
Agencies Issue Final Statement on Subprime Mortgage Lending

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On June 29, 2007, the federal financial regulatory agencies [jointly issued final guidance](#) to address safety, soundness and consumer protection concerns relating to subprime mortgage lending practices, particularly those relating to adjustable rate mortgages such as hybrid ARMs (e.g., 2/28 and 3/27 ARMs) ([the Statement](#))[1]. The Statement supplements the recent [Interagency Guidance on Nontraditional Mortgage Products](#)[2], which was limited in scope to products that have the potential for negative amortization such as “interest-only” and “payment option” mortgages, and it encourages workouts by incorporating the [Interagency Statement on Working with Borrowers](#) that was issued in April 2007.

The Agencies published the proposed Statement on Subprime Mortgage Lending for comment on March 8, 2007.[3] They received 137 unique comments from financial institutions, trade associations, consumer and community organizations, state and financial regulatory organizations, and other members of the public. The final Statement responds to industry concerns and provides some clarification, but retains the basic structure of the original proposal.

As discussed in more detail below, we believe the Statement should be of significant interest to financial institutions because of its likely impact on underwriting and risk management practices, consumer disclosure obligations and control systems. Failure to carefully consider the Statement, particularly the risk management and consumer disclosure obligations, could increase litigation risk for lenders. Moreover, noncompliance with the control guidelines could subject lenders to regulatory enforcement. We also anticipate continued congressional scrutiny of mortgage lending practices, as well as significant increases in enforcement activity by state attorneys general. The Federal Reserve Board has also recently invited comments and held a public hearing on whether it should exercise its authority under the Homeownership and Equity Protection Act to prohibit abusive mortgage lending practices in the subprime market.[4] We expect to see further activity from the Board in this area.

Scope

Although many commenters requested clarification of the term “subprime,” the Agencies ultimately determined that the reference to the *2001 Expanded Guidance for Subprime Lending Programs* provides sufficient information in terms of a range of credit risk characteristics that are associated

with subprime borrowers. In addition, while the Agencies declined to expand the Statement beyond the subprime market, they noted that institutions generally should look to the Statement when ARM products with the characteristics noted below are offered to non-subprime borrowers.

The Agencies are primarily concerned with 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 interest rate plus a margin for the remaining term of the loan (e.g., 2/28s);
- — Very high or no limits on how much the payment amount or interest rate may increase;
- — Limited or no documentation of borrower's income;
- — Product features likely to result in frequent refinancing to maintain affordable monthly payments; and/or
- — Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

The Statement applies to all banks and their subsidiaries, bank holding companies and their subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Risk Management Practices

The Statement clarifies that subprime lending is not synonymous with predatory lending and that the product features described above are not per se predatory. Nevertheless, the Statement reminds mortgage lenders and brokers to refrain from engaging in the types of predatory lending practices described in previously issued interagency guidance on subprime lending^[5], namely (1) making loans based primarily on the foreclosure value of the underlying collateral rather than repayment ability; (2) engaging in repeated refinancings to generate additional points and fees ("loan flipping"); and (3) engaging in fraud or deception to conceal the true nature of the mortgage obligation. Engaging in these practices may subject the lender or broker to risks including potential violations of the prohibition in Section 5 of the FTC Act against unfair or deceptive acts or practices.

The Statement also focuses on ensuring that appropriate underwriting standards, including the existing *1993 Interagency Guidelines for Real Estate Lending*, are followed. Lenders should ensure that subprime loans are underwritten in such a way that the borrower's ability to service the debt is adequately analyzed, including the potential effect of payment shock. Significantly, **the Statement retains its most contentious provision, which provides that lenders should evaluate the borrower's ability to repay the mortgage debt by final maturity at the fully indexed rate (assuming a fully amortizing repayment schedule) without the need to refinance or sell the property.** The Statement discusses one widely accepted approach to assessing repayment ability—utilizing a debt-to-income ratio that considers the borrower's total housing-related payments (e.g.,

principal, interest, taxes and insurance, or “PITI” as a percentage of gross monthly income. Accordingly, this analysis should include the principal and interest obligations at the fully indexed rate with a fully amortizing repayment schedule, **plus** a reasonable estimate for taxes and insurance, whether or not escrowed.

