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Thrift Bulletin

TB 72

Handbooks: **Thrift Activities** **Sections: 210, 211, 212**

Subject: **Asset Quality, Lending**

High Loan-to-Value Home Mortgage Lending

RESCINDED

Summary: High loan-to-value (LTV) home mortgage lending entails risks that are different from traditional home or consumer loans. This is particularly true for home equity loans where the combined first and junior mortgages result in loans in excess of the value of the security property. High LTV home loans also have characteristics (higher dollar amounts, longer terms, limited remedies in event of default, for example) that present greater risk to a lender than other types of unsecured consumer lending, including credit cards. When made in large concentrations, or without adequate controls, high loan-to-value loans present supervisory concerns. Extensions of credit that are secured by liens on or interests in real estate are subject to 12 CFR 560.100-101, including the appended Interagency Guidelines for Real Estate Lending Policies that establish supervisory LTV limits. While the guidelines do not prohibit investment in loans that exceed the supervisory LTV limits, they do set percentage of capital limits on an institution's aggregate investment in such loans. This bulletin provides additional guidance relating to the way OTS will apply the interagency guidelines to high LTV loans. The policies set forth in this bulletin are effective upon publication.

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Thrift Bulletin 72

High LTV Home Mortgage Lending

I. Background and Definitions.

An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property.[1] Furthermore, some lenders have begun making first mortgage loans in amounts that exceed the value of the security property.[2] Until recently, the high LTV home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders. There is also the concern that high LTV loans may contribute to undesirable increases in consumer debt.

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[1] The loan-to-value of a loan is calculated as the ratio of the loan granted by the institution, plus the amount of any senior liens, divided by the appraised value (or evaluation amount) of the real estate collateral, plus any readily marketable collateral taken as additional security for the loan.

[2] For the purposes of this bulletin, high LTV home mortgage loans are loans secured by liens on or interests in 1-4 family owner-occupied residential real estate that, when combined with any senior liens, exceed 90% of the value of the real estate collateral, unless the loan has appropriate credit support in the form of either private or government mortgage insurance or readily marketable collateral sufficient to effectively reduce the LTV below 90%.

Traditionally, lenders have made home loans and home equity loans combined with any senior liens with a maximum LTV from 80 percent to 90 percent of the value of the property securing the loan. The average actual LTV for home equity loans was approximately 73% before 1997 but increased to about 76% in 1997.[3] The more traditional home equity loans are well secured and have historically experienced very low default rates. It is likely, however, that high LTV mortgages pose a significantly higher level of risk to an institution than traditional 1-4 family mortgages, or home equity loans with an LTV ratio (when combined with any senior liens) limited to 80%. In addition, in some respects (such as loan size, lack of performance data during a recession, and lower interest margins), high LTV home equity loans have characteristics that may pose more risks than unsecured credits, including credit cards.

II. Risks Associated with High LTV Lending.

Some of the increased risks associated with high LTV loans are:

1. Increased default risk. Although limited data is available for delinquency on high LTV home equity loans, OTS's Research and Analysis Division reports that delinquency rates rise with LTV ratios.[4] From 1993 through 1995, after 24 months of seasoning, mortgage loans with LTV ratios from 96% to 105% experienced 10 times the serious delinquency rate (90 days or more past due or in foreclosure) than loans with LTV ratios from 76% to 80%. In 1995, for example, the delinquency rate for loans with LTVs between 76% and 80% was 0.24%, and the delinquency rate for loans with LTVs between 95% and 105% was 2.54%.

