

## **Nontraditional Mortgage Products, Risks, and Examination Procedures**

### **What are Nontraditional Mortgage Products?**

The products are known as “interest-only,” and “payment option” adjustable-rate mortgages. They are called, variously, “nontraditional,” “alternative,” or “exotic” products.

The products allow borrowers to defer payments of principal and sometimes, interest, on the mortgage loans. Borrowers exchange lower payments during an initial period for higher payments during a later amortization period.

### **Associated Risks to Nontraditional Mortgage Loans**

Many of the exotic products are underwritten with less stringent requirements (like reduced documentation), and combined with simultaneous second-lien loans. These risks are known as layering. Other risks include the fact that the products have no principal amortization, and have potential for negative amortization. The recast of the product features may create payment shocks, and defaults.

DFI expects providers to effectively assess and manage the risks associated with their exotic products and:

- \*Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s repayment capacity; and
- \*Ensure that consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a product choice.

The Department has determined that the guidelines for the risks associated with the growing use of the exotic products require regulatory oversight to mitigate risks to borrowers who are increasingly using the products.

### **Examination Procedures of Nontraditional Mortgage Loans**

Procedures are for the examination of nontraditional mortgages. The procedures will provide examiners guidance in the evaluation of the product risks during the examination of mortgage lenders and mortgage brokers (or, providers). The procedures are intended to be used as the minimum standard for compliance with the State of Washington’s prohibited practices when soliciting, originating or making nontraditional mortgage loans to consumers.

Examiners will have to evaluate providers’ compliance with consumer protection laws, proper underwriting standards, and risk management practices. Examiner should use provisions guiding the nontraditional mortgage product risks to address risk management broadly. Examiners will review and ensure that providers have adequate controls for compliance risk, reputation risk, and litigation risk as well as the disclosure of borrower risks.

## Examination Scope Guidelines

During examinations, examiners will carefully scrutinize providers' risk management processes, policies, and procedures. Providers that do not adequately manage risks will be required to institute remedial action. Those providers with sound exotic mortgage products underwriting and adequate risks management will not be subjected to criticism merely for offering such products.

The worksheet provided herewith is to form the framework for the evaluations. The worksheet is set up to address and establish the exotic products' quality, required risks management, controls, and compliance with the State of Washington laws and regulations, using the following parameters:

- 1) Loan Terms and Underwriting Standards
- 2) Risks Management
- 3) Consumer Protection Issues
- 4) Recommended Practices

### Exotic Mortgage Loans Evaluation Worksheet:

Apparent Violation (If No)	Yes	No	Basis for Y/N Conclusion
<b>1) <u>Loan Terms and Underwriting Standards</u></b>			
Are loan terms and underwriting standards prudent? <ul style="list-style-type: none"> <li>- are the terms sound, despite competitive pressures?</li> <li>- do third-parties handle underwriting, even where they have different business objectives, risk tolerances, and core competences?</li> </ul>			
How qualified are the borrowers? <ul style="list-style-type: none"> <li>- do borrowers know that payments on exotic products can increase significantly when the loans begin to amortize?</li> <li>- do borrowers know that structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate can create payment</li> </ul>			

shocks for them?			
<p>Are the loan terms collateral-dependent?</p> <ul style="list-style-type: none"> <li>- are borrowers dependent on the sale or refinancing of their property at amortization</li> <li>- does provider understand that loan to a person with less capacity to payback may be predatory or abusive?</li> </ul>			
<p>Are the loan risks layered, do they support underwriting decisions?</p> <ul style="list-style-type: none"> <li>- do the layering mitigating factors support support underwriting decisions, and borrowers' capacity to repay?</li> </ul>			
<p>Were there reduced documentations, were there mitigating factors?</p> <ul style="list-style-type: none"> <li>- were mitigating factors like higher credit scores, lower loan-to-value, debt-to-income ratios, significant liquid assets, mortgage insurance and other determined credit enhancements verified?</li> </ul>			
<p>Were simultaneous second-lien loans taken?</p> <ul style="list-style-type: none"> <li>- were borrowers informed of the possible credit risk increase?</li> </ul>			
<p>Were there introductory interest rates?</p> <ul style="list-style-type: none"> <li>- do borrowers know that a wide initial spread between the introductory interest rate and the fully indexed interest rate means that they are more likely to experience negative amortization, severe payment shocks, and earlier-than-scheduled recasting of their monthly payments?</li> </ul>			
<p>Were loans made to subprime borrowers, can they be predatory or abusive?</p> <ul style="list-style-type: none"> <li>- do borrowers know the effect of layered risks?</li> <li>- Are providers aware that risks-layering features in loans to subprime borrowers could significantly increase for them and the borrowers?</li> </ul>			
<p>Were they non-owner-occupied loans, with what levels of LTV, DTI and equity?</p> <ul style="list-style-type: none"> <li>- were these underwriting risk mitigating factors verified?</li> </ul>			

<b>2) <u>Risks Management</u></b>			
Are there adequate policies and procedures, and appropriate layering limits?			
Are there enhanced performance measures and management reporting for early warning?			
Do concentrations exist, are there third-party incentive programs? <ul style="list-style-type: none"> <li>- do sound monitoring systems and risk management practices exist?</li> <li>- do employee and third-party incentive programs produce higher concentrations?</li> </ul>			
Do adequate controls exist to monitor standards and exceptions?			
Are there third-party originations, do they have procedures for due diligence? <ul style="list-style-type: none"> <li>- do they have controls for establishing and maintaining relationships?</li> <li>- does oversight of third-parties involve monitoring the quality of originations?</li> <li>- do the oversight reflect the provider's lending standards and compliance with applicable laws and regulations?</li> </ul>			
Is there secondary-market activity, has reduced demand been planned for? <ul style="list-style-type: none"> <li>- are secondary market risk management practices commensurate with the nature and volume of activity?</li> <li>- are there comprehensive, and formal strategies for managing risks, for reduced demand in the secondary market?</li> </ul>			
<b>3) <u>Consumer Protection Issues</u></b>			
Do borrowers understand the dangers of exotic products?			
Are there management concerns about payment shocks during recast of interest rates to borrowers? What are the objectives, how are the marketing terms?			

Are there legal risks, are laws and regulations complied with?			
<b>4) <u>Recommended Practices</u></b>			
Do they entertain timely communications with consumers?			
Do promotions and products provide terms, features and risks information?			
Are there information on the causes of payment shocks to borrowers?			
Do borrowers know how negative amortization can affect them? - are they informed that payments left unpaid would eventually result in increases to their loan balances?			
Has prepayment penalty been explained to borrowers? How?			
Are pricing premium attached to reduced documentation program? - are borrowers charged extra for this?			
Are monthly statements on payment option ARMs explained to borrowers?			
Do they avoid practices that can obscure significant risks?			
Are there control systems for compliance and consumer information?			
Do lending personnel direct consumers to particular products?			