Questions and Answers on Risk Weighting 1-to-4 Family Residential Mortgage Loans

1. When do 1-to-4 family residential mortgages receive 100% risk weight?

Any 1-to-4 family residential mortgage loan that is not a Qualifying Mortgage Loan receives a 100% risk weight. A Qualifying Mortgage Loan is a loan that:

(i) Is fully secured by a first lien on a 1-to-4 family residential property;

(ii) Is underwritten in accordance with prudent underwriting standards, including standards relating the ratio of the loan amount to the value of the property (LTV ratio). See Appendix to 12 CFR § 560.101. A nonqualifying mortgage loan that is paid down to an appropriate LTV ratio (calculated using value at origination) may become a qualifying loan if it meets all other requirements of this definition;

(iii) Maintains an appropriate LTV ratio based on the amortized principal balance of the loan; and

(iv) Is performing and is not more than 90 days past due.

Thus, loans that are non performing and more than 90 days past due; loans not prudently underwritten in accordance with the Real Estate Lending Standards, such as loans over 90 percent LTV without private mortgage insurance or other additional readily marketable collateral, and loans that do not reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt (see answers 8 and 9 below) would receive a 100 percent risk weight.

2. (a) Does the value for calculating loan-to-value (LTV) continue to be based on the appraisal or evaluation at origination? If an institution has an updated appraisal, may it be used to calculate an updated LTV? (TFR Q&A 126) If a 1-to-4 family residential loan continues to meet all the other qualifying criteria for a 50 percent risk weight but the institution has a valid appraisal indicating a much lower value, MUST the institution use the new appraisal?

Answer for Risk-based Capital: For the Qualifying Mortgage Loan definition that is used to determine whether a loan may be risk weighted at 50 percent, you use value at origination. The applicable value at origination is the lower of the appraised value or sales price. You continue to use value at origination throughout the life of the loan, even if housing prices in the area have changed. However, if the loan is refinanced, has defaulted, or has been otherwise modified generating a new appraisal – then assuming the new appraisal is valid and meets all applicable standards – you use the new appraisal.

Answer for Schedule Loan Data (LD): While an institution must use value at origination for capital risk weighting purposes, there are other valid reasons for an institution to track home values in its lending area or to seek reappraisals of certain properties. For example, the institution might use this information to assess its overall risk exposure and make an assessment of its individual capital adequacy. An institution may also want an assessment of current values to determine its exposure and policies for home equity lines. Follow the TFR instructions and Q&A 126 for Schedule LD.

(b) Does the loan amount for calculating LTV continue to be based on the amount of the loan at origination?

No. A Qualifying Mortgage Loan is one that "maintains an appropriate LTV ratio based on the amortized principal balance of the loan." Moreover, "a nonqualifying mortgage that is paid down to an appropriate LTV ratio (calculated using value at origination) may become a qualifying loan if it meets all other requirements of this definition" (see definition of Qualifying Mortgage Loan at 12 CFR § 567.1). Conversely, should a loan's amortized principal balance increase (e.g., as a result of negative amortization on the loan), a qualifying loan may become a nonqualifying loan based on an increase in the LTV ratio (that is, current balance divided by value at origination).

Thus, a loan's outstanding balance changes due to amortization -- whether ordinary positive amortization that decreases the loan balance, or negative amortization that increases the balance. The current balance is used to determine the LTV ratio and whether the loan meets the Qualifying Mortgage Loan definition.

3. **Does the definition of "subprime" continue to rely on the examples in CEO Memo 257 or has the definition evolved to using 620 or less for real estate secured loans and 660 or less for nonreal estate secured loans to define subprime loans (rather than the 660 or below indicated in the CEO memo)? Does the institution still need to define any programmatic subprime loan programs? Do the examples in the guidance continue to be potential characteristics of subprime?**

   The guidance and definition of subprime have not changed. Borrower credit risk characteristics define whether the borrower is subprime. FICO score alone does not determine whether a borrower is subprime. A number of borrower credit risk characteristics are listed in both the "Interagency Statement on Subprime Lending" (CEO Memo 257) and the 2001 "Interagency Expanded Guidance for Subprime Lending Programs" ("Expanded Guidance") (CEO Memo 137).

