CONFERENCE OF STATE BANK SUPERVISORS

AMERICAN ASSOCIATION OF RESIDENTIAL MORTGAGE REGULATORS

NATIONAL ASSOCIATION OF CONSUMER CREDIT ADMINISTRATORS

STATEMENT ON SUBPRIME MORTGAGE LENDING

I. INTRODUCTION AND BACKGROUND

On June 29, 2007, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) publicly released the Statement on Subprime Mortgage Lending (Subprime Statement).

The Agencies developed the Subprime Statement to address emerging risks associated with certain subprime mortgage products and lending practices. In particular, the Agencies are concerned about the growing use of adjustable rate mortgage (ARM) products[1] that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. The Agencies are concerned that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period. In addition, borrowers may not be adequately informed of product features and risks, including their responsibility to pay taxes and insurance, which might be separate from their mortgage payments.

These products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have more recently been offered to subprime borrowers as "credit repair" or "affordability" products. The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Agencies are also concerned that subprime borrowers may not fully understand the risks and consequences of obtaining this type of ARM loan. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in

[1] 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.

paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

Like the interagency Guidance on Nontraditional Mortgage Product Risks that was published in the *Federal Register* on October 4, 2006 (Volume 71, Number 192, Page 58609-58618), the interagency Subprime 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.

Recognizing that the interagency Subprime Statement does not apply to subprime loan originations of independent mortgage lenders and mortgage brokers, on June 29, 2007 the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit Administrators (NACCA) announced their intent to develop a parallel statement. CSBS, AARMR and NACCA strongly support the purpose of the Subprime Statement and are committed to promoting uniform application of the Statement's origination and underwriting standards for all mortgage brokers and lenders (herein referred to as providers).

The Subprime Statement identifies many important standards for subprime lending, and CSBS, AARMR, and NACCA support additional efforts to enhance subprime lending oversight. For instance, the Subprime Statement encourages depository institutions to consider a borrower's housing-related expenses in the course of determining a borrower's ability to repay the subprime mortgage loan. However, the Agencies did not explicitly encourage the consideration of total monthly debt obligations. Rather than create confusion or adopt a higher standard, CSBS, AARMR, and NACCA have determined to mirror the interagency statement. We will continue to work with the Agencies and our state members to improve industry-wide mortgage lending practices.

In order to promote consistent application across the states, AARMR and CSBS are developing Model Examination Guidelines (MEGs) to implement the 2006 Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) and the following Statement on Subprime Mortgage Lending. These guidelines are being developed as examination standards to assist state regulators to in determining proper compliance with the NTM Guidance and the Subprime Statement. The MEGs will also be published as a public document to guide mortgage providers and their auditors in reviewing transactions covered by the NTM Guidance and the Subprime Statement.

The following statement will assist state regulators of mortgage providers not affiliated with a bank holding company or an insured financial institution in promoting consistent regulation in the mortgage market and clarify how providers can offer subprime loans in a safe and sound manner that clearly discloses the risks that borrowers may assume.

In order to maintain regulatory consistency, this statement substantially mirrors the interagency Subprime Statement, except for the removal of sections not applicable to non-depository institutions.

II. STATEMENT ON SUBPRIME MORTGAGE LENDING

CSBS, AARMR and NACCA developed this Statement on Subprime Mortgage Lending (Subprime Statement) to address emerging issues and questions relating to subprime mortgage lending practices. The term "subprime" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income (DTI) ratios, or other criteria that may encompass borrowers with incomplete credit histories. "Subprime loans" are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, but should be viewed as a starting point from which the Kentucky Office of Financial Institutions will expand examination efforts.[2]

[2] "Subprime" and "subprime loans" are defined by the 2001 *Interagency Expanded Guidance for Subprime Lending Programs*. To promote consistency and uniformity, CSBS, AARMR and NACCA support these definitions for the purposes of this statement.

CSBS, AARMR and NACCA are concerned that borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.[3] In particular, CSBS, AARMR and NACCA are concerned with certain adjustable-rate mortgage (ARM) products typically[4] 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;[5]

- 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 providers. 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 providers may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

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[3] 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.

