

## Commentary, Subprime Lending—In General

“Subprime” lending refers to the practice of making loans to borrowers who do not meet traditional credit underwriting standards. In general, subprime borrowers have poor or limited credit history. According to the federal banking agencies, subprime borrowers display a range of credit characteristics that may include one or more of the following:

- At least two 30-day delinquencies on loans within the past year, or at least one 60-day delinquency on loans within the past two years;
- Judgment, foreclosure, repossession, or non-payment of a loan within the past two years;
- Bankruptcy within the past 5 years;
- Relatively high default probability as evidenced by a low credit score;
- Debt service-to-income ratio of 50% or more or otherwise limited ability to cover living expenses after deducting monthly debt-service requirements from income.

[[Federal Banking Agencies, \*Expanded Guidance for Subprime Lending Programs\* \(Jan. 31, 2001\)](#)]

Since these loans involve greater risks, the interest rates and loan fees on these loans are higher than for loans to prime borrowers. Borrowers obtain subprime loans from financial institutions that specialize in subprime lending or that deal with subprime loans as part of their broader business. In general though, many subprime loan originators are not under the control of banking regulators.

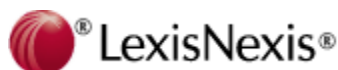
Most subprime lenders securitize their mortgages or credit card loans by packaging mortgage or credit card receivables into fixed income securities or bonds that are sold in the secondary markets to investors. The sale of these mortgage-backed securities provides lenders with the cash flow to fund additional lending.

## Characteristics of Subprime Loans

Subprime mortgage lending is typically characterized by mortgages that are in smaller amounts than prime mortgages, but with shorter terms and higher costs and fees. Most subprime mortgages are structured as adjustable rate mortgages (“A.R.M.s”). A.R.M.s have an initial interest rate (a “teaser rate”) that is lower than a similar fixed-rate mortgage; the rate later resets to a higher than market interest rate for the remainder of the loan. These loans are frequently option A.R.M.S that allow the borrower to pay “interest only” to minimize initial loan payments, or to pay a “minimum payment” that is usually less than the interest-only payment and results in negative amortization. Since the teaser rates usually reset at much higher rates, these loans are frequently referred to as “exploding A.R.M.S.” Prepayment penalties are another characteristic of subprime loans.

Subprime credit cards loans usually impose any combination of the following: higher late fees, higher over limit fees, yearly fees, high upfront fees, no grace periods, double cycle billing, universal default provisions, and phone payment charges.

## Subprime Lending vs. Predatory Lending



Because subprime lending tends to involve minority, elderly, moderate-to-lower income or less-educated people whose need for credit makes them vulnerable, the subprime market is susceptible to abusive lending practices. However, subprime lending is not the same as predatory lending. Subprime lending includes loans to borrowers with heightened credit risk, and when responsibly underwritten, priced and administered, the subprime loans are legitimate. However, predatory loans, while they may involve subprime borrowers, are not directed at a single class of borrowers and are typified by a lack of exchange of fair value or loan prices that exceed the risk that a borrower presents.

In 2001, the federal banking agencies issued the [Expanded Guidance for Subprime Lending Programs](#) that set forth particular characteristics that tend to be present in predatory loans. Subprime lending may be abusive if at least one of the following factors is present:

- the extension of unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
- the inducement of a borrower to refinance repeatedly for the purpose of charging high points and fees; or
- the use of fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsophisticated borrower.

In 2007, these policies were incorporated into the [Supervisory Policy on Predatory Lending](#) issued by the F.D.I.C., reaffirming their position that such activities are inconsistent with safe and sound lending practices.

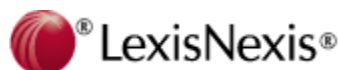
### **Growth of Subprime Mortgage Market**

Economic factors such as rising home prices, low interest rates, increased competition among lenders, and a wealth of capital from lenders and mortgage securities investors fueled the growth of the subprime mortgage market. Lenders relaxed underwriting standards to increase mortgage sales; debt-to-income ratios and loan-to-value ratios increased, and little documentation of borrowers' income or employment was required. Borrowers were qualified for A.R.M.s at the initial rate rather than the fully-indexed rate, and lenders offered "piggyback loans" (simultaneous primary and secondary lien-mortgages) that avoided the requirements of downpayments and private mortgage insurance. Lenders used risk-based pricing instead of verifying borrowers' assets, and inattention to collateral values and disregard of appraisal guidelines all amplified the risk for financial institutions.