4. **Do loans that are originated as prime and subsequently have subprime characteristics have to follow the subprime lending guidance? Are these loans not "subprime" as defined by the guidance and thus do not have to be treated as such – although there might be credit and capital implications because of performance?**

   As explained in the Expanded Guidance, subprime lending does not refer to individual subprime loans originated and managed in the ordinary course of business as exceptions to prime risk selection standards. The Agencies recognize that many prime loan portfolios will contain such accounts. Generally, this guidance will not apply to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded as a result of their performance to programs targeted to prime borrowers; and community development loans as defined in the Community Reinvestment Act (CRA) regulations that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk mitigation techniques.

5. **Do we currently apply the subprime multiplier (1.5 to 3 times the normal risk-based capital requirement) and capital stress testing only if the population of subprime loans is 25 percent or more of tier 1 capital, or do we apply these to any populations of 1-to-4 subprime loans?**

   The Expanded Guidance applies specifically to those institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

   However, the Agencies may also apply these guidelines to certain smaller subprime portfolios, in certain situations such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, those impacted by local or national economic conditions, or those where the activity is conducted with inadequate or weak controls, or other similar conditions. Thus, as a supervisory matter, we would expect stress testing and use of the multiplier for portfolios that are 25 percent or more of Tier 1 capital. However, it may behoove the savings association to analyze the potential impact of subprime portfolios on smaller populations, especially as concentrations develop, and even more so if they begin to approach the 25 percent of capital threshold.

6. **What are we currently using as the subprime multiplier for 1-to-4 family residential loans originated as part of a subprime lending program?**

   A subprime portfolio could be risk-weighted as high as 300 percent in the case of high LTV or other nonqualifying 100 percent risk weight loans with the 3 times capital subprime multiplier

applied. For loans that otherwise meet the Qualifying Mortgage Loan definition on an individual loan basis, the 50 percent base risk weight is used before a subprime multiplier is applied.

The Expanded Guidance states that: “Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for *fully documenting* the methodology and analysis supporting the amount specified. Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution’s own documented analysis of the capital needed to support its subprime lending activities. Examiners should expect capital levels to be risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters.” Examiners should also consider the impact on the Allowance for Loan and Lease Losses (ALLL).

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for nonsubprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with riskier subprime programs affected by this guidance should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

The subprime multiplier may also be applied to home equity lines of credit that are originated as part of a subprime program.

7. What is the risk weight for low doc loans? Can these still use the traditional 50 percent and 100 percent risk weight for risk-based capital?

For purposes of calculating minimum risk-based capital requirements, only Qualifying Mortgage Loans are eligible for the more favorable 50 percent risk weight. To be eligible, a mortgage loan must meet the criteria set forth in the regulation, including the criteria that it be underwritten in accordance with prudent underwriting standards (see Real Estate Lending Standards in Appendix to 12 CFR § 560.101). The real estate lending standards state that the prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. Those loans, particularly no-documentation loans or low-documentation loans, that do not reflect all relevant credit factors or support the borrower’s ability to repay the loan, would not be eligible for the more favorable 50 percent risk weight.

Further supplemental guidance on prudent underwriting practices, including the assessment of a borrower’s ability to repay a loan, is set forth in various agency issuances, including OTS

Examination Handbook Section 212 and its Appendix F (the October 4, 2006, Interagency Guidance on Nontraditional Mortgage Products); the July 10, 2007 Interagency Statement on Subprime Lending; and Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR Part 570).

Notwithstanding the minimum risk-based capital requirements for qualifying and nonqualifying mortgage loans, OTS may find that the risk weight assigned to any asset does not appropriately reflect the risk of that asset and may require the savings association to apply another risk weight that OTS deems appropriate (see 12 CFR § 567.11 Reservation of Authority). In addition, the OTS may find that the loans are otherwise unsafe and unsound based on the risks and the underwriting characteristics and take additional supervisory or enforcement action.

8. What is the risk weight for nontraditional mortgage loans?

For purposes of calculating minimum risk-based capital requirements, only Qualifying Mortgage Loans are eligible for the more favorable 50 percent risk weighting. To be eligible, a mortgage loan must meet all the criteria set forth in the regulation (12 CFR § 567.1), including the criteria that the loan be underwritten in accordance with prudent underwriting standards (see Real Estate Lending Standards in Appendix to 12 CFR § 560.101). The real estate lending standards state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.

