

## Statement on Subprime Mortgage Lending

The Agencies<sup>1</sup> developed this Statement on Subprime Mortgage Lending (Subprime Statement) to address emerging issues and questions relating to certain subprime<sup>2</sup> mortgage lending practices. The Agencies are concerned borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.<sup>3</sup> In particular, the Agencies are concerned with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;<sup>4</sup>
- Very high or no limits on how much the payment amount or the interest rate may increase (“payment or rate caps”) on reset dates;
- Limited or no documentation of borrowers’ income;
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could include: being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to lenders may include unwarranted levels of credit,

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<sup>1</sup> The Agencies consist of the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

<sup>2</sup> The term “subprime” is described in the 2001 *Expanded Guidance for Subprime Lending Programs*. Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*.

<sup>3</sup> Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

<sup>4</sup> For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

The Agencies note that many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 *Interagency Guidelines for Real Estate Lending (Real Estate Guidelines)*, the 1999 *Interagency Guidance on Subprime Lending*, and the 2001 *Expanded Guidance for Subprime Lending Programs (Expanded Subprime Guidance)*.<sup>5</sup>

While the 2006 *Interagency Guidance on Nontraditional Mortgage Product Risks (NTM Guidance)* may not explicitly pertain to products with the characteristics addressed in this Statement, it outlines prudent underwriting and consumer protection principles that institutions also should consider with regard to subprime mortgage lending. This Statement reiterates many of the principles addressed in existing guidance relating to prudent risk management practices and consumer protection laws.<sup>6</sup>

## **Risk Management Practices**

### **Predatory Lending Considerations**

Subprime lending is not synonymous with predatory lending, and loans with the features described above are not necessarily predatory in nature. However, institutions should ensure that they do not engage in the types of predatory lending practices discussed in the *Expanded Subprime Guidance*.<sup>7</sup> Typically, predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

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<sup>5</sup> Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*. National banks also should refer to 12 CFR 34.3(b) and (c), as well as 12 CFR part 30, Appendix C.

<sup>6</sup> As with the *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006), this Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

<sup>7</sup> Federal credit unions should refer to 12 CFR 740.2 and 12 CFR 706 for information on prohibited practices.

Institutions offering mortgage loans such as these face an elevated risk that their conduct will violate Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.<sup>8</sup>

### Underwriting Standards

Institutions should refer to the *Real Estate Guidelines*, which provide underwriting standards for all real estate loans.<sup>9</sup> The *Real Estate Guidelines* state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.<sup>10</sup> The 2006 *NTM Guidance* details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate,<sup>11</sup> assuming a fully amortizing repayment schedule.<sup>12</sup>

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (*e.g.*, principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

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<sup>8</sup> The OCC, the Board, the OTS, and the FDIC enforce this provision under section 8 of the Federal Deposit Insurance Act. The OCC, Board, and FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002-3—*Guidance on Unfair or Deceptive Acts or Practices*, March 22, 2002, and 12 CFR part 30, Appendix C; Joint Board and FDIC *Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks*, March 11, 2004. The OTS also has issued a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered (12 CFR 563.27). The NCUA prohibits federally insured credit unions from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition (12 CFR 740.2).

<sup>9</sup> Refer to 12 CFR part 34, subpart D (OCC); 12 CFR Part 208, subpart C (Board); 12 CFR part 365 (FDIC); 12 CFR §§ 560.100 and 560.101 (OTS); and 12 CFR 701.21 (NCUA).

<sup>10</sup> OTS Examination Handbook Section 212, *1-4 Family Residential Mortgage Lending*, also discusses borrower qualification standards. Federally insured credit unions should refer to LCU 04-CU-13- *Specialized Lending Activities*.

<sup>11</sup> The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

<sup>12</sup> The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, institutions should verify and document the borrower's income (both source and amount), assets and liabilities. Stated income and reduced documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

### **Workout Arrangements**

As discussed in the April 2007 interagency *Statement on Working with Borrowers*, the Agencies encourage financial institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Financial institutions should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.<sup>13</sup> Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The Agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

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<sup>13</sup> Institutions may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

## Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower's ability to repay the loan according to its terms; and
- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial reset period. In general, borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without penalty.<sup>14</sup>

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.<sup>15</sup> Therefore, mortgage product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of:

- *Payment Shock*. Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.<sup>16</sup>

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<sup>14</sup> Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

<sup>15</sup> Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

<sup>16</sup> To illustrate: a borrower earning \$42,000 per year obtains a \$200,000 "2/28" mortgage loan. The loan's two-year introductory fixed interest rate of 7% requires a principal and interest payment of \$1,331. Escrowing \$200 per month for taxes and insurance results in a total monthly payment of \$1,531 (\$1,331 + \$200), representing a 44% DTI ratio. A fully indexed interest rate of 11.5% (based on a six-month LIBOR index rate of 5.5% plus a 6% margin) would cause the borrower's principal and interest payment to increase to \$1,956. The adjusted total monthly payment of \$2,156 (\$1,956 + \$200 for taxes and insurance) represents a 41% increase in the payment amount and results in a 62% DTI ratio.

- *Prepayment Penalties.* The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.<sup>17</sup>
- *Balloon Payments.* The existence of any balloon payment.
- *Cost of Reduced Documentation Loans.* Whether there is a pricing premium attached to a reduced documentation or stated income loan program.
- *Responsibility for Taxes and Insurance.* The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

## **Control Systems**

Institutions should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

## **Supervisory Review**

The Agencies will continue to carefully review risk management and consumer compliance processes, policies, and procedures. The Agencies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

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<sup>17</sup> See footnote 14.