[4] As noted by Agencies in the final statement, the Subprime Statement focuses on subprime borrowers; however, the statement applies to ARM products that have one or more characteristics that can cause payment shock. Providers should look to the principles of this statement when such ARM products are offered to non-subprime borrowers.

[5] 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.

CSBS, AARMR and NACCA note that many of these concerns are addressed in existing interagency guidance.[6] CSBS, AARMR and NACCA recognize that these guidance documents may not apply to state-supervised providers. However, CSBS, AARMR and NACCA believe these guidelines provide sound principles for mortgage lending as a reference for state-supervised providers.

While the 2006 *CSBS-AARMR 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 providers 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.[7]

Risk Management Practices

Predatory Lending Considerations

Subprime lending is not synonymous with predatory lending, and loans with features described above are not necessarily predatory in nature. However, providers should ensure that they do not engage in the types of predatory lending practices discussed in the *Expanded Subprime Guidance*. 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.

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged may lack sufficient consumer protection safeguards and are generally considered unsafe and unsound. Examiners are instructed to criticize such lending practices in the Report of Examination. Further, examiners are

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[6] 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)*.

[7] As with the *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006), the interagency Subprime 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. This statement, developed by CSBS, AARMR and NACCA, is applicable to all state-supervised mortgage providers.

instructed to refer any loans with the aforementioned characteristics to the Kentucky Office of Financial Institutions, Division of Financial Institutions, for additional review.

Providers 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) or other state laws, which prohibit unfair or deceptive acts or practices.

Underwriting Standards

The 1993 interagency *Real Estate Guidelines* provide underwriting standards for all real estate loans and state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. Providers should refer to the 2006 *NTM Guidance*, which 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. A provider'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,[8] assuming a fully amortizing repayment schedule.[9]

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. A provider'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.[10]

This assessment is particularly important if the provider 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 provider and the borrower. Therefore, a provider 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, a provider should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

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[8] 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%, providers 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.

[9] 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.

[10] A prudent practice used by the industry is to include a borrower's total monthly debt obligations as a percentage of gross monthly income in the DTI analysis.

Recognizing that loans to subprime borrowers present elevated credit risk, providers 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 provider. However, a higher interest rate is not considered an acceptable mitigating factor.

Workout Arrangements

The June 26, 2007 CSBS-AARMR *Consumer Alert: Mortgage Payment Increase*, urged borrowers to:

- Seek information on the characteristics of their mortgage;
- Budget accordingly for the scheduled "recast" or "reset" of their loan's interest rate;
- Contact their provider for assistance, if needed; and
- Inquire about possible solutions if payments are past due.

The June 26, 2007 CSBS-AARMR *Industry Letter: Mortgage Payment Increase* encouraged providers to reach out to consumers to provide information on their loans and to work with consumers to avoid foreclosure.[11] Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the provider and the borrower.

Providers should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.[12] Such arrangements can vary widely based on the borrower's financial capacity. For example, a provider 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 Kentucky Office of Financial Institutions will not criticize providers that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance

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[11] The CSBS-AARMR Consumer Alert and Industry Letter can be found at the CSBS web site: http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/RecastStatements/Recast_Statements.htm.

[12] For those providers that portfolio loans, they may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

and applicable accounting standards do not require providers to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. For those providers that portfolio loans, they should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

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. Providers should not use such communications to steer consumers to these products to the exclusion of other products offered by the provider 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.

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.[13] 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.[14]

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[13] Providers generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

[14] 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 +

- *Prepayment Penalties*. The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.

- *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

Providers 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. Providers 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.

Providers should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. A provider'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, providers should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

Supervisory Review

The Kentucky Office of Financial Institutions will carefully review risk management and consumer compliance processes, policies, and procedures. The Kentucky Office of Financial Institutions will take action against providers that exhibit predatory lending

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$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.

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.

Adopted this the 17th day of August 2007.

Cordell G. Lawrence, Executive Director
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