RESCINDED

Outdated – See OCC 2020-11
For more recent information, refer to Comptroller's Handbook, "Residential Real Estate Lending."

AL 97-7
Subject: Affordable Mortgage Portfolios

TO: Chief Executive Officers of all Nati
and Division Heads, and all Examining Personnel

PURPOSE

The Office of the Comptroller of the Currency (OCC) has reviewed the single family affordable mortgage portfolios (AMPs) of the largest national banks and found that overall banks are providing affordable mortgages profitably and safely. Although AMP losses have remained almost non-existent, we noted that delinquency rates have risen at some banks, especially those that have recently entered the affordable mortgage market. In contrast, banks that have been in the market at least five years have developed more effective risk management techniques and consequently have experienced lower delinquency rates.

The purpose of this advisory letter is to provide guidance on techniques that have proven to be effective in controlling risk in AMPs. By providing such guidance, we hope to support banks entering the affordable mortgage market and to promote prudent affordable mortgage lending practices.

As of June 15, 2015, this guidance applies to federal savings associations in addition to national banks.

BACKGROUND

The OCC's 1996 Survey of Credit Underwriting Practices, published September 11, 1996, included a review of national banks' AMPs. The survey found that 80 percent, or 66 of the 82 banks surveyed, had AMPs that largely comprised mortgages which could not be sold in the traditional secondary market. Affordable mortgage loans were described as those mortgages on 1- to 4-family dwellings having 95 to 97 percent loan-to-value (LTV) ratios, 40 to 43 percent maximum debt-to-income ratios, and a 3/2 down payment option. The 3/2 option means that 3 percent of the down payment must come from the borrower's funds and 2 percent may be borrowed or obtained as a grant or gift. For most banks, AMPs represented a small portion (less than 10 percent) of their residential real estate portfolios.

The 1996 survey found that delinquencies in AMPs were higher than in conventional residential mortgage portfolios. Total delinquencies in AMPs averaged 4 percent, compared to 3 percent for residential real estate portfolios as a whole. Losses in AMPs were either nonexistent or minimal at less than 0.1 percent. However, the low loss ratio may be attributable to the fact that many AMPs are unseasoned.

In early 1997, the OCC conducted a follow-up review at the 13 banks with the largest dollar volume of AMPs. The follow-up review noted that, although losses remained minimal, AMP delinquencies at some of the banks increased more than 100 basis points in the last six months of 1996. By contrast, according to the Mortgage Bankers Association of America, delinquencies for all residential mortgages increased only slightly (2 basis points) over the same time period. The primary reasons noted for the increased level of delinquencies in affordable mortgage loans included, but were not limited to, borrowers managing their finances with minimal reserves and unstable borrower employment caused by employer downsizing. The increase in delinquencies was most noticeable in the banks that had recently entered this market.

FINDINGS

The 1996 OCC survey and 1997 follow-up review noted a correlation between the level of delinquencies and the number of years a bank had offered affordable mortgage loans. Banks with more than three years experience in this market generally had a higher loan volume but more effective risk management and lower delinquency levels in their AMPs.

The banks with lower delinquency rates had three common characteristics:

- Applicants at those banks were generally required to complete a comprehensive program of pre-purchase counseling as a pre-requisite for qualifying for affordable mortgages; applicants at a few banks with low delinquencies also completed post-purchase counseling as well as home ownership counseling.

- Banks with low delinquencies had rapid response delinquency intervention programs that enabled them to contact customers early and establish or enforce their collection programs.

- At banks with low delinquency levels, there was a limited layering of risk factors, such as high debt-to-income ratios and minimal borrower reserves for unexpected expenses and repairs.

At banks that required pre-purchase counseling for their AMPs, the counseling varied from a two-hour self study program to a four-week Fannie Mae/HUD approved course. Banks that had more structured and comprehensive counseling generally had lower affordable mortgage delinquency rates. Conversely, banks with higher AMP delinquency rates often did not provide any form of required pre-purchase counseling or offered far less comprehensive counseling.

Banks with longer experience in affordable mortgage lending and better credit performance generally had rapid delinquency intervention processes that included contacting delinquent borrowers immediately after the grace period or a missed payment and developing a customized plan to bring the borrower current. Again, less experienced, poorer performing banks usually lacked rapid-response delinquency intervention programs.

Increases in affordable mortgage delinquencies were most evident at banks that layered risk factors. These risk factors include high debt service coverage ratios, limited borrower reserves to cover emergencies, unstable borrower employment and income, and unstable local economies.

To help reduce the level of delinquencies in their AMPs, banks are encouraged to review their strategies for providing pre- and post-purchase counseling and to consider developing rapid response programs to follow up with delinquent AMP borrowers even before the loans become 30 days past due. Banks are also encouraged to carefully monitor mortgages that layer multiple risk factors.