2. Inadequate collateral. If foreclosure becomes necessary, an 80% LTV loan will generally allow a lender to cover foreclosure, fix-up, and selling expenses (which typically run 10 percent or more of the value of the property) and still be able to liquidate its loan and any senior liens. When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, so lenders are likely to suffer a complete loss if they make a mistake in assessing a borrower's credit and the borrower subsequently defaults.[5]

3. Limited default remedies. High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure. Thus, lenders have limited remedies in the event of default. Unlike credit card lenders, high LTV mortgage lenders may not be able to raise interest rates or cut off or reduce the borrower's credit line. In addition, according to Moody's Investor Services, they will be forced to adopt a credit card collections mentality that will require early intervention and the ability to "talk" the borrower into making a payment without resorting to foreclosure. [6]

4. Excess debt burden. Loans with LTVs of 100% or more are often made to borrowers with substantial amounts of high cost debt. These loans are often marketed as debt consolidation loans where a borrower's cash flows may be improved by the refinancing of their debt through the home equity loan. The lender, however, may not be able to prevent the borrower from running up additional credit card and other consumer debt after the loan is made. A recent survey of over 6,000 borrowers[7] who used home equity loans to consolidate their debts indicated that only 30% of those borrowers remained free of credit card debt a

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[3] "1998 Home Equity Loan Study," Consumer Bankers Association, 1997, pp. 12-13.

[4] OTS Research and Analysis, National Mortgage Default Rates and the Vintage Effect, May 19, 1997, p. 5.

[5] Linda Stesney, Structured Finance, Special Report "High LTV Mortgage Securitization: A High Stakes Game with Fast Changing Rules," Moody's Investor Services, August 7, 1998, p. 1.

[6] *Ibid*. p. 7.

[7] "Impact of Home Equity Lending on Credit Card Balances," Brittain Associates, Atlanta, GA, June, 1998.

year later. Thus, in many cases, home equity loans to debt-burdened borrowers may only serve to amplify or postpone their credit problems.

5. Longer term/longer exposure. The long-term nature of high LTV debt consolidation loans also presents a problem not usually identified with short-term consumer credit. Because these loans do not amortize to provide positive equity for many years, the lender will be particularly exposed to any unpredictable negative events that may befall the borrower, such as loss of job, divorce, death or illness. The Moody's report also points out that high LTV mortgage loans are often underwritten using credit bureau or Fair Issac Company (FICO) scores, which have only been proven to be predictive of defaults over about a two-year period.[8]

6. Untested performance. The performance of high LTV home loans has not been tested during an economic downturn. Considering that loan terms range from 15 to 25 years, delinquency and losses could be considerably higher than current performance data might indicate.

7. Loan size. Currently, the average home equity loan in securitized pools is approximately $35,000.[9] This is much larger than the average credit card line or loan size for other types of unsecured or partially secured credit. Loans of this size are not typically made on an unsecured basis.

8. Borrower motivation. Loans in excess of 100% of the value of the security property leave borrowers with negative equity and, in times of financial hardship, less incentive and ability to stay with the property (i.e., work with the lender to bring the loan current rather than allow foreclosure).

9. Lack of liquidity. A high LTV home loan will make the liquidation of the loan more difficult in the event a borrower has to relocate or suffers financial hardship. In such an event, a borrower may not be able to sell the home because of the large amount of cash needed at closing.

10. Consumer protection concerns. In response to concerns that some financial institutions used abusive lending practices in extending high-rate, high-fee home equity loans to cash-poor homeowners, Congress enacted "The Home Ownership and Equity Protection Act of 1994" as Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This legislation amended the Truth in Lending Act to define a class of non-purchase or non-construction closed-end home mortgage loans with high interest rates or up-front fees ("§103(aa) mortgages"). The Act subjects this class of lending to particular disclosure requirements and prohibits certain loan terms and practices. High LTV home lending may display the characteristics that invoke the obligations under this Act. Finally, high LTV home equity lending must also comply with all other applicable regulatory requirements such as those set forth in Regulations B and Z, and other pertinent legal standards established under RESPA and the Fair Housing Act.

III. Risk Management.

Despite the above concerns, OTS recognizes that there may be instances where high LTV home loans (especially those with LTVs less than 100%) may be useful in helping financially burdened borrowers consolidate and manage their debts. Also, lenders may want to help first-time home buyers by financing closing costs into their mortgage. The remainder of Section III addresses issues that savings associations should consider if they currently make, or consider making, high LTV home mortgage loans.

