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COMMENTARY

Responsible Lending Policies Address 'Matters Requiring Attention'

By Anna DeSimone

"MATTERS REQUIRING ATTENTION" IS A familiar phrase to banks. It is the section contained within an examination report issued by a regulatory enforcement agency.

In response to the growing concern over past lending practices within the subprime sector and the extensive use of nontraditional mortgage products, regulators are urging lenders to establish a Responsible Lending Policy. Regulators advocate flexible lending practices that are designed to enhance credit access for both prime and nonprime borrowers and support lending practices that meet the diverse credit needs of the lender's marketplace.

The availability of diverse residential mortgage loan products, including those with nontraditional characteristics or extended to non-prime borrowers, has created more opportunities for a wider range of borrowers to purchase a home. However, the unsuitability of these products for certain borrowers can cause undesirable results for both the borrower and the lender.

As part of its credit risk management practices, lenders must take appropriate measures to monitor exposure to higher-risk residential mortgage loans. A policy for responsible lending should compliment any existing anti-predatory lending policies that exist. Regulators will, however, note deficiencies in the Matters Requiring Attention section of an examination report should existing policies or procedures inadequately address key components, as follows:

1) A general policy that the lender will attempt to prevent abusive, fraudulent, or unfair or deceptive practices, including equity stripping.

2) A policy for disciplinary action, including termination, of any employee or third party involved in such activities.

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3) A policy regarding whistle-blowing that allows employees and others a protected and confidential vehicle to report wrongdoing to senior management or authorities.

4) A policy regarding training on internal and external levels, including employees, mortgage brokers and third-party service providers.

5) A policy that all borrowers are qualified by their consumer credit score and/or other specific underwriting criteria.

6) A policy that the lender will not disparage, discredit or otherwise encourage a potential borrower to disregard the Good Faith Estimate or other required disclosures.

7) A policy that the lender will not close loans prior to the completion of the loan underwriting process, also known as "accommodation closings."

8) A policy that the lender will report the borrower's payment history to nationwide consumer credit bureaus so that consumers are able to build their credit profile.

9) A policy that defines underwriting guidelines to ensure the applicants' ability to repay the debt and sets documentation standards to support repayment not based on the equity in the mortgaged property.

10) A policy that the lender will not refinance loans for the purpose of generating fees and that refinancing must offer a reasonable tangible net benefit to the borrower.

11) A policy that prohibits features such as interest rate increases, balloon payments or acceleration clauses under certain circumstances, including default.

12) A policy that fees and costs charged by the lender for third-party services will not exceed the amount charged by the third party.

13) The process and circumstances under which the lender will make loans with negative amortization, and a description of the disclosures to be provided to borrowers who select negative amortization products.

14) The disclosure of any cap on the yield spread premium (YSP) that may be paid to a broker. Regulators expect that YSP should not exceed 2.5 percent of the loan amount and total broker compensation should not exceed 5 percent of the loan amount.

15) The lender's policy on whether compensation to employees is tied to loan production, and if so, a policy that such compensation will not result in the inflation of rates and fees charged in connection with the mortgage loan.

16) A general statement that requires loan originators and third-party mortgage brokers to comply with the policy. Lenders must have procedures for performing due diligence on its brokers, loan originators and appraisers prior to entering into relationships, including proper licensure and checking industry anti-fraud databases.

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Some industry advocates, as well as regulators, are encouraging "suitability standards" where lenders are expected to consider whether a particular loan product is appropriate or suitable. The Mortgage Bankers Association of America has compared such standards to the securities industry and claims such standards would have a negative impact on the industry. However, in light of the recent subprime debacle that has swept across America, perhaps any standard can be considered a positive step if it helps control the risk of default.

Regulators expect lenders to exercise caution in using certain terms and phrases in loan solicitation materials, such as "pre-approved" or "cash savings," and should not promote monthly payment figures that are unlikely to occur. Predictions about the future direction of interest rates are considered inappropriate representations. Prepayment penalties that exceed 5 percent and/or go beyond the first re-pricing date in the case of an adjustable-rate mortgage or in excess of 3 years in the case of a fixed-rate loan are subject to greater scrutiny by regulators.

Lenders are expected to employ their own underwriting standards and reliance upon investor guidelines is not considered consistent with the responsible lending policy. Areas of concern to regulators because they are considered potential risks to lenders include the timely and accurate disclosures of the Good Faith Estimate and HUD Settlement Statement under the Real Estate Settlement Procedures Act, particularly the disclosure of broker and lender fees.

It has been often stated that the lender's obligations do not end with origination and regulators have listed the following issues as relevant to the continued operation of a sound lending program:

- Ongoing monitoring of retail and wholesale service areas;
- Record retention;
- Adequate and organized loan files and documentation; and
- Timely and documented borrower complaint resolution.

Existing policies or procedures that do not adequately address key issues will be noted as deficiencies in the Matters Requiring Attention section of examination reports. Internal controls and workflow processes that assure compliance are critical to the overall effectiveness of a responsible lending plan. The development of the plan can be an interdepartmental project where each service area, such as retail or wholesale origination, processing, underwriting, closing and servicing, is represented by an individual. Each individual could be made responsible for developing technical content and quality control checklists. Projects that are broken into smaller, segmented groups are easier to manage. A well-deployed system for responsible lending in today's mortgage banking environment can serve to be a dual-purpose benefit for managing credit and compliance risk. ■

Nontraditional and Subprime Loans

Nontraditional mortgage loans are mortgage products that allow borrowers to defer payment of principal and (sometimes) interest. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period, resulting in or creating the potential for negative amortization. They include mortgages with "interest-only" and "payment-option" adjustable-rate terms. These products present additional risks when combined with other features such as simultaneous second-lien mortgages; introductory "teaser" rates; bought-down rates, reduced documentation in supporting an applicant's creditworthiness; underwriting to less than the fully indexed rate and fully amortizing payment, very high or no payment or rate caps; high margins; and product features likely to encourage frequent refinancing to maintain an affordable monthly payment.

Subprime mortgage loans are defined as loans extended to borrowers who, at the time of loan origination or purchase, exhibit a credit history and financial characteristics indicating a higher probability of default than borrowers who have consistently demonstrated the financial capacity to service the debt, sometimes referred to as "affordability needs borrowers." Affordability needs borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments and bankruptcies. They also may display reduced repayment capacity as measured by credit scores, debt-to-income ratios or other criteria that may encompass borrowers with incomplete credit histories. For the purpose of establishing a credit score threshold, loans extended to borrowers with FICO scores below 660 are considered to be potentially subprime mortgage loans. However, mitigating factors may exist that, on balance, reduce the risk of these mortgage loans such as low loan-to-value or dept-to-income ratios and/or high cash reserves.

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