Press Releases

November 18, 2005

OTS 05-42 - OTS Director Reich Addresses Alternative Mortgage Products

Office of Thrift Supervision

FOR RELEASE at 6:00 A.M. EDT	For further information
Friday, November 18, 2005	Contact: Erin Hickman
OTS 05-42	202/906-6677

OTS Director Reich Addresses Alternative Mortgage Products

WASHINGTON, DC -- In a speech today before the Community Bankers Association of New York State (CBANYS) in Naples, Florida, OTS Director John Reich urged thrifts to continue to practice sound underwriting and strong risk management as they offer alternative, or "non-traditional," mortgage products.

"OTS expects the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence," Director Reich told his audience; "and, as a result, to manage them successfully."

The market for certain new non-traditional loans, such as "interest-only" and "pay option" adjustable rate mortgages (ARMs), has expanded rapidly as lenders seek to meet consumer mortgage demand -- especially as interest rates increase for traditional mortgages, and in areas with higher cost homes.

The features of non-traditional loans can temporarily protect borrowers from payment increases resulting from rising interest rates, he said, and be a valuable source of steady mortgage credit to communities. These products "can be effective financial management tools for some borrowers, but are not appropriate for every borrower."

Reich stressed thrifts must continue to prudently manage the greater risk posed by newer non-traditional mortgages "by the application of sound underwriting practices and strong risk management systems, together with complete disclosure of not only the benefits of these products but also the risks they pose for the borrower." Adequate disclosure is important for consumer protection and supervisory purposes.

"The experience with these instruments has thus far been favorable," noted Reich. "However, these new products share a common, potentially substantial additional risk element -- a payment shock when the loan terms are eventually recast." Furthermore, "given the relatively short period of time many of these newer instruments have been offered," he said, and the favorable economic conditions, "our industry's experience with these two particular products is limited."

"These new products have the potential to take risk to a higher level than bank managers may be accustomed to." Of particular concern is that in the wake of the refi boom, the market competition from overcapacity in the industry seems to be promoting lending practices that may prove imprudent in the long term.

Reich also emphasized the challenges that new entrants into the market face. "Rapid growth of any product, and for these products in particular, can challenge existing management information systems and risk management systems," he told the group. "This is especially true for new entrants to the market that may not fully appreciate all the risks involved, especially given several years of benign business conditions. I urge any institutions that are rolling out these new products to limit their concentrations by establishing prudent limits as a percentage of their capital until they gain more experience and are more comfortable with their assessment and management of the risks involved."

Another area of concern is risk layering. "Banks should also pay particularly close attention to `risk layering,' which involves relaxing other underwriting standards, such as loan-to-value ratios, or credit scores, when offering these products," he said. "Risk layering tends to multiply the risks involved, not just add to them."

Reich noted that, because thrifts have always focused on mortgage lending, they have a depth of experience in providing innovative mortgage loan products to consumers. "Thrifts have offered adjustable rate mortgages (ARMs) for more than thirty years," said Reich. "And thrifts have offered -- and successfully managed -- ARMs with negative amortization features for twenty years."

"It is our experience," said Reich, "that thrifts specializing in mortgage lending are keenly aware of the need to manage carefully all of the risks involved, including sound underwriting standards, close attention to loan and portfolio performance, and effective oversight and controls."

In June, OTS issued a revised Examiner Handbook on residential mortgage lending which emphasized the need for proactive enterprise-wide risk management, including addressing the additional risks in mortgage lending arising from interest-only and pay option ARMs. Reich told the CBANYS members that OTS is also collaborating with the other federal banking agencies on drafting interagency guidance that addresses the additional risks presented by nontraditional mortgage products.

###