

Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

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**BANKING SUPERVISION AND REGULATION:
NONTRADITIONAL MORTGAGE PRODUCT
RISKS**

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

Final Guidance on Nontraditional Mortgage Product Risks

The federal financial regulatory agencies issued final guidance to address the risks posed by residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest (*Interagency Guidance on Nontraditional Mortgage Product Risks*).

Nontraditional mortgage loans include "interest-only" mortgages and "payment option" adjustable-rate mortgages, and allow borrowers to exchange lower payments during an initial period for higher payments later.

While similar products have been available for many years, the number of institutions 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 a similar-size mortgage under traditional terms and underwriting standards. The agencies are concerned that some borrowers may not fully understand the risks of these products. While many of these features exist in other adjustable-rate mortgage products, the agencies' concern is elevated with nontraditional products because of the lack of principal amortization and the potential for negative amortization. In addition, institutions are increasingly combining these loans with other features that may compound risk ("risk layering"). These features include making simultaneous second-lien mortgages and relying on reduced or no documentation in evaluating an applicant's creditworthiness.

The final guidance discusses the importance of carefully managing the potential heightened risk levels created by these loans. Toward that end, 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. These products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice

The agencies published for comment proposed interagency guidance on Nontraditional Mortgage Products on December 29, 2005. Comments were received from financial institutions, trade associations, consumer and community organizations, state and financial regulatory organizations, and other members of the public. The agencies made a number of changes to the proposal to respond to the commenters' concerns and to provide additional clarity.

The agencies are issuing two additional related documents:

1. *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products*
2. Addendum to the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending*

Several commenters on the proposed guidance encouraged the agencies to include model or sample disclosures or other descriptive materials as part of the interagency guidance. In response, the agencies are issuing for comment *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products*. The agencies believe that illustrations of consumer information may be useful to institutions as they seek to implement the consumer information recommendations of the guidance. The agencies seek public comment on all aspects of the proposed illustrations, including whether these illustrations or a modified form should be adopted by the agencies. Comments on the proposed illustrations are due 60 days after publication in the Federal Register.

The agencies are also issuing an [addendum](#) to the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending* that provides additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only features. While HELOCs with these features may provide flexibility for consumers, the agencies are concerned that consumers may not fully understand the product terms and associated risks. This addendum provides guidance addressing the timing and content of communications with consumers obtaining interest-only HELOCs. These consumer protection recommendations are similar to the guidance contained in the *Interagency Guidance on Nontraditional Mortgage Product Risks* referenced above.

Additional Information

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

For additional information, please contact our Banking Supervision and Regulation Department at (415) 974-2225.

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Attachment: [Docket No. OP-1246](#)
[Docket No. OP-1267](#)