Interagency Guidance

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OCC; FRB; FDIC; NCUA; and CSBS

Home Equity Lines of Credit Nearing Their End-of-Draw Periods

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On July 1, 2014 the federal financial institution regulatory agencies (the agencies) and the Conference of State Bank Supervisors (CSBS) issued guidance for lenders on communicating with borrowers and managing exposure as Home Equity Lines of Credit (HELOCs) reach their end-of-draw periods.

HELOCs are loans, secured by a dwelling, that have a “draw period” during which a borrower has access to a revolving line of credit, followed by a repayment period. HELOCs often contain features that can lead to payment shock for borrowers, such as interest-only payments followed by a balloon payment or higher monthly payment over a condensed loan term. As such, these loans can present an elevated risk, especially when the draw period is approaching expiration and a higher payment schedule is set to begin. In order to effectively monitor and manage that risk, the agencies outlined some principles and expectations that management should adhere to. This guidance should be applied in a manner commensurate with the size and risk characteristics of a financial institution’s HELOC portfolio.

The agencies highlight 5 “risk-management principles” that examiners will be looking for in end-of-draw programs:

1) **Prudent underwriting for renewals, extensions, and rewrites:** Financial institutions should be evaluating the borrower’s willingness and ability to repay before modifying the loan.
2) **Compliance with pertinent existing guidance, including but not limited to the Credit Risk Management Guidance for Home Equity Lending and the Interagency Guidelines for Real Estate Lending Policies:** Underwriting criteria should include standards for debt service capacity, creditworthiness, equity and collateral requirements, maximum loan amounts, maturities, and amortization terms. Exceptions to the policies should be made in accordance with review and approval procedures and be timely and accurately reported.
3) **Use of well-structured and sustainable modification terms:** Management should participate in or establish workout and modification programs where feasible to promote orderly, systematic repayment of the outstanding balance. The agencies note that restructuring to another interest-only or balloon loan in generally inappropriate.
4) **Appropriate accounting, reporting, and disclosure of troubled debt restructurings (TDRs):** Modifications should be checked for identification of TDRs and accrual status. TDRs are generally appropriate where a concession has been made because of a borrower’s financial difficulties.

5) **Appropriate segmentation and analysis of end-of-draw exposure in allowance for loan and lease losses (ALLL) estimation processes:** HELOCs approaching their end-of-draw periods should generally be a separate portfolio segment in the ALLL estimation process. Estimates should be informed by analysis of loss of line availability and payment shock considerations.

The guidance also includes a list of 10 "risk-management expectations" that should be reflected in management's policies and procedures for managing HELOCs nearing their end-of-draw periods:

1) **Developing a clear picture of scheduled end-of-draw period exposures.**
    - View maturity schedules in aggregate and by segments of performing and non-performing borrowers;
    - Segment between product type, high and low-risk borrowers, origination channels, or borrower characteristics (credit score, etc.);
    - Refer to the Interagency Junior Lien Allowance Guidance; and
    - Consider expected payoffs, attrition, utilization rates, and delinquency or modification status of other loans.
2) **Ensuring a full understanding of end-of-draw contract provisions.**
    - Payment changes, interest rate options, amortization terms, lockout and debt consolidation options, and payment processing should be built into the servicing system. Management must understand all parties' rights and obligations in relation to the loan.
3) **Evaluating near-term risks.**
    - Assess collateral value and borrower payment history for early identification of loans that will need modification.
4) **Contacting borrowers through outreach programs.**
    - Begin outreach efforts to borrowers at least 6-9 months before end-of-draw dates.
5) **Ensuring that refinancing, renewal, workout, and modification programs are consistent with regulatory guidance and expectations, including consumer protection laws and regulations.**
    - Programs should base eligibility and payment terms on borrower's financial condition and reasonable ability to repay, and should amortize principal in an orderly and timely fashion.
    - Lenders must comply with the Equal Credit Opportunity Act, the Fair Housing Act, federal and state prohibitions against unfair and deceptive acts and practices, the Real Estate Settlement Procedures Act (RESPA), the Service Members Civil Relief Act, and the Truth in Lending Act (TILA), among others.
6) **Establishing clear internal guidelines, criteria, and processes for end-of-draw actions and alternatives (renewals, extensions, and modifications).**
    - Lenders should have trained customer service representatives familiar with the characteristics of the product and alternatives available.
    - Loss mitigation steps and documentation requirements should be clearly defined so that customer service representatives can quickly process requests.
7) **Providing practical information to higher-risk borrowers.**

- Lenders should supply basic information on refinancing options available, eligibility criteria, the process for requesting a modification, and the lender's contact information.

8) **Establishing end-of-draw reporting that tracks actions taken and subsequent performance.**
    - Reporting should be both in aggregate and by action type.
    - Actions types should include transition according to contract, short-term extensions, temporary modifications, permanent modifications, and renewals.

9) **Documenting the link between ALLL methodologies and end-of-draw performance.**
    - High-risk borrowers should be monitored separately for appropriate consideration in the ALLL estimation process.

10) **Ensuring that control systems provide adequate scope and coverage of the full end-of-draw period exposure.**
    - Testing system should confirm that:
        - Draw terms and interest-only periods are not extended without credit approval
        - Servicing systems function accurately for the full range of potential HELOC repayment terms that exist once a draw period ends
        - The program is staffed appropriately
        - Borrower notifications of upcoming draw period expirations are timely and made in accordance with contracts and procedures
        - Reports provide accurate and timely information to enable management to evaluate end-of-draw activities.

Additional Resources:

NCUA Letter to Credit Unions 05-CU-07, "Joint Statement—Credit Risk Management Guidance for Home Equity Lending" at http://www.ncua.gov/Resources/Documents/LCU2005-07.pdf.

NCUA Letter to Credit Unions 03-CU-01, "Loan Charge-off Guidance" at http://www.ncua.gov/Resources/Documents/LCU2003-01.pdf

NCUA Letter to Credit Unions 13-CU-03, "Supervisory Guidance on Troubled Debt Restructuring" at http://www.ncua.gov/Resources/Pages/LCU2013-03.aspx

NCUA Accounting Bulletin 12-1 transmitting interagency guidance at http://www.ncua.gov/Legal/GuidesEtc/AccountingBulletins/AcctBul12-1.pdf

NCUA Letter to Credit Unions 13-CU-03, "Supervisory Guidance on Troubled Debt Restructuring" at http://www.ncua.gov/Resources/Pages/LCU2013-03.aspx

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