Securitization of mortgages further added to the growth of the subprime mortgage market. Financial institutions securitize mortgage-backed assets into pools to acquire capital to fund their mortgage activities. Although securitization spreads some of that risk, financial institutions remain subject to risk where representation and warranty clauses allow investors to "put back" loans, requiring the financial institution to repurchase or replace those loans if they fail to meet certain standards. Borrower delinquency and high debt-to-income ratios are common triggers for put-backs.

### **Federal Regulatory Framework**

#### **Background**



In 1999, the federal banking agencies issued the [Interagency Guidance on Subprime Lending](#), applicable to direct extensions of credit, the purchase of subprime loans from other lenders, the purchase of subprime automobile or other financing “paper” from lenders or dealers, and the purchase of subprime loan originators. The 1999 Subprime Lending Guidance directed financial institutions to implement strong risk management practices and internal controls to identify, measure, monitor and control the risks inherent in subprime lending. It stated that unless the associated risks are properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound, and that examiners should carefully evaluate this activity during regular and special examinations.

This guidance was supplemented two years later when the banking agencies issued the [Expanded Guidance for Subprime Lending Programs](#). The 2001 Expanded Subprime Lending Guidance focused on the intensive risk management required for subprime lending, as well as the possible requirement for additional capital. The directive included the following points:

- An institution’s Allowance for Loan and Lease Losses (“A.L.L.L.”) must have a sufficient portion allocated to the subprime loan portfolio to absorb estimated credit losses.
- A lender must quantify the amount of capital needed to offset the risk of subprime lending activities, and must document the methodology and analysis used to determine that amount.
- Two levels of review will be performed for each regularly scheduled examination cycle: portfolio-level reviews and transaction-level testing.
- Classification policies and required documentation for such practices as reaging, extensions, renewals, rewrites or other types of account restructuring are also addressed.

The regulators also issued joint guidelines on asset securitization activities. The [Interagency Guidance on Asset Securitization Activities](#) addressed problems stemming from financial institutions’ (1) failure to recognize and hold sufficient capital against recourse obligations accompanying securitizations; (2) excessive or inadequately supported valuation of retained interests; (3) liquidity risk associated with too much reliance on asset securitization as a funding source; and (4) inadequate independent risk management and audit functions.

### Recent Agency Initiatives

In response to the rapid growth in subprime mortgage lending in recent years and to address loosened underwriting standards, the federal banking agencies issued [Credit Risk Management Guidance for Home Equity Lending](#) that set forth items that would warrant supervisory attention and prescribed underwriting standards and risk management principles. In 2006, an [addendum](#) to this was issued to ensure that consumers receive adequate, timely and clear information that allows them to make informed credit decisions.

Federal banking agencies also issued [Interagency Guidance on Nontraditional Mortgage Product Risks](#) that clarifies how banks can offer nontraditional mortgage products, such as A.R.M.s, in a safe and sound manner. The guidance stresses that financial institutions should carefully consider and mitigate risks associated with these loans by (1) ensuring that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s repayment capacity; (2) recognizing that such loans warrant strong risk management standards, capital commensurate with the risk, and an allowance for loan and lease losses that reflects the portfolio’s collectibility; and (3) ensuring that consumers have sufficient information to understand the loan terms and associated risks prior to making a product choice.

On July 10, 2007, the federal banking agencies issued a [Statement on Subprime Mortgage Lending](#) that reiterated the fundamental principles that loans should be made based upon the borrower’s ability to repay the loan according to its terms, rather than upon just the teaser rate, and that consumers should receive clear



information regarding the terms of loans so that they can understand at a relevant time whether the loan product meets their needs. Although it focused on subprime lending, the statement directs institutions to apply these principles when offering loans to any borrowers. It adopted the already existing guidance regarding subprime lending, expressing concern about the elevated credit risk inherent in subprime mortgage products and discussing criteria that an institution should assess in determining a borrower's ability to repay a subprime mortgage loan. A discussion of workout arrangements addressed concerns that the ability of subprime borrowers to refinance might be restricted by the policy adopted.

