FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-88-2008
September 4, 2008

BEST PRACTICES FROM THE FDIC'S FORUM ON MORTGAGE LENDING FOR LOW- AND MODERATE-INCOME HOUSEHOLDS

Summary: The FDIC is issuing the attached document to highlight best practices that were discussed at the FDIC's July 8, 2008, Forum on Mortgage Lending for Low- and Moderate-Income (LMI) Households. The purpose of the forum was to explore a framework for LMI mortgage lending in the future, in light of current problems in the mortgage market. The forum examined ways to encourage profitable, responsible and sustainable mortgage lending to lower-income households and strategies to rejuvenate the secondary market for these loans.

Distribution:
FDIC-Insured Institutions (Commercial and Savings)

Suggested Routing:
Chief Executive Officer
Chief Loan Officer
Chief Compliance Officer
Board of Directors

Attachment:
Best Practices from the FDIC's Forum on Mortgage Lending for Low- and Moderate-Income Households

Contact:
Special Advisor Rae-Ann Miller at rmiller@fdic.gov or 202-898-3898

Note:
FDIC financial institution letters (FILs) may be accessed from the FDIC's Web site at www.fdic.gov/news/news/financial/2008/index.html.

To receive FILs electronically, please visit http://www.fdic.gov/about/subscriptions/fil.html.

Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 3501 Fairfax Drive, E-1002, Arlington, VA 22226 (1-877-275-3342 or 703-562-2200).

Highlights:

The best practices listed below and in the attached document are not intended as supervisory guidance, but are being provided to banks for informational purposes as a summary of issues discussed at the forum. Banks are encouraged to review and consider the best practices in the context of their LMI mortgage lending programs.

Back-to-Basics Underwriting – Basic, traditionally underwritten, 30-year fixed-rate mortgages are the most suitable mortgages for most LMI borrowers.

Incentives/Compensation – Ensuring that all parties to mortgage transactions have a long-term stake in the outcome of the transactions will improve the quality of LMI mortgages.

Transparency and Due Diligence – Improved transparency throughout the mortgage process is critical to reviving the secondary market for LMI mortgages.

Expanding Existing Products and Innovations – A variety of existing and proposed products and processes may increase availability of LMI mortgage credit, including extending amortization schedules, expanding alternative underwriting processes for consumers with limited credit history, and creating innovative insurance products to address temporary income disruptions, among other things.

Public/Private Partnerships – Partnerships with community organizations, nonprofit corporations, banks, borrowers, local government, and others facilitate credit enhancements and home ownership counseling that make responsible LMI mortgage lending possible.

BEST PRACTICES FROM THE FDIC'S FORUM ON MORTGAGE LENDING FOR LOW- AND MODERATE-INCOME HOUSEHOLDS

On July 8, 2008, the FDIC held a Forum on Mortgage Lending for Low- and Moderate-Income (LMI) Households to explore a framework for LMI mortgage lending in the future, in light of current problems in the mortgage market. The availability of credit to mortgage borrowers has sharply contracted over the past year, with total originations in the first quarter down almost 30 percent from the first quarter a year ago.[1] Origination volumes have fallen even more dramatically in the subprime and Alt-A segments, 90 percent and 80 percent, respectively, and private label securitizations of nonprime mortgages have nearly ceased.[2]

The disruptions in mortgage credit availability and in the secondary mortgage market disproportionately affect lower-income borrowers' opportunities for homeownership, given their existing lower homeownership rates. The Census Bureau reports that the national homeownership rate was about 68 percent as of the second quarter 2008. However, the homeownership rate is only about 52 percent for those households with below median incomes. Moreover, data from the Federal Reserve's 2004 Survey of Consumer Finances, the latest income stratification information available, show that for households with incomes in the bottom fifth of all earners, homeownership rates are far lower - about 40 percent.

The FDIC's forum examined ways to encourage profitable, responsible and sustainable mortgage lending to lower-income households and strategies to rejuvenate the secondary market for these loans. The forum featured leading experts in banking, investment, government, academia and the nonprofit community, including the Honorable Henry M. Paulson, Jr., Secretary of the Treasury; the Honorable Ben S. Bernanke, Chairman, Federal Reserve Board of Governors; and James Dimon, Chairman of the Board and Chief Executive Officer of JPMorgan Chase & Co. The agenda for the forum can be found at http://www.fdic.gov/about/comein/agendaJuly808.html, and an on-demand version of the webcast of the forum is at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_advisorycommittee&SessionArgs=0A1U0100000100000101.