Further supplemental guidance about prudent underwriting practices for Nontraditional Mortgage Products is set forth in the October 4, 2006 Interagency Guidance on Nontraditional Mortgage Product Risks. Among other things, the guidance discusses underwriting standards for assessing a borrower's ability to repay the loans. For example, the guidance states that "For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortized repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provisions." (See Appendix F of Section 212 of the Examination Handbook.) OTS expects that loans made after the issuance of CEO Memo 244, Interagency Guidance on Nontraditional Mortgage Product Risks, October 2006 must be underwritten in accordance with that guidance in order to be considered prudently underwritten for purposes of being eligible for the 50 percent risk weight. Loans made prior to the Interagency Guidance may receive a 100 percent risk weight or higher if warranted due to poor underwriting. In addition, higher capital requirements may be imposed using the OTS Reservation of Authority if OTS finds, based on the substance of the transaction, that the assigned risk weight does not appropriately reflect the risks imposed.

9. CEO Memo 244 and the Interagency Nontraditional Loan Guidance indicate that an adjustable loan must be underwritten to the "fully indexed rate". What does this mean?

Assume a borrower qualifies for a maximum payment of $1,200 per month based on payment-to-income and debt-to-income ratios. In other words, this is the most the borrower can pay without exceeding the ratio limits. If interest rates are 6 percent on a 30-year fixed rate loan, and assuming that all other underwriting criteria is satisfactory, this implies the borrower can qualify for a $200,000 fixed-rate loan.

Say then for example, that the savings association has an adjustable rate product that starts out at a rate lower than 6 percent, but adjusts to a fully indexed rate of 7 percent. In that case, the maximum loan that this borrower may qualify for would be $180,000 (based on 7 percent interest, 30-year term, and this borrower's maximum $1,200 payment). If the savings association lends him more than $180,000 on the adjustable loan, the loan would not qualify for 50 percent risk weight as it has not been prudently underwritten to the fully indexed rate.

10. What is the appropriate conversion factor for the undrawn portion of a home equity line of credit (HELOC)?

Whether the 0 percent or 50 percent conversion factor is appropriate depends upon the terms of the HELOC at the particular savings association. The undrawn portion of a HELOC receives a zero percent risk weight if the unused commitment is unconditionally cancelable at any time at the option of the savings association and the savings association has the contractual right to make, and in fact does make, either:

- A separate credit decision based upon the borrower's current financial condition before each "drawing" under the lending facility; or
- An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued.

A commitment is unconditionally cancelable if the savings association can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable laws (e.g., applicable language in Reg Z which allows for cancellation under certain safety and soundness related conditions).

11. Can HELOCs and HELs that otherwise meet the definition of Qualifying Mortgage Loan be risk weighted at 50 percent?

Yes, but only if the same institution owns the first mortgage, the combined LTV does not exceed 90 percent, and there is no intervening lien.

For this purpose, LTV is calculated using the combined outstanding balance of the first mortgage loan plus the drawn and undrawn portions of the second.

The risk-weighted assets amount is calculated using outstanding balance of the first mortgage loan, plus the outstanding balance (the drawn amount) of the second, plus the credit equivalent amount of any outstanding commitment (HELOC).

For example:

Value of Home:	$100,000
Balance of first mortgage:	$ 70,000
Undrawn portion of HELOC	$ 10,000
Drawn balance of HELOC	$ 5,000
Total amount of HELOC	$ 15,000

In this case, the first mortgage and HELOC are from the same institution. There is no intervening lien. The HELOC extends more than one year and is *not* unconditionally cancellable.

To calculate maximum LTV: $70,000 + $15,000 = $85,000, or 85 percent of $100,000. The LTV does not exceed 90 percent; therefore the loan can receive 50 percent risk weight, assuming prudent underwriting and that it meets the other requirements for Qualifying Mortgage Loan.

To calculate risk weighted assets and the capital requirement:

Outstanding balance of first plus drawn portion of second:
$70,000 + $5,000 = $75,000. Then, $75,000 x 50 percent risk weight = $37,500 in risk-weighted assets for the outstanding combined drawn balance. $37,500 x 8 percent = $3,000 capital required on the outstanding combined drawn balance.

Undrawn portion of second:
$10,000 x 50 percent credit conversion factor = $5,000 in credit equivalent on-balance sheet assets. $5,000 x 50 percent risk weight = $2,500 in risk-weighted assets. $2,500 x 8 percent = $200 capital required on the undrawn portion.

Total: Thus the total risk-weighted assets for this loan are: $37,500 + $2,500 = $40,000. And the total capital requirement is $3,000 + $200 = $3,200.

