



SUMMARY OF REGULATORS' FINAL SUBPRIME STATEMENT June 29, 2007

GENERALLY: The Final Statement largely tracks the proposed statement. It generally covers subprime hybrid ARMs, requires underwriting to the “fully indexed rate,” limits the use of low-documentation or no-documentation loans to instances where there are mitigating factors and requires clear and balanced information about the relative benefits and risks of products including the risk of payment shock, ramifications of prepayment penalties, balloon payments, and responsibility for taxes and insurance. It also requires the establishment of control systems to assure compliance and notes that there will be supervisory review toward this end. Notably, there are new provisions on workout arrangements that encourage institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable.

SCOPE: The Statement is generally directed to subprime ARM products offered to subprime borrowers that can cause “payment shock” and that have one or more of the following characteristics:

- Low initial payment period based on a fixed introductory or teaser rate that expires after a **short** initial period and then adjusts to a variable index rate plus a margin;
- Very high or no limits on how much payment amount or interest rate may increase (“payment or rate caps”) on reset dates;
- 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 interest rate period.

Important Note: The regulators do not specify what they mean by a “short” initial period in order to define whether only 2/28s and 3/27s are covered. There is reason to believe, however, based on a footnote, that only these types of loans are covered. The Statement also says that while it “has retained its focus on subprime borrowers, the Agencies note that institutions generally should look to the principles of this Statement when ARM products are offered to non-subprime borrowers.” It is unclear what is meant by “principles.”

STRUCTURE: The Statement covers five main subjects; 1) Risk Management Practices, 2) Workout Arrangements, 3) Consumer Protection Principles, 4) Control Systems and 5) Supervisory Review.

1. Risk Management Practices. The Statement provides:

- **Subprime lending is not predatory lending.** The Statement reminds that under previous guidance, predatory lending involves:
 - Making a mortgage loan based predominantly on the foreclosure or liquidation value of borrower's collateral rather than on 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; 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.
- **Institutions should follow underwriting standards that include:**
 - Prudent qualifying standards that recognize the potential effect of a borrower's payment shock in evaluating the borrower's ability to service debt.
 - **Evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate assuming a fully amortizing repayment schedule.** The Statement at page 20, footnote 11 provides the fully indexed rate equals the index rate prevailing at origination plus the margin to be added after the expiration of an introductory interest rate.
 - In qualifying a borrower's capacity to service debt based upon debt-to-income ratio (DTI), institutions should assess a borrower's total housing payments including principal, interest, taxes and insurance, or "PITI," as a percentage of gross monthly income.
 - Stated income and reduced documentation loans should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Mitigating factors include a record of repayment performance or substantial liquid reserves or assets. Mitigating factors do not include charging a higher interest rate.

2. Workout Arrangements. These new provisions of the Statement:

- **Encourage institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable.** Such arrangements can vary widely based on the borrower's capacity to repay. Institutions might consider modifying loan terms including converting loans with variable rates into fixed-rate products.
- **Indicate Agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers.**

3. Consumer Protection. The Statement provides institutions should:

- Approve loans based on borrower's ability to repay;

- **Provide information that enables consumers to understand material terms, costs and risks of loan products at a time that will help the borrower select a product;**
- **Communicate to borrowers, in ads, oral statements and promotional materials, clear and balanced information about the relative benefits and risks of products including the risk of payment shock; ramifications of prepayment penalties, balloon payments; and responsibility for taxes and insurance; and**
- Not extend prepayment penalties beyond the initial reset period, and borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without a penalty.

4. Control Systems. Statement says institutions should:

- Develop strong internal control systems to determine whether actual practices are consistent with institution policies and procedures and that address compliance and consumer information concerns encompassing institution personnel and third parties, including hiring and training standards;
- **Design compensation programs that avoid providing incentives for origination inconsistent with sound underwriting and consumer protection principles and that do not result in steering to certain products to the exclusion of others;**
- Have controls that provide for appropriate corrective actions in the event of failure to comply with laws, regulations third-party agreements or policies; and
- Initiate procedures to review consumer complaints.

5. Supervisory Review. Statement indicates that Regulatory agencies will:

- Review risk management and consumer protection compliance processes, policies and procedures at regularly scheduled examinations.
- Take action against institutions that fail to implement or adhere to safe and sound standards, exhibit predatory lending practices or violate consumer protection or fair lending laws.