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[8] Stesney, Structured Finance, Special Report p. 9.

[9] *Ibid*. p. 6.

1. Regulatory Framework. The Home Owners' Loan Act permits thrifts to make loans secured by residential real property without a percentage of asset limitation. There are no statutory restrictions on lien position or LTV percentage. However, institutions should, pursuant to 12 C.F.R. 560.100-101, establish prudent investment limits for any type of high risk lending activity in which they are engaged. Pursuant to that rule, savings associations must establish written policies that contain appropriate limits and standards for their real estate lending activities. The rule applies to all extensions of credit that are secured by liens on, or interests in real estate, or that are made for the purpose of financing permanent improvements to real estate.[10]

Moreover, the interagency guidelines attached to the rule establish supervisory LTV limits for various loan types. For owner-occupied 1-4 family residential real estate loans, there are no set supervisory LTV limits; however, loans with LTVs in excess of 90% should have private mortgage insurance (PMI) or readily marketable collateral. Loans insured or guaranteed by the US, state, or local governments are excluded from the LTV limitations of the Interagency Guidelines, provided that the amount of guarantee or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limits.

If an institution makes loans with LTVs of 90% or more without PMI or other readily marketable collateral, the loans should have credit strengths that offset the higher risks. According to the interagency guidelines, such loans are exceptions to supervisory LTV limits and should be limited to 100% of total capital when aggregated with other high LTV loans. When an institution holds both the first and second mortgages, and only the second mortgage exceeds the supervisory LTV limits, only the second mortgage is counted toward the percentage of capital investment limits. Finally, for loans with PMI or a government guarantee, if the PMI or government guarantee is less than the portion of the loan that exceeds the supervisory LTV limits, only that portion not covered by PMI or a government guarantee would count toward the percentage of capital investment limit.

As a thrift's 90% or higher LTV loans approach 100% of capital, it will come under increasing supervisory scrutiny. Institutions that engage in high LTV lending must address the risks identified in this bulletin. Failure to adequately control those risks will subject the institution to supervisory action, which may include the establishment of individual investment limits less than 100% of total capital. If, in the examiner's judgment, credit deficiencies could result in losses that would seriously erode the thrift's capital, the thrift will likely be cited for unsafe and unsound banking practices.

Exceptions. The interagency guidelines also state that there are lending situations when other factors significantly outweigh the need to apply the supervisory LTV ratio limits and, as such, are excluded from the reporting and percentage of capital limitations. The interagency guidelines list two excluded transactions where questions have arisen concerning their applicability to home equity lending: (1) loans for which a lien or interest in real estate is taken solely as an "abundance of caution (e.g., the institution takes a blanket lien on all, or substantially all, the assets of the borrower and the value of the real estate is low relative to the aggregate of all other collateral)," and (2) loans that are to be sold promptly after origination, without recourse, to a financially responsible third party.

Abundance of Caution. Some institutions have asked whether a loan would be subject to the real estate lending standards rule if it were made on an unsecured basis and the borrower met the institution's lending standards for unsecured consumer credit, but obtained a lien in the borrower's real estate as an added measure of protection. The answer to that question is generally yes. The real estate lending standards rule states that any loan secured by or made for the financing of real estate is a real estate loan and subject to its provisions, unless an exclusion applies.

[10] The classification of a loan as a real estate loan for applying 12 C.F.R. 560.101 should not be confused with asset classification for determining a thrift's investment limits under the Home Owner's Loan Act and 12 C.F.R. 560.30 and 560.31.

To qualify for the "abundance of caution" exception cited in the guidelines, the loan should otherwise be secured, so that the institution's interest in the other collateral would provide substantial security for the loan. For example, if a lender made a $10,000 auto loan secured by a car with a purchase price of $10,000 and took a second lien on the borrower's house in addition, the real estate security would be an abundance of caution and the loan would not be subject to 12 CFR 560.100-101. Likewise, a $100,000 commercial loan secured by a business' accounts receivable, inventory and equipment worth $90,000, with a second lien on the borrower's residence, would be a commercial business loan and not subject to the real estate lending standards rule, if the business had the ability and willingness to repay. In such an instance, the taking of the real estate security as an abundance of caution would be justified.