12. What is the appropriate conversion factor for the undrawn portion of a loan that allows negative amortization and an increase in the principal (e.g., option ARM)?

The unfunded portion of a loan with a negative amortization feature is treated the same as other unfunded commitment (see the response to Questions 11 and 13 above).

As stated above, whether the unfunded off-balance sheet commitment is subject to a zero or a 50 percent credit conversion factor depends on whether the unused commitment is unconditionally cancelable at any time at the option of the savings association and whether the savings association has the contractual right to make, and in fact does make, either:

- A separate credit decision based upon the borrower's current financial condition before each "drawing" under the lending facility; or
- An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued.

An example with a negatively amortizing loan subject to a 50 percent credit conversion factor:

Assume that an $85,000 Option ARM loan to purchase a $100,000 house permits negative amortization for 3 years up to a cap of 110 percent of the original balance. For the example assume there is no private mortgage insurance or other credit enhancement.

Value of Home:	$ 100,000
Day 1 balance of disbursed 1st mortgage:	$ 85,000
Maximum permitted negative amortization Over three year's time:	$ 8,500

For determining LTV, you treat the negative amortization commitment similarly to the HELOC or HEL commitment described in the answer to Question 13 above:

First calculate the LTV: $85,000 + $8,500 = $93,500. LTV is 93.5 percent ($93,500/$100,000). Therefore, the loan would receive 100 percent risk weight.

To determine the capital requirement, add together the capital requirements for the drawn and undrawn portions:

Drawn portion: $85,000 x 100 percent r.w. x 8 percent:	$6,800
Commitment to allow negative amortization	
$8,500 x 50% conversion factor x 100 percent r.w. x 8 percent	340
Total Capital Requirement	$7,140

13. Can a mortgage loan to a homeowner/borrower for a second principal residence be considered a Qualifying Mortgage Loan for purposes of receiving a 50 percent risk weighting?

Among other things, a Qualifying Mortgage Loan is a loan that is:

- Fully secured by a first lien on a 1-to-4 family residential property and
- Is underwritten in accordance with the prudent underwriting standards, including LTV ratio standards (per the Real Estate Lending Guidelines in 12 CFR § 560.101).

The LTV requirement for a 50 percent risk weight depends on whether the 1-to-4 family residential property is owner-occupied or nonowner-occupied. Non owner-occupied 1-to-4 family residential loans must have an LTV of 85 percent or less to receive a 50 percent risk weight. While the Real Estate Lending Guidelines do not set a specific LTV for *owner-occupied* 1-to-4 family loans, generally loans over 90 percent LTV at origination require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral in order to receive the 50 percent risk weight.

The definition of *owner-occupied* in turn requires that the owner of the underlying property occupy at least one unit of the property as a *principal residence*. Generally, a borrower has only one principal residence. When reviewing loans on second homes or vacation homes the rebuttable presumption is that only the first home is the principal residence for this purpose. Thus, the loan on the second home would be considered *non* owner-occupied and would have to have an LTV of 85 percent or lower in order to qualify for 50 percent risk weight.

There may be *some limited exceptions* where a borrower may in fact have two principal residences. For example, a couple who, due to their particular circumstances, both have jobs in different states and each resides in that state; or, a retired couple who live half the year in one location and half the year in another location. In such limited circumstances, it would be the bank’s responsibility to have documentation to support that a second home is, for all intents and purposes, a principal residence if the bank wishes to avail itself of the LTV/risk weight benefit associated with owner-occupied 1-to-4 family qualifying mortgage loan.

14. Can a nonowner-occupied 1-to-4 family residential mortgage loan receive 50 percent risk weight?

Yes. But as discussed above, the maximum LTV is 85 percent for nonowner- occupied residential real estate (see definition of “other improved property” in the Real Estate Lending Guidelines at 12 CFR § 560.101). Moreover, the loan must meet the other requirements set forth in 12 CFR Part 567 for a Qualifying Mortgage Loan. For example, to meet the prudently underwritten criteria, cash flow from the rented property combined with other income or

resources of the borrower must be sufficient to adequately service the debt without relying on resale of the property as means of repaying the loan.

