

Interagency Guidance on Subprime Lending

March 1, 1999

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Background and Scope

Insured depository institutions have traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, in recent years a number of lenders¹ have extended their risk selection standards to attract lower credit quality accounts, often referred to as subprime loans. Moreover, recent turmoil in the equity and asset-backed securities market has caused some non-bank subprime specialists to exit the market, thus creating increased opportunities for financial institutions to enter, or expand their participation in, the subprime lending business. The federal banking agencies have been monitoring this development and are providing guidance on this activity.

For the purposes of this guidance, “subprime lending” is defined as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.² Risk of default may be measured by traditional credit risk measures (credit/repayment history, debt to income levels, etc.) or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does

¹ The terms “lenders,” “financial institutions,” and “institutions,” in this document refer to insured depository institutions and their subsidiaries.

² For purposes of this paper, loans to customers who are not subprime borrowers are referred to as “prime.”

not include loans to borrowers who have had minor, temporary credit difficulties but are now current. This guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit impaired loans purchased at a discount; the purchase of subprime automobile or other financing “paper” from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Moreover, the ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Recently, however, a number of financial institutions have experienced losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution’s staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk. Institutions that began a subprime lending program prior to the issuance of this guidance should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards. If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.

Capitalization

The federal banking agencies believe that subprime lending activities can present a greater than normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. The amount of additional capital necessary will vary according to the volume and type of subprime activities pursued and the adequacy of the institution’s risk management program. Institutions should determine how much additional capital they need to offset the additional risk taken in their subprime lending activities and document the methodology used to determine this amount. The agencies will evaluate an institution’s overall capital adequacy on a case-by-case basis through on-site examinations and off-site monitoring procedures considering, among other factors, the institution’s own analysis of the capital needed to support subprime lending. Institutions determined to have insufficient capital must correct the deficiency within a reasonable timeframe or be subject to supervisory action. In light of the higher risks associated with this type of lending, the agencies may impose higher minimum capital requirements on institutions engaging in subprime lending.

Risk Management

The following items are essential components of a well-structured risk management program for subprime lenders:

Planning and Strategy. Prior to engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets and/or customers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Staff Expertise. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possesses sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

Lending Policy. A subprime lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime lending program. While not exhaustive, the following lending standards should be addressed in any subprime lending policy:

- Types of products offered as well as those that are not authorized;
- Portfolio targets and limits for each credit grade or class;
- Lending and investment authority clearly stated for individual officers, supervisors, and loan committees;
- A framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital;
- Collateral evaluation and appraisal standards;

- Well defined and specific underwriting parameters (i.e., acceptable loan term, debt to income ratios, loan to collateral value ratios for each credit grade, and minimum acceptable credit score) that are consistent with any applicable supervisory guidelines;³
- Procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines;
- Credit file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision; and
- Correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards.

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

Purchase Evaluation. Institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and the loan losses that may be experienced as they evaluate expected profits. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (i.e., the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due diligence review prior to committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.

Loan Administration Procedures. After the loan is made or purchased, loan administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically

³ Extensions of credit secured by real estate, whether subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory Loan-to-Value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. See 12 CFR Part 34, subpart D (OCC); 12 CFR Part 208, appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS) for further information.

employed stronger collection efforts such as calling delinquent borrowers frequently, investing in technology (e.g., using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business.

Subprime loan administration procedures should be in writing and at a minimum should detail:

- Billing and statement procedures;
- Collection procedures;
- Content, format, and frequency of management reports;
- Asset classification criteria;
- Methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- Criteria for allowing loan extensions, deferrals, and re-agings;
- Foreclosure and repossession policies and procedures; and
- Loss recognition policies and procedures.

Loan Review and Monitoring. Once loans are booked, institutions must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for sub-portfolios. Institutions should have information systems in place to segment and stratify their portfolio (e.g., by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

Consumer Protection. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of "The Home Ownership and Equity Protection Act of 1994," Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This Act amended the Truth-in-Lending Act to provide

certain consumer protections in transactions involving a class of non-purchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z, 12 C.F.R. §226.32, and Regulation X, the Real Estate Settlement Procedures Act (RESPA), 12 USC §2601, and adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate-related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited basis characteristic (e.g., race, sex, age, etc.). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

Securitization and Sale. Some subprime lenders have increased their loan production and servicing income by securitizing and selling the loans they originate in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit quality problems.

Recent turmoil in the financial markets illustrates the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should

consider the appropriate discount rates, credit loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as predominant risk and cash flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

Reevaluation. Institutions should periodically evaluate whether the subprime lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?
- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored and controlled?
- Has the program met the credit needs of the community that it was designed to address?

Examination Objectives

Due to the high-risk nature of subprime lending, examiners will carefully evaluate this activity during regular and special examinations. Examiners will:

- Evaluate the extent of subprime lending activities and whether management has adequately planned for this activity.
- Assess whether the institution has the financial capacity to conduct this high-risk activity safely without an undue concentration of credit and without overextending capital resources.
- Ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage the program.
- Evaluate whether management has established adequate lending standards and is maintaining proper controls over the program.
- Determine whether the institution's contingency plans are adequate to address the issues of alternative funding sources, back-up purchasers of the securities or the attendant servicing functions, and methods of raising additional capital during a period of an economic downturn or when financial markets become volatile.
- Review securitization transactions for compliance with FAS 125 and this guidance, including whether the institution has provided any support to maintain the credit quality of loans pools it has securitized.

- Analyze the performance of the program, including profitability, delinquency, and loss experience.
- Consider management’s response to adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
- Determine if the institution’s compliance program effectively manages the fair lending and consumer protection compliance risks associated with subprime lending operations.

Richard C. Spillenkothen
Director, Division of Banking
Supervision and Regulation
Board of Governors of the Federal Reserve System

James L. Sexton
Director, Division of Supervision
Federal Deposit Insurance Corporation

Emory W. Rushton
Senior Deputy Comptroller for
Bank Supervision Policy

Richard M. Riccobono
Deputy Director
Office of Thrift Supervision