AMPs AND PRIVATE MORTGAGE INSURANCE

While many banks in the survey sold qualified loans in the secondary markets, some banks planned to hold AMP loans on their books through maturity. Many banks that hold affordable mortgages on their books do not require private mortgage insurance (PMI), either to compete with other lenders that do not require PMI or to provide borrowers with lower monthly payments (and implicitly, higher debt service capacities).

In some cases, banks cannot obtain PMI on affordable mortgage loans. Bank management and examiners should be careful to ensure that such portfolios are consistent with the bank's portfolio credit risk management process. High LTV loans without PMI further expose the bank to credit risk. In addition, these loans traditionally are not saleable in the public secondary market or may be sold only with unattractive discounts or recourse requirements.

When a bank chooses not to require PMI, management may want to consider other alternatives such as the general cost, benefits, and coverage of a master mortgage payment insurance policy on AMP loans. Several banks have purchased master policies on blocks of loans that they chose to securitize or sell. Some banks are considering the purchase of master insurance policies for loans in their portfolios or individual PMI policies on future affordable mortgage loans.

ASSESSING PORTFOLIO DELINQUENCY CHARACTERISTICS

Vintage analysis is used commonly in the mortgage banking industry and by many commercial banks to enable lenders to compare delinquency, foreclosure, and loss rates on similar portfolio products over comparable loan origination periods. Vintage analysis allows lenders to identify causes of credit quality problems early so they can take timely corrective measures. Lenders can develop reliable predictive data on delinquency and loss trends, and can adjust their policies and practices accordingly to improve the quality of existing and future loans.

CREDIT RISKS RELATED TO ADJUSTABLE-RATE AFFORDABLE MORTGAGES

Most banks' affordable mortgage portfolios contain a concentration of adjustable-rate mortgages (ARMs). ARMs are attractive to affordable mortgage customers because the initial interest rate is typically lower than that of a fixed-rate mortgage. But ARMs present additional credit risk in an environment of rising interest rates.

An increase in credit (default) risk can result when customers are unable to meet increasing debt service requirements associated with an upward shift in interest rates. Lenders and examiners should consider the impact of rising interest rates on credit risk for both individual loans and the portfolio as a whole. At a minimum, the impact should be weighed in terms of both annual and lifetime caps, as well as other embedded options.

ENHANCED AFFORDABLE MORTGAGE PORTFOLIO MANAGEMENT

Banks with significant AMP volume may want to consider treating their affordable mortgage loans as a specific portfolio and cost center or develop alternatives for enhanced monitoring of their AMP performance. Banks also may want to evaluate ways to strengthen their existing portfolios that will not negatively impact their market areas or give the appearance of disinvesting in their communities. Accordingly, banks with AMP programs may want to consider some of the following strategies:

- Providing comprehensive pre- and post-purchase counseling for borrowers (possibly through not-for-profit organizations or other firms experienced in this area).

- Reviewing management information systems for AMPs to ensure that management has adequate information to evaluate loan volume, delinquency rates, losses, and profitability consistent with management's goals and other key underwriting factors.

- Evaluating the bank's existing AMP delinquency intervention efforts. Banks that have structured, systematic rapid response programs are often the most successful in curtailing delinquencies.

- Considering a requirement (or providing an incentive for) AMP borrowers to set up an automatic payment plan, either through automatic debit of an existing deposit account or by payroll deduction.

- Employing vintage analysis techniques for AMPs.

- Considering a requirement for PMI, limits on the volume of non-PMI loans, or the use of master mortgage payment insurance on future affordable mortgage loans.

- After consultation with legal counsel concerning applicable consumer protection laws, considering establishing an additional reserve or restricted account to cover a missed payment, repairs, etc.

- Establishing a dedicated enhanced servicing division with personnel trained in collection techniques or enhancing the bank's contracted servicing arrangements to work more closely with the entities that provide counseling to the bank's customers.

- Contracting with a community development related firm that has experience in managing affordable mortgage portfolios and a good track record of delinquency reduction and prevention.

CONCLUSION

The OCC's review of the largest national banks' AMPs suggests that affordable mortgage programs can result in loan portfolios with quality performance consistent with conventional residential real estate lending. As with other mortgage lending, banks should use sound risk management practices and MIS for monitoring the performance of their AMPs. Banks should consider comprehensive counseling, rapid response delinquency intervention programs, reduced layering of multiple risk factors, and other effective practices to manage the risks in their AMPs.

The elements of AMP management discussed in this advisory complement the OCC's guidance on effective credit underwriting standards and portfolio credit risk management (see OCC Advisory Letter 97-3, March 7, 1997). Each bank must design its affordable mortgage loan program to include the features and the associated risk factors that fit the bank's risk profile. As banks' AMP programs continue to grow and their portfolios become more seasoned, it is important for banks to continue to focus their efforts on effective credit underwriting standards and credit risk management processes to maintain high quality assets.

ORIGINATING OFFICE

Questions concerning this advisory letter may be directed to the Community Development Division at (202) 874-4930.

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