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## Federal Bank Regulators Issue Final Statement on Subprime Mortgage Lending

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On June 29, 2007, the federal bank regulators issued their Final Guidance on Subprime Mortgage Lending (the “Final Guidance”). The Final Guidance describes prudent underwriting and consumer protection standards that banking institutions should follow when lending to subprime borrowers, and focuses on “2/28” adjustable-rate mortgages (“ARMS”), “stated-income loans” and loans with prepayment penalties. While the Final Guidance does not prohibit banking institutions from making these loans to subprime borrowers, it instructs the institutions on the factors they should consider when underwriting these types of loans, and the information they should be providing to consumers to whom they offer these types of loans. It is anticipated that the Conference of State Bank Supervisors (“CSBS”) and the American Association of Residential Mortgage Regulators (“AARMR”) will jointly issue similar guidance that state regulators may adopt to apply to non-bank mortgage lenders and mortgage brokers in their states. Some of the more critical details of the Final Guidance for the regulated institutions is set forth below in a question and answer format.

### Scope

**To Whom Does the Final Guidance Apply?** The Final Guidance applies to institutions regulated by one or more of the following agencies: the Board of Governors of the Federal Reserve System (the “FRB”), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (collectively, the “Agencies”). These institutions include federally insured banks and thrifts (national banks, federal savings associations, state banks, state savings associations and state savings banks, and state industrial loan companies) and their subsidiaries; federal and state credit unions; and bank and savings and loan holding companies; as well as their non-bank subsidiaries (collectively, the “Banks”).

**To What Loans Do the Final Guidance Apply?** The Final Guidance applies to all subprime loans offered by the Banks.

**What are “Subprime Loans”?** The Final Guidance does not define the term “subprime loans.” Instead, it refers to previous Guidance issued by the Agencies, specifically, the 2001 Expanded Guidance for Subprime Lending Programs (<http://www.fdic.gov/news/news/press/2001/pr0901a.html>), which uses the term “subprime loans” generally to refer to loans to borrowers with weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments and bankruptcies, and/or reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria.

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### *What Specific Types of Subprime Loans are the Agencies Most Concerned About in the Final Guidance?*

- ARMs with low initial monthly payments based on a fixed introductory rate that expires after a short period (e.g., two or three years) and then adjusts to a variable rate based on an index plus a margin for the remaining term.
- ARMs with very high or no limits on how much the monthly payment or the interest rate may increase when they are due to reset.
- Stated-income loans (requiring limited or no documentation of the borrower's income).
- Loans with features likely to result in frequent refinancing to maintain low monthly payments.
- Loans that carry substantial prepayment penalties or penalties for prepayment that extend beyond the loan's initial fixed-rate period.

***Should Banks Worry That the Final Guidance Will Be Applied in the Context of Prime Loans?*** Possibly. While the Agencies rejected requests from consumer groups to apply the Final Guidance beyond the subprime market, they indicated that “institutions generally should look to the principles in [the Final Guidance] when...ARM products [having one or more characteristics that can cause payment shock] are offered to non-subprime borrowers.”

***Do Non-Bank Lenders Need to Be Concerned About the Final Guidance?*** Yes. As indicated at the outset, CSBS and AARMR can be expected shortly to create a modified version of the Guidance that can be adopted by state mortgage regulators and applied to non-bank lenders operating in their states. If recent history is any guide, most states can be anticipated to adopt or approve the use of the modified CSBS/AARMR shortly thereafter.

***Do the Agencies Consider Such Loans to Be “Predatory”?*** Not necessarily. The Agencies specifically state that “[s]ubprime lending is not synonymous with predatory lending.” According to the Agencies, predatory lending involves additional elements, such as making loans based predominantly on the value of the borrower's collateral rather than his/her ability to repay; inducing the borrower to repeatedly refinance in order to earn high points and fees (“loan flipping”); and engaging in fraud or deception to conceal from an unsuspecting or unsophisticated borrower the true nature of the loan obligation.

## **Underwriting Standards**

***What Standards Must Banks Use When Underwriting Subprime Loans?*** Banks should analyze the borrower's capacity to repay the loan according to its terms. They should consider both principal and interest obligations at the fully indexed rate with a fully amortizing repayment schedule, plus a reasonable estimate for real estate taxes and insurance, *whether or not escrowed*. The Agencies encourage the use of debt-to-income ratios, including, specifically, “front-end” ratios (the percentage of monthly gross income necessary to meet the borrower's monthly housing expense, including principal, interest, real estate taxes and insurance) to quantify a borrower's repayment ability, *particularly* if the Bank is going to rely upon reduced documentation, “piggyback” second mortgages, or other (“risk layering”) features that significantly increase the risk to both the Bank and the borrower.

***What is the Appropriate Interest Rate to Use When Underwriting a Subprime ARM Loan?*** The fully indexed rate assuming a fully amortizing repayment schedule.

***Can Banks Still Make “Stated Income” Loans?*** Only in exceptional circumstances, *i.e.*, where mitigating factors exist that will clearly minimize the need for direct verification. Examples of such circumstances are where a borrower, with a favorable payment history and a financial condition that has not deteriorated, is refinancing an existing loan with a new loan in a similar amount and with similar terms, and where a borrower can demonstrate repayment capacity based on substantial liquid reserve or assets that are verified and documented by the Bank.

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(Banks choosing to make “low doc” or “no doc” subprime loans under such circumstances will have to verify and document that the necessary mitigating circumstances exist.) In all other situations, Banks should verify and document the borrower’s income (both as to source and amount), assets and liabilities.

