditional mortgage loans and controls in place to ensure that borrowers are adequately informed of the unique risks of nontraditional mortgage loans at the time of origination. Provide copies of relevant policies and any disclosures used.
3. Applicable to *Mortgage Brokers* (or Mortgage Lenders engaged in brokering or correspondent lending):
    - i. Provide a list of all lenders with whom you regularly do business that make nontraditional mortgage loans to your customers, along with estimated percentage of nontraditional loans originated with each lender.
    - ii. Describe licensee's policies and procedures for informing customers of the risks of nontraditional mortgage loans and controls in place to ensure that customers are adequately informed of the unique risks of nontraditional mortgage loans at the time of origination. Provide copies of relevant policies and any disclosures used.
    - iii. Provide a description of process used to select lenders that offer nontraditional mortgage loans, and the controls you have in place to ensure that your customers are offered loans in compliance with the nontraditional mortgage loan guidance.
2. **Examiner review:** Examiners should review material provided by licensee to ascertain compliance with the Nontraditional Mortgage Guidance. In the event that licensee's practices do not conform with the Nontraditional Mortgage Guidance, examiners should make a specific finding in the examination report and work with management to correct any violations. In events of significant non-compliance, examiners should notify the Director of the Mortgage Division in order to determine whether enforcement action is appropriate under the Mortgage Lending Act.