If, however, an institution made a $35,000 loan secured by a second lien on the borrower's home, but felt the borrower's credit and income was sufficient to support the loan on an unsecured basis, the loan would still be subject to the real estate lending standards rule because the institution secured the loan and there was no other collateral to qualify for the "abundance of caution" exception.

Sold Promptly Without Recourse. High LTV home equity loans that are "sold promptly without recourse" to a financially responsible third party need not be counted toward the 100% of total capital investment limit. To qualify for this exemption, the institution should sell the loans without recourse within 30 days after origination. If there is recourse, however, the loans should continue to be counted towards the 100% of total capital investment limit.

2. Overall Risk Assessment and Control. Because of the high-risk nature of high LTV home loans, a savings association's board of directors and management should carefully consider applicable regulatory provisions and whether such a program is appropriate for their institution, taking into account its staff resources, capital levels and other risk exposures inherent in the institution's asset structure. Savings associations should, consistent with regulatory requirements, establish prudent lending standards, credit management, servicing and collections procedures to identify, measure, monitor, and control the risks associated with high LTV lending.

a. Lending Standards. As cited above, the real estate lending standards rule requires savings associations to establish prudent written policies for real estate loans. The interagency guidelines attached to the rule include loan portfolio management considerations, underwriting standards, loan administration, and supervisory loan-to-value limits. Institution lending policies relating to its home lending program should be appropriate given the size and financial condition of the institution, the expertise and size of the lending staff, the need to avoid undue concentrations of risk, market conditions, and compliance with real estate laws and regulations. The policy should also clearly state the goals of the institution's home lending program.

b. Credit Management. Once loans are on the books, a savings association should perform periodic quality analyses through loan review and portfolio monitoring. Monitoring should include the evaluation of trends in loan volume, delinquencies, nonperforming and classified loans, as well as losses and the adequacy of the allowance for loan and lease losses (ALLL). At a minimum, portfolios should be segregated by LTV ratio (such as 80% to 89%, 90% to 99%, and 100% to 109%) and analyzed separately. If loans are approved using credit scores, performance should also be tracked by periodic credit score updates. Adjustments should be made to underwriting standards and loan administration and collection procedures when performance does not meet expectations or economic cycles dictate added concern.

c. Servicing and Collections. Because foreclosure will seldom be a viable option, lenders that engage in high LTV lending will have to make special efforts to develop and maintain effective servicing and collection procedures. Lenders involved in high LTV lending indicate that collection efforts must focus on

quickly contacting the borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary.

d. Other Strategies to Minimize Risk. When developing lending standards, savings associations should consider the items listed in the underwriting standards section of the interagency guidelines. To further minimize risk, institutions may want to adopt strategies more pertinent to the unique nature of high LTV home loans. For example, considering the likelihood that borrowers may reload on credit card debt after taking out a high LTV home equity loan for consolidation purposes, lenders might design procedures to prevent this. Many lenders pay off other creditors directly from the loan proceeds and limit "cash out" funds. Lenders may also consider other means to limit reloading exposure, such as requiring the borrower to cancel all, or all but one, limited line credit card, and monitoring subsequent charge account activity by updating credit bureau reports on a regular basis. When credit report data indicates a decline in the borrower's credit standing, lenders should consider taking action to limit their exposure, such as curtailing further advances on open-end lines of credit.

Some high LTV home equity lenders offset the higher credit risks inherent in low security or unsecured lending by requiring higher credit bureau scores. Lenders may also use other strategies such as setting maximum debt to income ratios that limit a borrower's total monthly debt burden to prudent levels, establishing maximum loan amounts and length of employment standards.

