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Office of the
Comptroller of the Currency
U.S. Department of the Treasury

OCC 2012-27

Subject: Investor-Owned One- to Four-Family Residential Properties
Date: September 17, 2012

To: Chief Executive Officers of All National Banks and Federal Savings Associations, Department and Division Heads, All Examining Personnel, and Other Interested Parties

OCC 2012-27 was replaced by OCC 2013-19

Description: Supervisory Guidance on Risk Management and Reporting Requirements

Purpose and Summary

This bulletin provides national banks and federal savings associations (collectively, banks) with guidance on appropriate credit risk management practices for investor-owned, one- to four-family residential real estate (IORR) lending where the primary repayment source for the loan is rental income. This type of lending has increased because of a variety of economic factors. This bulletin is intended to promote consistent risk management practices for IORR lending and to summarize the applicable requirements for regulatory capital and call reports for IORR lending.

Some banks manage IORR loans in a similar manner to owner-occupied one- to four-family residential loans. The credit risk presented by IORR lending, however, is similar to that associated with loans for income-producing commercial real estate (CRE). Because of this similarity, the Office of the Comptroller of the Currency (OCC) expects banks to use the same types of credit risk management practices for IORR lending that are used for CRE lending. This expectation does not change the regulatory capital, regulatory reporting, and Home Owners' Loan Act (HOLA) requirements for IORR.[1]

Credit Risk Management Expectations

Typically, IORR repayment sources have different risk characteristics than those of owner-occupied one- to four-family residential loans. The primary source of repayment for an IORR loan is normally the rental income from the financed property, supported by the borrower's other personal income. In addition, repayment sources for IORR loans may be volatile and highly leveraged in cases where the borrowers have multiple financed properties. Therefore, banks should have credit risk management policies and processes suitable for the risks specific to IORR lending. These policies and processes should cover loan underwriting standards; loan identification and portfolio monitoring expectations; allowance for loan and lease losses (ALLL) methodologies; and internal risk assessment and rating systems.

Loan Underwriting Standards

IORR lending should follow the federal banking agencies' uniform regulations on real estate lending.[2] Those regulations establish expectations for real estate loan policies, underwriting standards, portfolio administration, and supervisory loan-to-value (LTV) limits.

IORR loan policies should establish prudent underwriting standards that are clear, measurable, and within the risk appetite approved by the board of directors. An important area to address in the policy is an appropriate amortization period for IORR loans that considers both the property's useful life and the predictability of its future value. For income-producing properties, a normal amortization range is 15 to 30 years. The policy should also consider the need for additional controls to monitor and mitigate risk. These could include the use of loan covenants, requirements for periodic financial analysis, and the need for a willing and financially capable guarantor. Further, IORR loan policies should establish underwriting standards pertaining to appropriate owner equity (LTV), acceptable appraisal and/or valuation methods, insurance requirements, and ongoing collateral monitoring.

Borrowers may finance multiple properties through one or more financial institutions. Underwriting standards and the complexity of risk analysis should increase as the number of properties financed for a borrower and related parties increases. When a borrower finances multiple IORR properties, a comprehensive global cash flow analysis of the borrower is generally necessary to properly underwrite and administer the credit relationship. In such cases, bank management should analyze and administer the relationship on a consolidated basis.

Loan Identification and Portfolio Monitoring Expectations

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Identification of IORR properties is an important first step in measuring potential risk. Once identified, IORR properties should be segregated from other residential loans so that the bank can effectively manage the risk. The OCC recognizes that borrowers can convert homes into rentals without notifying their bank and that banks may not have historically identified or structured loans to allow for the heightened monitoring that is generally required for IORR loans. Banks should make every effort to properly identify, monitor and structure IORR loan relationships. Such efforts would include banks taking steps to strengthen their ability to monitor and control the credit relationship, where possible, on known IORR loans. Banks that have not previously distinguished between IORR loans and owner-occupied one- to four-family residential loans should implement methods to draw clear distinctions.

