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## Agencies Issue Proposed Statement on Subprime Mortgage Lending: New Standards for Assessing Borrower Ability to Repay, Consumer Disclosures and Internal Controls?

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On March 8, 2007, the federal financial regulatory agencies published proposed joint federal guidance to address certain subprime lending practices, particularly those relating to adjustable rate mortgages such as hybrid ARMs (e.g., 2/28 and 3/27 ARMs) (the Proposed Statement) [i]. The Proposed Statement is intended to address concerns about the credit risks such products present for financial institutions, as well as concerns about the potential risks and consequences of the products for borrowers. As discussed in more detail below, we believe the Proposed 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. When finalized, the Proposed Statement will supplement the recent [Interagency Guidance on Nontraditional Mortgage Products](#) [ii], which was limited in scope to products that have the potential for negative amortization such as "interest-only" and "payment option" mortgages. As presently drafted, the Proposed Statement--which has been met with praise from key members of Congress--could, in the opinion of many industry leaders, have a material and negative impact on consumer financing options. Comments on the Proposed Statement are due no later than May 7, 2007.

### Scope and Implications

The Proposed Statement expressly 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. The Proposed Statement will be used in bank examinations, and institutions that fail to comply may be subject to increased regulatory scrutiny, criticism or enforcement action. On March 7, 2007, the FDIC issued a [Cease and Desist Order](#) against Fremont Investment & Loan of Brea, California, which contains a number of requirements regarding subprime mortgage lending practices that parallel the Proposed Statement. In addition, failure to consider carefully the Proposed Statement--particularly the risk management and consumer disclosure guidelines--once final could increase litigation risk for lenders. We also anticipate increased congressional scrutiny of mortgage lending practices, as well as significant increases in enforcement activity by state attorneys general.

## **Risk Management Practices**

The Proposed 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 [iii], 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 Proposed 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 Proposed Statement also indicates 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 Proposed Statement discusses one widely accepted approach to assess repayment ability by utilizing a debt-to-income ratio that considers the borrower's total housing-related payments [e.g., principal, interest, taxes and insurance (PITI)] as a percentage of gross monthly income. The Proposed Statement also notes that assessment of repayment ability is especially critical if the lender engages in risk layering, such as the use of reduced documentation.

## **Consumer Protection Principles/Disclosure Obligations**

The Proposed Statement also 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 the 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. Consumers 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. *In addition, the Proposed 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 immediately prior to the reset date to refinance without penalty.*

## **Control Systems**

Lenders are advised in the Proposed 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; entering into, maintaining and monitoring relationships with third parties (e.g., third-party originators); and implementing procedures to identify potential adverse credit trends.

### **Comment Period**

Comments are requested by May 7, 2007, on all aspects of the Proposed Statement, especially whether:

- the covered products always present inappropriate risks to lenders and borrowers and should be discouraged, or alternatively, the circumstances under which the products can be appropriately utilized;
- the Proposed Statement will unduly restrict existing subprime borrowers from refinancing their loans and avoiding payment shock;
- other mortgage products are available that would not present the risk of payment shock;
- the Proposed Statement should be applied beyond the subprime ARM market; and
- limiting prepayment penalties to the initial fixed-rate period would assist consumers by providing them with sufficient time to assess and act on their mortgage needs and how such a limitation would affect lenders.

### **Industry Reaction**

The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued a press release endorsing the Proposed Statement and noted that they are particularly interested in comments regarding the applicability of the Proposed Statement to state-licensed/supervised mortgage lenders and brokers. CSBS and AARMR intend to develop parallel guidance for such state-supervised entities. While lauding the regulators' efforts to address subprime lending issues, the Mortgage Bankers Association has urged caution, noting that overly prescriptive guidance may eliminate critical financing options for consumers.

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

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

[ii] 71 Fed. Reg. 58609.

[iii] 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.