IV. Sales of High LTV Home Mortgage Loans.

Even when a lender plans to sell all or most of its high LTV loans promptly without recourse, it may still be exposed to substantial pipeline, liquidity, and warehouse risks. These risks could include:

- A possible drop in demand due to investors' credit quality or prepayment concerns. While investment by these sources will likely continue so long as loan performance is acceptable, there is the risk that market demand could diminish, and that loan prices could decline.
- The limited size and capacity of secondary market participants. It may be difficult to get binding agreements with loan purchasers to ensure that all future originations will be promptly sold without recourse.
- Internal problems with loan servicing or processing. As loan volumes increase, staff resources may be stretched, delays may occur, and cash demands may exceed available funds.

In smaller volumes, the pipeline of committed and funded but unsold loans would likely be minimal; however, as volumes increase, the institution could be exposed to unacceptable levels of pipeline, warehouse, and liquidity risk and will come under increased supervisory scrutiny. Savings associations will be expected to control these risks.

V. Compliance Obligations.

OTS expects an association to be diligent about meeting its compliance obligations when engaged in high LTV lending. A savings association engaged in high LTV home lending must establish and monitor policies that ensure compliance with the Home Ownership and Equity Protection Act. An association is expected to have a program in place that ensures compliance with the restrictions of the Act and the implementing regulations contained in Regulation Z, 12 C.F.R. 226.1 et seq., at 226.32. This means that consumers applying for 103(aa) mortgages must receive timely disclosures under 226.32(c) of Regulation Z and that loan terms prohibited by 12 C.F.R. 226.32(d) are not part of these transactions. OTS further expects an association to conduct all of its high LTV home lending in a manner that ensures that consumers understand the terms,

costs and risks of such loans and are not subjected to high pressure sales tactics in connection with such credit transactions.

Associations engaged in §103(aa) mortgage lending must have policies and programs in place to ensure that they are not extending credit without regard to the payment ability of the borrower and that payments to home improvement contractors occur in accordance with regulatory requirements. In addition, an association must monitor points and fees paid in connection with closed-end home equity mortgages to ensure that the "trigger" amounts recited for §103(aa) mortgages in Regulation Z are accurately calculated.

VI. Examination Considerations.

1. Examiner review. During the course of reviewing a savings association's residential real estate lending policies and activities, examiners will ensure that the institution's lending policies for the origination or purchase of high LTV home mortgage loans comply with 12 CFR 560.100-101 and the Interagency Guidelines for Real Estate Lending Policies and this bulletin. Examiners will review the institution's level of loans in excess of the supervisory LTV limits and determine if the institution is reporting such loans to the board of directors pursuant to the interagency guidelines. For savings associations with high concentrations of high LTV home loans, examiners will determine if the institution has adequate staff and proper systems and controls to address the additional risks inherent in such lending. OTS examiners will also review compliance management programs pertaining to high LTV lending.

2. Unsecured loans. Examiners will also determine whether an institution makes a significant level of large dollar debt consolidation or similar type loans without security. If it is found that the institution does not secure those loans in order to avoid conflict with the percentage of capital limitations set forth in this bulletin, it may be subject to criticism. In addition, OTS may establish higher individual minimum capital requirements for the institution because of the higher risk presented by large concentrations of high-dollar, unsecured loans.

3. Excess concentrations of high LTV loans. Since the policies in this bulletin are effective immediately upon publication, some thrifts may exceed the limitations cited herein. When concentrations of loans in excess of the supervisory LTV limit, including high LTV home loans, are deemed by OTS to be excessive, given the institution's capital levels and risk profile, the savings association will be directed to reduce its investment to appropriate levels of capital in accordance with those levels established in the Interagency Guidelines for Real Estate Lending Policies and this bulletin within a reasonable period of time. If an institution's investment in such loans exceeds those limits, management should, within 90 days of the issuance of this bulletin, present a plan of action to the OTS Regional Director, to achieve compliance, which could include reducing the savings association's investment to the applicable limits or raising capital within a reasonable time frame (generally within one year, depending on the volume and nature of the portfolio).

4. Capital. Under current OTS regulation 12 C.F.R. Part 567, high LTV home loans, as defined in footnote 2 of this bulletin, will be 100% risk weighted for risk-based capital purposes.

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