The purpose of this document is to highlight best practices that were discussed at the forum, including "back-to-basics" underwriting, expanding existing products and innovations, compensation and other incentives, transparency and due diligence, and public and private partnerships. The best practices discussed below are not intended as supervisory guidance and are provided to banks for informational purposes as a summary of issues discussed at the forum. Banks are encouraged to review and consider these best practices in the context of their LMI mortgage lending programs.

Best Practices

Back-to-Basics Underwriting – A number of forum participants emphasized the advantages of basic, traditionally underwritten, 30-year fixed-rate mortgages for most LMI borrowers. They pointed out that fixed-rate mortgages, without prepayment penalties, provide payment stability, which is important for long-term affordability. According to these participants,

[1] "Inside Mortgage Finance," May 23, 2008.
[2] Ibid.

lenders, investors, and consumers have not fared well when loan pricing and house appreciation were used as substitutes for the underwriting process, and solid, traditional underwriting is essential to rebuild a healthy housing market. The following were emphasized as important best practices to consider when originating responsible fixed-rate mortgages for LMI borrowers:

- Full Documentation: LMI mortgages must be underwritten using full documentation and traditional underwriting criteria. Full documentation reduces fraud, and the process of gathering and preparing documentation is very useful for consumers in understanding the responsibilities of home ownership.

- Ability to Repay: The ability to repay must be documented using reasonable "front-end" housing debt-to-income analysis, including all housing related expenses, and "back-end," total debt-to-income calculations incorporating the new, fixed mortgage payment.

- Mandatory Escrows: Taxes and insurance should be escrowed for LMI borrowers and included in the analysis of their ability to repay.

- Opt-Out Agreements: Some suggested that LMI borrowers who choose a variable rate product should sign an agreement indicating that they are aware that fixed-rate mortgages are available, having received comparative illustrations of fixed and variable costs. Variable rate products should be underwritten to the fully indexed rate.

- Purpose of Homeownership: There should be a societal and industry-wide re-emphasis on housing as shelter and a long-term investment, rather than as a short-term source of cash through refinancing.

Incentives/Compensation – A recurring theme at the forum was ensuring that all parties to mortgage transactions have something at risk and, therefore, a long-term stake in the outcome of the transactions. The following were suggestions for imposing liability at various stages in the mortgage process:

- Required Down Payments: Prospective homeowners, including LMI borrowers, should have some capital invested. Borrowers who make no down payments are much more likely to default than those who invest just three percent.

- Second Mortgages: Second mortgages are not appropriate substitutes for down payments, and in the current environment, these so-called "piggy-back" structures are making it much more difficult to restructure mortgage loans. Piggyback mortgages should be used only rarely, such as when the second mortgage is provided through a nonprofit or government program and accompanied by homeownership counseling.

- Independent Fiduciary: The current compensation structure for servicers of mortgage-backed securities is not designed to address a material level of troubled borrowers. There should be independent surveillance of structured finance transactions, such as a special servicer or credit risk manager. The fiduciary should be compensated and indemnified to seek maximum returns for the investors, which could involve principal write-downs or other strategies to avoid the high cost of foreclosure.

- <u>Mortgage Broker Compensation</u>: Mortgage brokers and other originators who are paid based on interest rate or other terms of the loan versus loan performance have no incentive to provide good loans to borrowers, lenders, securitizers, or ultimately, to investors. To realign incentives with performance, brokers should be compensated based on loan performance over time, or rated using a performance-based scorecard and dismissed if they provide poorly performing loans. Brokers should also be licensed and subject to minimum capital requirements.

Transparency and Due Diligence **–** Several participants remarked that improved transparency throughout the mortgage process is critical to reviving the secondary market for LMI mortgages. The following were identified as best practices for improving transparency.

- <u>Consumer Disclosures and Counseling</u>: It is difficult for consumers to understand the true cost of loans, especially with complex features like prepayment penalties and rate resets that were common in subprime mortgage loans. Disclosures should be as simple as possible and provided early in the process, and LMI consumers should have access to advisors to explain the mortgage process and documents. Standards should be established to ensure that mortgage financing is appropriate for the borrowers.

- <u>Bank versus Nonbank Lenders</u>: Consumers may not know if their lender is a bank or nonbank, and accordingly, whether the lender is operating under an appropriate regulatory framework. Uniformity in consumer regulation between bank and nonbank mortgage lenders will improve consumer information and is an important step for restoring public trust in the market.[3]

- <u>Bond Ratings</u>: Confidence in the process of rating bonds backed by mortgages has been diminished by recent downgrades of previously highly rated bonds. To restore confidence, rating firms should increase the amount and usefulness of information published regarding structured finance transactions. Among other things, additional information should include underlying assumptions for various asset classes, stress tests for ratings and scenario analysis.