The Statement also notes that assessment of repayment ability is critical, particularly if the lender engages in risk-layering, such as the use of reduced documentation. The Statement restricts stated income loans, providing that stated income should only be used if there are mitigating factors that clearly minimize the need for standard documentation of repayment capacity. The Statement indicates that income verification should be standard for subprime borrowers.

Workout Arrangements

The Statement also incorporates the principles set forth in the April 2007 *Interagency Statement on Working with Borrowers*, which encourages financial institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Financial institutions are instructed to follow prudent underwriting practices in considering loan modifications or workout arrangements, noting that such arrangements can vary widely based on the borrower’s financial capacity. The Agencies also state that they will not criticize financial institutions that pursue reasonable workout arrangements with borrowers, provided that institutions identify and report credit risk, maintain an adequate allowance for loan losses and recognize credit losses in a timely manner.

Consumer Protection Principles/Disclosure Obligations

The Statement provides that communications with consumers, including advertisements, oral statements and promotional materials, should include clear and balanced information regarding the relative benefits and risks of mortgage products. Moreover, such information should be provided early in the mortgage shopping process to ensure that the consumer has adequate information to make an informed product choice.

Consumer should be provided clear, detailed information about all the costs, terms, features and risks of the mortgage product. The risk of payment shock should be clearly explained to consumers, as should the existence of any prepayment penalty (including how it will be calculated and when it can be imposed), balloon payment, premium pricing for reduced documentation loans, and the requirement to pay taxes and insurance. The Statement highlights the importance of the consumer understanding whether the monthly mortgage payment includes taxes and insurance. Consumers should be informed that the requirement to make payments for real estate taxes and insurance, if not escrowed, is in addition to their loan payments and that these payments can be substantial. **In addition, the Statement strongly encourages lenders to structure prepayment penalties so that they do not extend beyond the initial reset period and so that the borrower is provided with a sufficient period of time (typically at least 60 days) immediately prior to the reset date to refinance without penalty.**

In response to comments received, the Agencies also state that they are working on proposed illustrations of the type contemplated in the Statement and expect to publish these illustrations for

comment.

Control Systems

Lenders are advised in the Statement to develop strong control systems to ensure that actual practices are consistent with their policies and procedures, as well as to monitor compliance with applicable laws and regulations and third-party agreements. Controls should also include appropriate corrective actions in the event of compliance failures. **Important controls include establishing appropriate criteria for hiring and training loan personnel and entering into, maintaining and monitoring relationships with third parties (e.g., third-party originators), as well as implementing procedures to identify potential adverse credit trends.**

Industry Reaction

The Mortgage Bankers Association (MBA) responded by stating: “This is a strong statement that will help curb abuses, but will likely also constrain consumer credit choices.” In addition, the MBA urged Congress to quickly pass FHA modernization in order to restore affordable credit options for worthy borrowers, refrain from passing legislation that will further constrain credit by forcing lenders to deal with rigid underwriting standards and litigation risk, and focus on legislation to improve transparency and accountability throughout the mortgage transaction.

The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) previously issued a press release endorsing the proposed Statement and stating their intention to develop parallel guidance for such state-supervised entities.

For further information on this or other financial institutions matters, please contact authors listed above.

[1] 72 Fed. Reg. 37569.

[2] 71 Fed. Reg. 58609.

[3] NR 2007-19, March 2, 2007; 72 Fed. Reg. 10533.

[4] 72 FR 30380. The deadline for submitting comments is August 15, 2007.

[5] *Interagency Guidance on Subprime Lending*, March 1, 1999, and *Expanded Guidance for Subprime Lending Programs*, January 31, 2001. Federally insured credit unions should refer to LCU 04-CU-12 - *Specialized Lending Activities* (NCUA). National Banks should also refer to 12 C.F.R. 34.3(b) and (c), as well as 12 C.F.R. part 30, Appendix C.