NONTRADITIONAL MORTGAGE LENDING

Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

References

- *Interagency Guidelines Establishing Standards for Safety and Soundness (FRB: 12 CFR 208, Appendix D-1; FDIC: 12 CFR 364, Appendix A)*
- *Interagency Guidelines for Real Estate Lending Policies (FRB: 12 CFR Part 208, Appendix C; FDIC: 12 CFR Part 365, Appendix A)*
- *Appraisal regulations (FRB: 12 CFR 225.61-67; FDIC: 12 CFR Part 323)*
- *Interagency Appraisal and Valuation Guidelines (FRB: SR 10-16; FDIC: FIL-82-2010)*
- *Frequently Asked Questions on the Appraisal Regulations and the Interagency Appraisal and Evaluation Guidelines (FRB: SR 18-9; FDIC: FIL-62-2018)*
- *Interagency Advisory on Use of Evaluations in Real Estate-Related Financial Transactions (FRB: SR 16-5; FDIC: FIL-16-2016)*
- *Working with Residential Borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments (FDIC: FIL-35-2007)*
- *Interagency Guidance on Nontraditional Mortgage Product Risks, and Addendum to Credit Risk Management Guidance for Home Equity Lending (FDIC:* FIL-89-2006*; FRB: SR 06-15)*
- *Uniform Retail Credit Classification and Account Management Policy (FRB: SR 00-8; FDIC:* FIL 40-2000*)*
- *Interagency Guidance on High LTV Residential Real Estate Lending (FRB: SR 99-26: FDIC: FIL-94-99)*
- *Interagency Guidance on Third-Party Relationships: Risk Management (FRB: SR 23-4; FDIC: FIL-29-2023)*

Considerations and Background

This module is directed toward nontraditional mortgage lending programs. The term "program" refers to the process of acquiring nontraditional mortgage loans on a regular or targeted basis, either through origination or purchase, to be held in the institution's own portfolio or accumulated and packaged for sale (refer to the Securitization and Mortgage Banking modules when securitization or mortgage banking activities are material to the institution's operations). If the institution does not have a recognized nontraditional mortgage lending program but is systematically targeting nontraditional mortgage loans through processes that employ tailored marketing, underwriting standards, or risk selection, examiners should discuss with management whether these activities constitute a nontraditional mortgage lending program.

NTM products may defer the repayment of principal and, sometimes, interest. NTM loans include interest-only loans, payment-option adjustable rate mortgages (ARMs) that may result in negative amortization, and loans with an extended maturity (40 or 50 years) that typically have a balloon payment prior to the maturity date. These procedures do not address reverse mortgages and home equity lines of credit, with the exception of simultaneous second-lien loans.

Examiners should use these procedures in conjunction with other applicable modules and should refer, as needed, to the Subprime Lending, Mortgage Banking, Securitization, Residential Real Estate Lending, and Third Party Risk modules. Use of these procedures should be coordinated with other examination procedures to avoid duplication.

For example, if the institution sells nontraditional mortgage loans (NTM) into the secondary market, these procedures should be used in conjunction with the applicable mortgage banking module. In addition, many institutions may use the services of various third parties relative to NTM lending. Examiners reviewing NTM lending activity should coordinate with examiners reviewing overall third-party risk management, as needed.

Findings and Conclusions
Document findings and conclusions here, and include a summary of these findings and conclusions in the Core Analysis Decision Factors in the appropriate Primary or Supplemental modules.

Preliminary Review
1. Review prior examination reports, file correspondence, and audits for information concerning NTM lending to identify previous concerns. Also review outstanding litigation, consumer complaints, and prior compliance examination reports for information concerning the institution's NTM lending activities.
2. Identify planned or newly initiated lending programs and related portfolios that management considers NTM. Common loan features of such programs include:[1] • **Payment-option ARMs, which include flexible payment options that can result in negative amortization** • **Interest only loans** • **Loans with initial below-market (i.e., teaser) rates** • **Extended maturity loans (e.g., 40-year maturity loans with a 30-year balloon payment)** • **Collateral dependent loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged** • **Reduced or minimal documentation standards for substantiating a borrower's income or assets (i.e., low-doc or no-doc loans)** • **Underwriting guidelines that allow high debt-to-income (DTI) ratios** • **Simultaneous second-lien loans (i.e., 80/20 and 90/10 loans)**
3. Determine whether there have been any significant changes in mortgage lending policies, products, or volumes since the previous examination, including purchasing NTM loans from third-party originators.