Mortgage brokers and loan offers in nonbank companies have historically been regulated by the states; however the Comptroller of the Currency ("O.C.C.") takes the position that it has the authority to supervise mortgage activities conducted through national banks' operating subsidiaries. This position was upheld in 2007 by the Supreme Court in [Watters v. Wachovia](#).

As to state agency regulation of mortgage brokers and loan officers, the State Conference of Bank Supervisors and the American Association of Residential Mortgage Regulators have issued their own [Guidance on Nontraditional Mortgage Product Risks](#) regarding nontraditional mortgage products to the state agencies that is substantially the same as the guidance by the same name issued by the federal banking agencies. To date, more than half of the states and the District of Columbia have adopted those agencies' guidance. Moreover, both agencies have endorsed the 2007 *Subprime Lending Statement* and have indicated that they intend to develop a similar statement for state supervisors of state-licensed residential mortgage brokers and companies

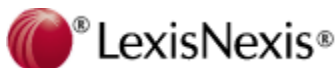
### Congressional Activity

Extensive hearings have been held in both the House of Representatives and the Senate as well. In April 2007, a concurrent resolution was introduced that articulated Congress' belief that to protect buyers who have been victims of unscrupulous mortgage brokers and lenders, legislation should be enacted that:

- includes anti-predatory provisions and provisions that require lenders to evaluate a borrower's ability to repay at the fully indexed rate for the fully amortized amount;
- establishes federal regulatory requirements for licensing, education and experience for mortgage brokers and loan officers in nonbank companies;
- requires plain, clear, effective and prominent disclosures for potential borrowers;
- reduces or eliminates prepayment penalties;
- requires notification to potential home buyers of lenders or brokers with high foreclosure rates and pre-loan counseling.

[H. Cong. Res. 127, 101st Cong., 152 Cong. Rec. H4050 (daily ed. Apr. 24, 2007)]

Subsequently, the [Predatory Mortgage Lending Practices Reduction Act](#) was introduced in the House. The bill amends the Real Estate Settlement Procedures Act to provide certification requirements for mortgage lenders and brokers, including training and examination regarding subprime loans and predatory practices. The bill also amends the Home Owner's Equity Protection Act ("H.O.E.P.A.") provisions of the Truth-in-Lending Act to require any creditor who extends high cost mortgages to implement a best practices plan that applies to the creditor, its agents and subcontractors that includes training, good faith resolution of complaints, requirements for disclosures of charges, fees and rescission rights, and a prohibition on charges not previously disclosed. It also includes provisions prohibiting unfair and deceptive practices regarding appraisal valuation and provides money penalties for violations of the Act. Also pending in the House is the [Fair Mortgage Practices Act of 2007](#) that targets predatory lending in the subprime market.



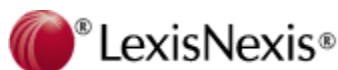
The [\*Borrower's Protection Act of 2007\*](#) was introduced in the Senate. The bill is a two-step solution that includes \$300 million in new federal funds to be directed to community non-profit groups by the Department of Housing and Urban Development to boost refinancing programs to help homeowners prevent foreclosures. A letter to banks and other lenders encourages that they provide matching funds. It also includes a bill that upgrades the standards for all loan originators and mortgage brokers, as well as creates a standard to insure borrowers can repay their loans. Also pending in the Senate is the [\*Homeownership Protection and Enhancement Act of 2007\*](#).

## **Consumer Protections**

In addition to financial institutions' safety and soundness concerns, consumer protections exist as well. Two of the most important are the Truth in Lending Act and the Home Owners Equity Protection Act.

The Truth in Lending Act ("T.I.L.A.") applies to consumer credit transactions in which a security interest will be acquired in real or personal property used or expected to be used as the consumer's principal dwelling, and to other loans in which the amount financed is under a certain amount. T.I.L.A. contains disclosure requirements for both closed-end and open-end credit.

The Home Owners Equity Protection Act ("H.O.E.P.A.") was enacted as an amendment to T.I.L.A. and pertains to "high cost" loans. H.O.E.P.A. subjects certain refinancings and closed-end home equity loans that are considered "high-cost" to enhanced disclosure requirements. H.O.E.P.A. also restricts certain loan terms and prohibits lenders from extending high cost mortgages based upon the value of the borrower's home without considering the borrower's ability to repay the loan from income sources other than home equity.



