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M E M O R A N D U M

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To Our Clients and Friends

Re: Credit Risk Management Guidance for Home Equity Lending

The Federal Reserve Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency and Office of Thrift Supervision (the “Agencies”) have issued guidance to banking organizations relating to risk management practices for home equity lending. The guidance was issued in response to the Agencies’ concern that in some cases credit risk management practices of depository institutions have not kept pace with the rapid growth and easing of underwriting standards.

RISK FACTORS

The guidance indicates that while delinquency and loss rates for home equity loans have been low, certain risk factors, combined with an inherent vulnerability to interest rate increases, suggest that the risk of these portfolios may not be fully recognized. The Agencies identify the following product, risk management, and underwriting risk factors that are the focus of additional scrutiny:

- Interest-only features that require no amortization of principal for a protracted period
- Limited or no documentation of a borrower’s assets, employment, and income (“low doc” or “no doc” lending)
- Higher loan-to-value and debt-to-income ratios
- Lower credit risk scores for underwriting home equity loans
- Greater use of automated valuation models and other collateral evaluation tools for the development of appraisals and evaluations
- An increase in the number of transactions generated through a loan broker or other third party

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CREDIT RISK MANAGEMENT SYSTEMS

The guidance emphasizes that depository institutions should actively assess a home equity loan portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values.

The guidance describes credit risk management systems for:

- Product Development and Marketing
- Origination and Underwriting
- Third-Party Originations
- Collateral Valuation Management
- Account Management
- Portfolio Management
- Operations, Servicing and Collections
- Secondary Market Activities
- Portfolio Classifications, Allowance for Loan and Lease Losses and Capital

A copy of the Agencies' guidance can be found on our web site at http://www.schwartzandballen.com/whats_new.html.

If you have any questions, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.