[1] **Institutions could further increase portfolio risk through risk layering by combining nontraditional features (e.g., interest-only loans with reduced documentation requirements) or by combining nontraditional features with other risk factors (e.g., payment-option ARM with high debt-to-income (DTI) ratio).**

4. Determine whether any mortgage lending activities are outsourced. If so, obtain a list of the third parties used.[2]

Policy Considerations

5. Review and assess the strategic or business plan regarding NTM lending, and determine whether the plan:

- **Includes clear performance objectives, such as financial goals or growth in target markets, and performance benchmarks for each segment and the portfolio as a whole**
- **Includes mortgage products that are consistent with overall business strategies and risk tolerances, and are offered as envisioned by the plan (e.g., within portfolio limits, concentration limits, volume, growth, performance, and markets served)**
- **Appropriately addresses risks, such as credit, operating, liquidity, compliance, interest rate, and legal, risk**
- **Appears reasonable, including projections and assumptions, in light of economic, market, and competitive conditions; management expertise; technological and operational capacity; and capital support**
- **Establishes a clear solicitation and origination strategy that allows for assessments of underwriting performance**
- **Assesses the level of capital and allowance for credit losses (ACL), when applicable, needed to support the volume and overall risks of NTM activities**
- **Documents reasonable curtailment strategies in the institution's contingency planning[3]**

6. Determine whether written lending policies and procedures are appropriate for the institution's NTM lending activities. The following items are typically addressed in written policies:

- **Permissible and prohibited types of residential mortgage loans**
- **Concentrations-of-credit limits[4]**
- **Sub-portfolio targets and limits for each credit grade or class**
- **Qualifying standards that require analysis of a borrower's capacity to repay the full loan amount extended, considering both principal and interest at the fully indexed rate (versus low introductory or teaser rates)**
- **Well-defined underwriting parameters, including guidelines for income and employment verification, and tax returns (e.g., Consumer Financial Protection Board's *Ability to Repay Rule*)**
- **Risk factors or red flags that trigger concerns regarding possible fraud activity**
- **Guidelines for obtaining and reviewing appraisals or evaluations**
- **Guidelines that govern the use of reduced documentation;**
- **Procedures for ensuring third-party loan originations meet the institution's lending standards**

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[2] Third parties may include correspondents; brokers; and marketing, collection, servicing, or technology firms. The latter may generate unique data reports that are useful to evaluate the institution's NTM lending activities.

[3] May include exit strategies for a given business line(s) when risks or costs prove excessive.

[4] Concentrations may include segmentations such as by geographic location, product type, source of origination, type of recourse, limited documentation, or stated-income credits.

- **Due diligence procedures for relationships with third-party originators (TPOs), including initial approval, ongoing monitoring, and remedial actions for reporting and resolving problems**
- **Officer and committee lending authorities**
- **Credit file documentation requirements**
- **Procedures for approving policy exceptions**
- **Procedures for tracking and monitoring loans approved as policy exceptions**
- **Asset classification and charge-off criteria**
- **Loan review requirements and ACL criteria**
- **Guidance regarding the monitoring of loans held in the portfolio (e.g., segmentation by vintage and subsequent analysis by profitability, delinquencies, losses, ACL adequacy, stress testing)**
- **Periodic re-scoring and credit bureau (FICO) updates for loans held in the portfolio**
- **Guidance for loans originated with the intent to sell (i.e., secondary marketing, counterparty responsibility, put-back triggers, and subsequent responsibilities such as funding requirements and capital allocation)**
- **Billing, collection, and foreclosure procedures**
- **Content and frequency of management reports**
- **Guidance related to compliance risks (e.g., fair lending, predatory pricing, steering) and marketing practices**

Internal Controls

7. **Review and evaluate the effectiveness of procedures for preventing, detecting, reporting, and responding to policy exceptions.**

8. **Determine whether management monitors consumer complaints for recurring issues and appropriate disposition.**

9. **Determine whether comprehensive quality control procedures exist to monitor compliance with loan program requirements, underwriting standards, and contractual obligations. Determine whether the quality control function regularly reviews a representative sample of NTM loans from all origination channels and underwriters.**

Audit or Independent Reviews

10. **Assess audit programs and independent reviews relating to NTM lending (i.e., scope, frequency, and effectiveness). Determine whether audits or independent reviews:**
    - **Assess the ability of management information systems (MIS) to collect information and provide reports sufficient to keep management and the board satisfactorily informed**
    - **Evaluate TPOs**
    - **Follow-up on internal and external audit exceptions**

- **Consider board or management reviews of lending policies and standards**
- **Assess management's evaluation of outside entities' ability and willingness to buy the institution's loans and securities**
- **Evaluate contingency plans for events where third parties are unwilling or unable to buy the institution's loans and securities**
- **Consider management's criteria for selecting third-party vendors such as credit reporting agencies, appraisal firms, and other service providers**
- **Assess criteria for monitoring brokers and correspondents (i.e., how management tracks the quality of purchased loans (by origination source and key borrower characteristics) and whether certain brokers or correspondents generate a disproportionately high volume of put-backs)**

11. Determine whether audit or independent review results are promptly reported to the audit committee or the full board.

12. Determine whether management promptly and appropriately responds to findings identified by audits or independent reviews.

Management Information Systems

13. Determine whether management reports help achieve compliance with loan policy objectives. Determine whether reports are missing data items that could enhance management's ability to monitor mortgage operations.