## Research Guide

### Exclusive LexisNexis Content

- Expert Commentaries and Emerging Issues Commentaries:
  - [Subprime Lending: An Update of the Issues and Approaches \(Aug. 2007\)](#)
  - [The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis \(Aug. 2007\)](#)
  - [Jaworski on Subprime: Final Guidance \(Aug. 2007\)](#)
  - [Bergman on Subprime - Effect on Foreclosures](#)
  - [Sommer on Foreclosures: Bankruptcy Issues \(June 2007\)](#)
- [Banking Law](#)

### Case Law and Enforcement Actions

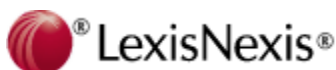
- [Watters v. Wachovia, 127 S. Ct. 1559, 167 L. Ed. 2d 389 \(2007\)](#)

### Statutes and Regulations

- [Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601 et seq.](#)
- [Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801 et seq.](#)
- [Community Reinvestment Act, 12 U.S.C. §§ 2901 et seq.](#) and [12 C.F.R. pt. 228 \(Regulation BB\)](#)
- [Truth in Savings Act, 12 U.S.C. §§ 4301 et seq.](#) and [12 C.F.R. pt. 230 \(Regulation DD\)](#)
- [Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. §§ 4701 et seq.](#)
- [Truth in Lending Act, 15 U.S.C. §§ 1601 et seq.](#) and [12 C.F.R. pt. 226 \(Regulation Z\)](#)
- [Home Ownership and Equity Protection Act, 15 U.S.C. §§ 1639 et seq.](#)
- [Fair Credit Reporting Act, 15 U.S.C. §§ 1681 et seq.](#) and [12 C.F.R. pt. 222 \(Regulation V\)](#)
- [Equal Credit Opportunity Act, 15 U.S.C. §§ 1691 et seq.](#) and [12 C.F.R. pt. 202 \(Regulation B\)](#)
- [Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692 et seq.](#)
- [Electronic Funds Transfer Act, 15 U.S.C. §§ 1693 et seq.](#) and [12 C.F.R. pt. 205 \(Regulation E\)](#)
- [Gramm-Leach Bliley Act, 15 U.S.C. §§ 6801 et seq.](#)
- [Fair Housing Act, 42 U.S.C. §§ 3601 et seq.](#)

### Agency Guidance

- Federal Banking Agencies, [Statement on Subprime Mortgage Lending](#) (July 2007)
- Federal Banking Agencies, [Statement on Working with Mortgage Borrowers](#) (Apr. 17, 2007)
- Federal Banking Agencies, [Interagency Guidance on Nontraditional Mortgage Product Risks](#) (Oct. 2006)
- Federal Banking Agencies, [Addendum to Credit Risk Management Guidance for Home Equity Lending](#) (Oct. 2006)
- Federal Banking Agencies, [Credit Risk Management Guidance for Home Equity Lending](#) (May 24, 2005)
- Federal Banking Agencies, [Interagency Expanded Guidance for Subprime Lending Programs](#) (Jan. 31, 2001)
- Federal Banking Agencies, [Interagency Guidance on Asset Securitization Activities](#) (Dec. 13, 1999)



- Federal Banking Agencies, [Interagency Guidance on Subprime Lending](#) (Mar. 3, 1999)
- F.D.I.C., [Supervisory Policy on Predatory Lending](#) (Jan. 22, 2007)

### **Congressional Activity**

- Predatory Mortgage Lending Practices Reduction Act, [H.R. 2061](#) (introduced 4/26/07)
- Borrower's Protection Act of 2007, [S. 1299](#) (introduced 5/3/07)
- Credit Card Act of 2007, [H.R. 1461](#) (introduced 5/9/07)
- Homeownership Protection and Enhancement Act of 2007, [S. 1386](#) (introduced 5/14/07)
- Fair Mortgage Practices Act of 2007, [H.R. 3012](#) (introduced 7/12/07)

### **Targeted News Sources**

- ❖ [Mega News, Subprime Lending](#)
- ❖ [Mega News, Subprime Mortgages](#)

