

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA

December 27, 2005

**BANKING SUPERVISION AND REGULATION:
COMMENT REQUESTED ON NONTRADITIONAL
MORTGAGE PRODUCTS GUIDANCE**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Federal Financial Regulatory Agencies Propose Guidance on Nontraditional Mortgage Products (Docket OP-1246)

The federal financial regulatory agencies have issued for comment proposed guidance on residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest.

These nontraditional mortgage products include “interest-only” mortgage loans where a borrower pays no principal for the first few years of the loan and “payment option” adjustable-rate mortgages where a borrower has flexible payment options, including the potential for negative amortization. Institutions are also increasingly combining these mortgages with other practices, such as making simultaneous second-lien mortgages and allowing reduced documentation in evaluating the applicant’s creditworthiness.

While innovations in mortgage lending can benefit some consumers, the agencies are concerned that these practices can present unique risks that institutions must appropriately manage. They are also concerned that these products and practices are being offered to a wider spectrum of borrowers, including subprime borrowers and others who may not otherwise qualify for more traditional mortgage loans or who may not fully understand the associated risks of nontraditional mortgages.

The proposed guidance discusses the importance of carefully managing the potential heightened risk levels created by these loans. Toward that end, management should ensure the following:

- Assess a borrower’s ability to repay the loan, including any balances added through negative amortization, at the fully indexed rate that would apply after the introductory period. The agencies recognize that this requirement differs from underwriting standards at some institutions and are specifically requesting comment on this aspect of the guidance.
- Recognize that certain nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves.
- Ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

Comment is requested on all aspects of the guidance, particularly on the section regarding comprehensive debt service qualification standards. Comments are due sixty days after publication in the *Federal Register*. The docket is attached.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>.

For additional information about the proposed guidance, please contact our Banking Supervision and Regulation Department at **(415) 974-2585**.

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[Attachment: Docket OP-1246](#)