15. **Can a construction loan to a builder on a 1-to-4 family residence receive a 50 percent risk weight?**

    Yes, if the loan meets all of the criteria under the definition of Qualifying Residential *Construction* Loan (12 CFR § 567.1). The definition of Qualifying Residential Construction loan is different from the definition of Qualifying Mortgage Loan. Both definitions may be found in section 12 CFR § 567.1.

16. **Can a construction/permanent loan, or similar loan for construction of a borrower's own residence, receive 50 percent risk weight?**

    Yes. Under the definition of Qualifying Mortgage Loan, the applicable LTV is 85 percent during the construction phase, and 90 percent after the house is complete and occupied by the owner. (We do not envision a change in LTV at the end of construction; this is simply to note that if the loan is 85 percent LTV or less, it can receive 50 percent risk weight all along; if a loan is in the 85 percent to 90 percent range, it cannot receive 50 percent risk weight until construction is complete and the home is occupied by the owner.)

17. **Can a 1-to-4 family construction loan or acquisition/renovation loan to an individual investor for purposes of resale receive a 50 percent risk weight?**

    Yes, but only if the loan meets all of the criteria for inclusion as a Qualifying Mortgage Loan. For example, it is unlikely that such loan would qualify as an "owner-occupied" 1-to-4 family home. Thus the appropriate LTV would be 85 percent. In addition, the criteria that the loan be underwritten in accordance with prudent underwriting standards must be met. Among other things, prudently underwritten loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. If the sole source of repayment of the loan is from the sale of the house and the borrower lacks other resources to make the loan payments if the house does not sell in a timely manner, then the loan would be speculative and would not meet the underwriting standards for a preferential 50% risk weight.

18. **Can Private Mortgage Insurance (PMI) be used on a nonowner-occupied loan to get 50 percent risk weight?**

    No. Pursuant to the Real Estate Lending Standards (12 CFR § 560.101) PMI is taken into consideration in the calculation of LTVs for owner-occupied, 1-to-4 family residential units.

19. Can pool PMI be used for purposes of reducing the LTV on owner-occupied, 1-to-4 family residential loans?

Generally no, because pool PMI does not provide loss coverage on a loan by loan basis for all loans covered by the policy. Bank-paid pool PMI (also referred to as portfolio PMI) generally has a cap on the maximum loss coverage provided for a portfolio of loans. Once enough losses have occurred such that the cap is reached there is no more coverage for the remaining loans in the portfolio.

If, however, the particular policy does not have a cap on maximum coverage, or if the portfolio PMI will otherwise provide adequate protection for every individual loan in the portfolio (thereby giving the same coverage of traditional borrower-paid PMI), then it could be available for the purpose of reducing LTV for the Qualifying Mortgage Loan definition. From what we have seen, this is not ordinarily the case.

20. (a) If a 12-month construction loan allows for an automatic extension, what is the appropriate credit conversion factor?

The appropriate credit conversion factor is 50 percent, as the loan commitment is for more than 12 months.

(b) What is the appropriate conversion factor when construction loans are routinely extended beyond 12 months?

For determining risk-weighted assets, you use a 50 percent credit conversion factor for loan commitments over 12 months, unless the commitment is unconditionally cancellable at any time at the option of the savings association, and the savings association has the contractual right to make, and in fact does make, either: (1) a separate credit decision based upon the borrower’s current financial condition before each drawing under the lending facility; or (2) an annual (or more frequent) credit review based upon the borrower’s current financial condition to determine whether or not the lending facility should be continued.

As a practical matter, however, construction loans are not likely to be unconditionally cancellable. There may be exceptions of course depending upon the nature of the construction. The bank ought to take a realistic approach when structuring the terms of construction loans. It may make sense to have a 12-month loan term for construction projects which can realistically be completed within 12 months. For construction projects expected to take longer than 12 months, a longer loan term is probably appropriate and should be assumed for risk-based capital purposes. Given this context, there have been instances where an occasional weather delay or other unforeseen event causes a construction project originally planned for less than 12 months to take longer than anticipated, and as a result the original 12-month loan term had to be extended. We would not necessarily advise a supervisory action to require extension of terms on all other similar loans or otherwise hold risk-based capital for the commitment solely because of

an occasional, unanticipated delay – if in fact a 12-month schedule and 12-month loan term was realistic to begin with.

21. In the case of a construction/permanent loan, to determine LTV for risk-weight capital purposes, does OTS require a new appraisal at the time that construction is complete and the borrower is ready to occupy the home?

No. For capital risk-weighting purposes, OTS does not require a reappraisal.