Advisory Bulletin

Nontraditional and Subprime Residential Mortgage Loans

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Pertains To: FHLB & Office of Finance

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To: Federal Home Loan Bank Chairs, Presidents, and Directors of Internal Audit Managing Director, Office of Finance

From: Stephen M. Cross, Director, Office of Supervision

Subject: Nontraditional and Subprime Residential Mortgage Loans

Background:

On October 4, 2006, the federal banking agencies issued credit administration, risk management, and consumer disclosure guidance to their regulated entities regarding certain residential mortgage products that allow borrowers to defer payment of principal or interest, such as interest-only mortgages, payment option mortgages, and negative amortization mortgages. [1] Similar guidance also was issued by many state bank regulatory authorities, the Office of Federal Housing Enterprise Oversight, and the American Association of Residential Mortgage Regulators.

On March 2, 2007, the federal banking agencies issued for comment a proposed statement addressing emerging issues and questions on subprime mortgage lending practices and risk management.[2] The proposed statement addresses factors that a lender should assess in determining a subprime borrower's ability to repay a loan, such as payment shock due to interest rate adjustments. The statement also discusses consumer compliance issues and the need for policies, procedures, and systems to assure that an institution's subprime lending is conducted in a safe and sound manner.

Nontraditional residential mortgage loans, for purposes of this guidance, are defined as mortgages that allow borrowers to defer payment of principal or interest. These loans, also referred to as "alternative" or "exotic" mortgage loans, might be interest-only mortgages, payment option mortgages, or negative-amortization mortgages, or have other features, such as, but not limited to, variable interest rates with below-market introductory rates, simultaneous second-lien loans, and reduced documentation to support the repayment capacity of the obligor. Nontraditional residential mortgages exhibit characteristics that may result in increased risk relative to traditional mortgage products. They may pose even greater risk when granted to borrowers with undocumented or undemonstrated repayment capacity, e.g., low or no documentation loans, or credit characteristics that would be characterized as subprime. The potential for increased risk is particularly true if the nontraditional mortgages are not underwritten to the fully indexed payment rate.

The Federal Home Loan Banks (Banks) do not originate mortgage credit. Therefore they do not make subprime loans or nontraditional mortgage loans. However, the Banks have exposure to nontraditional and subprime mortgages in their holdings of mortgage backed securities (MBS) and in the collateral for advances to members. Further, some Banks may have exposure to the risks presented by nontraditional or subprime mortgages in their purchased mortgage portfolios (Acquired Member Assets or AMA).

Guidance:

As part of their risk management programs, the Banks must measure, monitor, and manage credit risk. Their risk management programs should keep pace with the types of credit exposures and economic conditions facing the Bank. In recent years, the use of nontraditional residential mortgage loans may have provided consumers with greater credit options for purposes of home ownership, but often with increased credit or reputational risk to the financial institutions that underwrite, acquire, or hold as collateral these types of loans.

Each Bank should adopt and implement policies and risk management practices as part of its credit risk management program that establish appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans. The Bank's policies should be discussed with and approved by its board of directors. Those board-approved policies must identify the attributes of nontraditional and subprime residential mortgages that have the potential for increased risk. The policies should establish limits and require regular monitoring of exposure to nontraditional and subprime residential mortgage loans. The policies should apply to all activities of the Bank that expose it to the increased risks of nontraditional and subprime residential mortgages. Bank risk management practices must establish appropriate board and management reporting of exposures and risk mitigation efforts.

By June 30, 2007, each Bank's board of directors should review its existing policies and adopt any necessary additional policies related to nontraditional and subprime residential mortgage products. Examiners will review those policies and related risk management procedures and practices during annual examinations, and we may require periodic reporting of volumes, policies, procedures, and risk management practices. Each Bank should require periodic confirmation from its members subject to federal or state regulatory oversight that the member is complying with nontraditional residential mortgage and subprime mortgage lending guidance.

Acquired Member Assets

AMA programs currently allow only for the acquisition of non-jumbo, fixed-rate loans. Since the AMA rule became effective July 17, 2000, the Federal Housing Finance Board's (Finance Board) practice has been to approve the mortgage programs of the Banks as "new business activities" as described in part 980 of Finance Board regulations. Any AMA program that would allow for the purchase of mortgage loans with risk characteristics of nontraditional residential mortgages would entail risks "… not previously and regularly managed by that Bank …" as stated in part 980 and, consequently, would require approval from the Finance Board as a "new business activity." To date, no Bank has received approval from the Finance Board to purchase anything other than non-jumbo, fixed-rate loans under the AMA programs.

Prior to the adoption of AMA rule, the Finance Board approved two programs that allowed the Banks to invest in participation interests in loans. One of those programs allows for participation investment in affordable multi-family loans. The other program allows for participation investment in affordable single-family and multi-family mortgage loans and construction and community development loans. Other mortgage programs approved prior to the adoption of the AMA rule allow for underwriting that does not require full documentation of the obligor's repayment capacity.

Borrower characteristics suggestive of subprime lending, specifically, low FICO scores, are evident in some of the Banks' mortgage portfolios. Some Banks are known to hold residential mortgages underwritten according to reduced documentation requirements. Each Bank should review its AMA portfolio to determine whether it holds any subprime or low documentation residential mortgages and, if so, the extent of its exposure to each. If there are subprime or low documentation residential mortgages in its portfolio, the Bank's loan loss reserve and credit enhancement practices and levels should be reassessed in light of those holdings.

Mortgage Backed Securities

In monitoring MBS with underlying nontraditional or subprime residential mortgage pools, the Bank cannot rely solely on investment ratings of the securities, as ratings of certain products may be untested over a credit cycle and ratings can be a lagging indicator of credit risk. A Bank's risk management practices should include pre-purchase analysis and periodic reviews of the characteristics of the underlying mortgages that serve as collateral for MBS, such as loan-to-value ratios, FICO scores, product types, performance of the credit support tranches, geographic concentrations and delinquency rates, while also considering the level of credit enhancements associated with the MBS. Monitoring also might include periodic stress testing of the security. As a matter of policy, we expect the Banks' boards of directors to establish limits on the level of MBS with underlying nontraditional or subprime mortgage collateral requirements for the level of credit protection for particular credit tranches when purchased at the time of original issuance of the security, and limitations on concentrations by geographic area, issuer, servicer, and size.

Collateral Securing Advances

A Bank's collateral risk management policies and practices should identify any restrictions on nontraditional and subprime residential mortgage collateral, including limits and acceptable adjustments to collateral coverage requirements or "haircuts." Procedures for monitoring collateral securing advances should allow a Bank to identify the volume of nontraditional residential mortgages and subprime mortgages pledged to secure advances. Collateral review procedures should include assessments and testing of member underwriting and monitoring of nontraditional and subprime loans. Policies and practices for advance collateral should also address the acceptance of MBS with nontraditional and subprime collateral.

Related Guidance:

Advisory Bulletin 1999-AB-15, Collateral Considerations for Sub-Prime and High Loan-to-Value Single-Family Mortgage Loans

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[1] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006).

[2] Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533 (March 8, 2007).

Attachments: **Nontraditional and subprime residental mortgage**
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