***Must Banks Now Perform a “Suitability” Analysis Before Making a Subprime Loan?*** No. The Agencies specifically rejected requests from consumer groups to create such a requirement. Instead, as discussed further below, the Agencies required the Banks to do a better job of informing potential borrowers of both the benefits and the risks associated with these products, so that consumers can determine for themselves whether the loan is “suitable.”

### Workout Arrangements

***Under What Circumstances May Banks Enter Into Workout Arrangements With Their Subprime Borrowers?*** Banks should follow prudent underwriting practices in determining whether to consider a loan modification or workout arrangement. If they do, and the terms of the workouts are reasonable, they will not be criticized. Regardless, Banks must identify and report credit risk, maintain adequate loan loss reserves, and write off losses in a timely manner.

### Consumer Protections

***What About Prepayment Penalty Periods/Must They Be Limited?*** Yes. The period during which prepayment penalties apply in connection with 2/28 (or 3/27) ARM loans should not exceed the initial fixed-rate (or reset) period, and Banks should generally allow borrowers to refinance without penalty beginning at least 60 days prior to the reset date.

***Are Banks Going to Have to Make More Consumer Disclosures?*** Apparently yes. The Agencies want the Banks to provide “clear and balanced information about the relative benefits *and risks* of the [subprime] loans” they are marketing, including in advertisements, oral statements and other promotional materials, and to make sure that these promotional materials are not used to “steer” customers to these products to the exclusion of other types of loans for which they might qualify.” (Italics added).

***Are There Prescribed Forms That Must/May Be Used for This Purpose?*** No. It looks as if the Agencies intend to allow the Banks to make their own decisions in this regard. They did not issue any sample illustrations with a request for comments, as they did when they issued the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006). See 71 Fed. Reg. 58609 (Oct. 4, 2006), adopted 72 Fed. Reg. 31825 (June 8, 2007).

***What Kind of Information Must Be Disclosed?*** Clear, detailed information about the costs, terms, features, and risks of the loan to the borrower, including relevant information about:

- *Payment Shock* – Information about potential payment increases, including how a new payment will be calculated when an introductory fixed rate expires.
- *Prepayment Penalties* – Whether one exists, how it is calculated, when it may be imposed.
- *Balloon Payments* – Whether one exists.
- *Cost of Low-Doc and No-Doc Loans* – Whether borrowers will save money by taking out a full-income verification loan.
- *Escrows* – Whether payments for taxes and insurance are included in the borrower’s monthly payment and, if not, that they can be substantial.

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### Controls

**Will Banks Need to Have Controls to Ensure Compliance?** Yes. Banks must not only develop policies and procedures that are consistent with the Final Guidance, but they must also develop systems to monitor compliance with those policies and procedures. These systems should address compliance, consumer information, and safety and soundness concerns, and encompass Bank employees as well as third parties. As part of these systems, Banks should:

- Establish criteria for hiring and training loan personnel, and hiring and conducting initial and ongoing due diligence on third parties.
- Design compensation programs that will not provide incentives for originating loans that are inconsistent with the principals in the Final Guidance.
- Implement procedures and systems to monitor compliance, to effect appropriate corrective measures in the event of non-compliance, and to review consumer complaints to identify potential compliance problems or negative trends.

### Summary

**What will be the impact of the Final Guidance?** We suspect it will be a mixed bag. On the consumer side, the Final Guidance may help to prevent consumers from taking out loans that they really cannot afford; but it may also make it more difficult for consumers who already hold these loans to refinance them when they reset and more difficult for those wishing to purchase a home to qualify for the necessary financing. On the industry side, it may help Banks generally to avoid some of the risks associated with these loans, and should help Banks that focus on more traditional loan products to compete more successfully with those lenders who aggressively marketed the types of products addressed in the Final Guidance; but it could also prove to be a further drag on an already-down housing market.

**Is More Regulatory Action on the Horizon?** Possibly. On June 14, 2007, the FRB held hearings on whether it should use its rulemaking authority under section 129(l)(2) of the Home Ownership and Equity Protection Act (“HOEPA”) to address concerns about many of the same practices discussed in the Final Guidance, such as prepayment penalties that extend beyond the expiration of an introductory rate, “stated income” or “low doc” loans, and the underwriting of ARMs based on fully-indexed rates. Under this provision of HOEPA, the FRB has broad authority to prohibit acts or practices in connection with mortgage loans that it finds to be associated with unfairness or deception, abusive lending, or not otherwise in the interest of borrowers, whether or not the loans fall within the HOEPA rate and fee triggers. Most significantly, if the FRB were to use its HOEPA authority to implement new regulations, those regulations would apply to all lenders, whether banks or non-banks, that regularly make mortgage loans. In a request for comments on these issues published at 72 Fed. Reg. 30380 (May 31, 2007), the FRB asked commentators to address whether the identified practices should be prohibited for all mortgage loans, only for loans offered to subprime borrowers, or only for other subsets of loans such as loans to first-time homebuyers or certain products, such as ARMs or “nontraditional” mortgages.

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*This article is based on an expert commentary prepared by Robert M. Jaworski, Esq. for LexisNexis Matthew Bender and posted on lexis.com in the following location: Legal> Area of Law-By Topic> Real Estate> Emerging Issues. Portions of the expert commentary are reproduced with permission. ©2007 by Matthew Bender & Co., Inc., A Member of the LexisNexis Group. All rights reserved.*

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