14. Determine whether performance standards, metrics, and management reports provide warnings of increasing risks and are available by:

- **Loan type (such as, interest-only loans, payment-option ARMs, non-owner occupied property loan, and loans to first time home buyers)**
- **Risk layering features (such as, interest-only loans with simultaneous second-lien mortgages)**
- **Underwriting characteristics (e.g., LTV, DTI, and credit score)**
- **Borrower performance (such as, delinquencies and negative amortizations)**

15. Assess the accuracy of the system for reporting past due status and other performance-related measures.

16. Assess the quality of managerial reports used in evaluating credit risk and interest rate risk associated with the NTM portfolio(s).

17. Assess management reports for monitoring vendors.

18. Assess the effectiveness of quality control programs over third-party originations.

NTM Portfolio Analysis

19. Review a sample of loans made from various NTM portfolio segments, including new accounts originated in the past quarter, for adherence to the following:

- **Underwriting standards**
- **Risk selection standards**
- **Pricing guidelines**
- **Classification guidelines**
- **Lending policies and procedures**

20. Determine whether the level of policy exceptions reflects a weakness in the underwriting process and results in higher levels of delinquencies and losses.

21. Identify any unique or troubled portfolio segments and determine whether concentrations exist by loan type, source (such as, TPOs or loan officers), geographic area, customer base, or property occupancy status. Evaluate the degree of risk and consider mitigating factors.

22. Assess the methodology for determining the level of capital needed to support NTM activities. Determine whether management sufficiently stratifies the NTM portfolio and evaluates capital needs for various risks (e.g., stated income, reduced documentation, high combined loan-to-values, and low FICO scores).

23. Determine whether the methodology for determining an appropriate ACL considers NTM risks.

24. Determine whether consumer complaint information and outstanding litigation indicate significant weaknesses in the institution's NTM lending activities.

25. Determine whether management provides credit correction services to loan applicants (commonly referred to as flash updates or rapid rescores to credit reports).[5]
26. Determine whether the cost of products (such as insurance policies) marketed to loan customers, or the amount of fees charged in connection with the loans, are a significant portion of the principal amount advanced.
27. Determine whether management performs stress testing on the NTM loan portfolio and if so, evaluate the stress test.
Servicing and Collections
28. Assess the structure, management, and staffing of the servicing and collections function (either internal or outsourced) and determine whether: • **The structure of the department (centralized or decentralized) appears efficient** • **Management and staff possess the necessary expertise** • **Management collects appropriate data to determine staffing levels and training needs**
29. Evaluate workout arrangements, such as loan restructures and modifications, deferrals, and fixed payment plans. Specifically, determine whether: • **Eligibility requirements appear reasonable** • **The terms of loan restructures or modifications are appropriate** • **Management monitors the performance of loans subject to cure programs to determine the effectiveness of such practices and the impact on the past due ratio**
30. Determine whether policy exceptions made by servicing and collection personnel are monitored to ensure that practices, such as term extensions, payment deferrals, and loan modifications are not materially increasing credit risks.

[5] Such a service may be characteristic of subprime lending programs.

Third Party Originations[6]
31. Evaluate the institution's policies and procedures for performing due diligence prior to engaging (and periodically thereafter) the services of TPOs. Areas to consider include: • **The degree to which management recognizes its legal responsibilities relating to consumer compliance risks associated with outsourcing** • **The adequacy of written policies and procedures addressing due diligence on third party relationships** • **The effectiveness of pre-purchase analyses on purchased loans** • **Potential conflicts of interests relating to insiders** • **Concentration risks in the customer base and funding and origination sources**

32. Assess the overall program for managing TPOs (both brokers and correspondents). Consider whether the program requirements for TPOs include:
• **Reasonable standards regarding TPO financial requirements**
• **Periodic reviews of the institution's policies for analyzing TPO financial statements**
• **An evaluation of the criteria for monitoring TPOs on an ongoing basis, such as:**
  ○ **How management tracks the quality of purchased loans (by both origination source and key borrower characteristics)**
  ○ **Whether certain TPOs are generating a disproportionately high volume of putbacks**
• **Maintenance of a TPO watch list, policies governing inclusion on the list, and events that would cause a TPO's dismissal**
• **Audit programs that address the TPO management system and processes**

Managerial Effectiveness
33. Assess the effectiveness of actions taken by management to correct audit and examination deficiencies.
34. Determine whether management provides appropriate staffing and training in light of the portfolio's volume, performance, and projected growth.
35. Determine whether management periodically evaluates whether its NTM program is within acceptable risk levels and meets profitability and performance goals.

[6] **The Subprime Lending core analysis procedures include additional areas to consider when evaluating third party lending relationships.**

36. Assess management's response to adverse performance trends, such as higher than expected charge-offs, delinquencies, prepayments, customer complaints, elevated expenses, or lower than expected profits.
37. Determine whether the level of policy exceptions results in higher levels of delinquencies and losses.
38. Determine whether compensation programs (at the institution and TPOs) promote behaviors that are consistent with portfolio objectives and risk tolerances.
39. Determine whether aspects of the NTM program appear predatory or abusive and refer to the appropriate agency consumer compliance or fair lending specialists: • **Loans approved based on the assets of the borrower rather than their ability to repay** • **Loans made by inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (loan flipping)** • **Loans originated through fraud or deception to conceal the true nature of the loan obligation (or ancillary products)**
End of Core Analysis.