Allowance for Loan and Lease Losses Considerations

Banks should ensure that ALLL methodologies appropriately consider factors to reflect the risk of loss inherent in the IORR portfolio. Individually impaired IORR loans should be evaluated in accordance with ASC 310-10 (formerly FAS 114). Loans that are not individually impaired may be evaluated as an ASC 450-20 (formerly FAS 5) pool. Until management information systems are capable of IORR identification and segmentation, management should consider this un-quantified risk when making qualitative adjustments to the ALLL analysis.[3]

Amounts incorporated into the ALLL methodology for IORR loans may be reflected within an ASC 450-20 pool that is separate from owner-occupied one- to four-family residential loans.

Internal Risk Assessment and Rating Systems

The OCC expects banks to have credit risk management systems that produce accurate and timely risk ratings.[4] Applying a rating system similar to that used for CRE lending is generally appropriate for an IORR portfolio. In some cases, however, a bank may have a separate rating system designed specifically for this type of lending. The risk assessment and rating process should not rely solely on delinquency status. The complexity of the ongoing analysis and risk rating should be commensurate with the number of properties financed globally by the borrower.

IORR loans are not specifically addressed within the scope of the interagency Uniform Retail Credit Classification and Account Management Policy (Retail Policy Statement).[5] Banks have sometimes applied the classification time frames and the 180-day delinquency charge-off requirement for real estate loans from this policy to IORR loans. Using the classification time frames and the 180-day delinquency charge-off requirements is acceptable as an outer limit for IORR. However, banks should classify loans and recognize losses sooner if the circumstances on these loans meet the interagency classification definitions, which are consistent for both retail and commercial loans. Deviation from the minimum classification guidelines outlined in the interagency Retail Policy Statement is warranted if underwriting standards, risk management, or account management standards are weak and present unreasonable credit risk. For further guidance and CRE risk management expectations and classification, refer to the interagency "Policy Statement on Prudent Commercial Real Estate Loan Workouts."[6]

Regulatory Reporting, HOLA, and Risk-Based Capital Treatment

Banks should continue to report IORR loans that meet the call report definition of one- to four-family residential lending in that category. IORR loans continue to qualify as residential real property loans under HOLA. IORR loans will qualify for the 50 percent risk-based capital category if certain regulatory requirements are met. IORR loans that do not meet the criteria will fall into a higher risk-based capital category. Refer to the call report instructions and the OCC's capital regulations[7] for further detail on these topics.

Additional Information

If you have questions, please contact your supervisory office or Grant Wilson, Director for Commercial Credit Risk, at (202) 87[illegible]-4660.

Darrin Benhart
Deputy Comptroller, Credit and Market Risk

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[1] 12 USC 1464(c)(1)(B) and 12 CFR 160.30. For federal savings associations, a home loan is defined as any loan made on the security of a home (including a dwelling unit in a multifamily residential property such as a condominium or a cooperative), a combination of a home and business property (i.e., a home used in part for business), a farm residence, or a combination of a farm residence and commercial farm real estate.

[2] Federal savings associations should refer to 12 CFR 160.101 and national banks should refer to 12 CFR 34.62 for details pertaining to the interagency guidelines for real estate lending policies.

[3] Refer to OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions on the ALLL," December 13, 2006.

[4] Refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*, April 2001.

[5] Refer to OCC Bulletin 2000-20, "Uniform Retail Credit Classification and Account Management Policy: Policy Implementation," June 20, 2000.

[6] Refer to OCC Bulletin 2009-32, "Commercial Real Estate (CRE) Loans: Guidance on Prudent CRE Loan Workouts," October 30, 2009.

[7] See 12 CFR 167.6(a)(1) for federal savings associations and 12 C.F.R. part 3, Appendix A, Section 3 (a)(3) for national banks for details pertaining to the risk-weighted capital treatment of one- to four-family real estate loans.