

NCUA and Other Agencies Issue Guidance on Home Equity Lending

Home equity lending is an attractive product for many homeowners and lenders. These portfolios are subject to increased risks if interest rates rise and home values decline. Sound underwriting practices and effective risk management systems are essential to mitigate this risk. With that in mind, the **National Credit Union Administration** (NCUA), along with the other federal bank and thrift regulatory agencies issued *Credit Risk Management Guidance for Home Equity Lending* (the Guidance) that would promote sound risk management practices for home equity loans and lines of credit.

As the Agencies looked at this market, they realized that in some cases credit risk management practices have not kept pace with the product's rapid growth and eased underwriting standards. Although the delinquency and loss rates for these portfolios have been low, the agencies identified risk factors that, coupled with the vulnerability to interest rate increases, have attracted scrutiny. Those include:

- Interest-only features that require no amortization of principal for a long period;
- Limited or no documentation of a borrower's assets, employment, and income;
- Higher loan-to-value (LTV) and debt-to-income ratios; and
- An increased number of transactions generated through a loan broker or other third party.

The Guidance outlines the agencies' expectations for sound underwriting standards and effective credit risk management practices. It also points out that these are not programs to be avoided, but rather programs that can be conducted in a safe and sound manner if pursued with the appropriate risk management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices include fully articulated policies addressing marketing, underwriting, collateral valuation management, individual account and portfolio management, and servicing. Financial institutions are encouraged to ensure that their risk management practices keep pace with the growth and changing risk profile of home equity portfolios.

The Guidance discusses Credit Risk Management Systems, including Product Development and Marketing; Origination and Underwriting; Third-Party Originations; Collateral Valuation Management Account Management; Portfolio Management; Operations, Servicing, and Collections; Secondary market Activities; and Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital.

While the Guidance pertains to credit risk management, it is appropriate to point out that lenders must also comply with all the laws and regulations that pertain to real estate lending, including those pertaining to flood insurance, real estate settlement and escrowing, etc. The regulators have been diligent recently in their review of flood insurance procedures and some very expensive penalties have been assessed on institutions that do not comply.

The Guidance can be reviewed at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050516/default.htm>.