- <u>Investor Due Diligence</u>: Bond ratings reflect credit risk only and do not address suitability, price, duration, volatility, or leverage in the underlying structure. Investors need to develop additional tools, beyond relying on ratings, for analyzing the bonds they buy. More granular information, such as loan level data, should be given to investors to develop their own models.

---

[3] On July 14, 2008, the Federal Reserve Board approved a final rule for home mortgage loans intended to better protect consumers and facilitate responsible lending. The rule prohibits unfair, abusive or deceptive home mortgage lending practices and restricts certain other mortgage practices. The final rule, which amends Regulation Z (Truth in Lending) and was adopted under the Home Ownership and Equity Protection Act (HOEPA), also establishes advertising standards and requires certain mortgage disclosures to be given to consumers earlier in the transaction. Importantly, the new rules will apply to all mortgage lenders, not just those supervised and examined by the Federal Reserve. The rule can be found at **http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm.**

***Expanding Existing Products and Innovations* –** Participants discussed a variety of existing and proposed products and processes banks and others can use to increase availability of LMI mortgage credit, which included the following:

- <u>Encourage Savings</u>: Provide a way to accumulate down payments through innovative savings products, such as deposit accounts with limited withdrawal features or Individual Development Accounts.[4]

- <u>Extended Amortization</u>: Longer amortization schedules such as 40-year, fixed-rate mortgages may be suitable for LMI borrowers who live in areas with high cost homes and/or need more affordable payments.

- <u>Full-Cycle Lending</u>: "Full cycle" lending involves using financial education as an underwriting tool for LMI borrowers and others and consists of pre-purchase counseling, assistance at the time of closing, and early intervention if consumers have payment problems. Rebates or rate concessions could be given to households that complete financial education courses, since there is a link between performance and education.

- <u>"Thin-File" Underwriting</u>: Originators can use alternative ways to verify payment history outside of the credit process, such as rent payments and utility bills. Some credit bureaus have developed, or are in the process of developing, alternative scoring processes for thin-file consumers.

- <u>Rent-to-Own</u>: In the past, rent-to-own models have been successful for LMI borrowers lacking down payments. Particularly for foreclosed homes, these models allow renters to assume a mortgage after successfully making a series of rent payments equal to the mortgage payment.

- <u>Income Disruption Insurance</u>: A home warranty-like program could provide borrowers the ability to build up a reserve for unforeseen expenses in exchange for a small increase in rate. Additionally, a "Life Event Clause" could be written into mortgage documents that would allow borrowers to defer one payment for every 18 payments made in the event of an income disruption.

- <u>Covered Bonds</u>: Covered bonds can be an innovative way to provide liquidity to the mortgage market as an alternative to securitization and can diversify a bank's funding base. Covered bonds provide funding to an issuer, through a debt instrument collateralized by a pool of residential mortgage loans that remain on the issuer's

[4] Individual Development Accounts are matched savings accounts that enable low-income families to save money for a particular financial goal, such as buying a home, paying for post-secondary education, or starting or expanding a small business.

balance sheet. A large covered bond market exists in Europe, but covered bonds are a relatively new innovation in the U.S., with only two issuers to date. The FDIC and the U.S. Treasury recently announced new initiatives designed to encourage the expansion of this market.[5]

Public/Private Partnerships **–** Partnerships between community organizations, nonprofit corporations, banks, borrowers, local government and others were cited at the forum as a "bridge" that makes responsible LMI lending possible. Participants indicated that nonprofits have mechanisms to make LMI consumers more attractive to banks by educating consumers regarding homeownership and obtaining credit enhancements for the benefit of consumers. Strategies mentioned to leverage these relationships included banks working with nonprofit partners on product design, offering bank staff time for counseling prospective borrowers prior to establishing a lending relationship, and participating on local and national affordable housing initiatives. Some banks, foundations, corporations, and government programs also provide loss reserves or other forms of guarantees for secondary market programs sponsored by nonprofits.

---

[5] On July 15, 2008, the Board of Directors of the FDIC approved a final covered bond policy statement to facilitate the development of the U.S. covered bond market by providing bondholders expedited access to collateral if the FDIC declines to continue the covered bonds after a bank failure. The policy statement can be found at http://www.fdic.gov/news/news/press/2008/pr08060.html. On July 28, 2008, the U.S. Treasury issued best practices to encourage the formation of a covered bond market in the U.S. The covered bond best practices can be found at http://www.treas.gov/press/releases/hp1102.htm.