



Regulatory Practice Letter

ADVISORY

RPL Number 07-05

Responsible Lending

Executive Summary

Responsible lending practices continue to be a focus of Federal bank, thrift and credit union regulatory agency guidance, government-sponsored enterprise announcements, and State and Federal legislative actions and discussions. Some of the most recently released guidance includes the:

- *Interagency Guidance on Nontraditional Mortgage Product Risks* ("Interagency Guidance") as jointly issued in final form by the Federal bank, thrift and credit union regulatory agencies (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision and the National Credit Union Administration – collectively, the "Agencies") on September 29, 2006.
- *Supervisory Policy on Predatory Lending*, as published by the Federal Deposit Insurance Corporation ("FDIC") on January 22, 2007 to address "abuses" in the subprime lending market over the past decade.
- February 27, 2007 announcement by Freddie Mac, a government sponsored enterprise, stating that it will cease to buy the 2/28 and 3/27 mortgage products that are not underwritten at the fully indexed and amortizing rate and/or lack sufficient documentation beginning September 1, 2007.
- March 5, 2007 statement by the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") fully endorsing the Interagency Guidance and encouraging a more coordinated effort among supervisory entities to monitor the residential mortgage industry.
- *Proposed Statement on Subprime Mortgage Lending*, as published by

Subject:

Responsible Lending Guidance

As Issued By:

**Board of Governors of the Federal Reserve System;
Office of the Comptroller of the Currency;
Federal Deposit Insurance Corporation;
Office of Thrift Supervision;
National Credit Union Administration**

Date:

April 1, 2007

the Agencies on March 8, 2007 with a request for comments due by May 7, 2007.

In addition, the Senate Committee on Banking, Housing and Urban Affairs conducted a hearing on subprime mortgage lending on March 22, 2007, to discuss with industry leaders and regulators their concerns regarding these mortgage products. A similar hearing was conducted in the House of Representatives Subcommittee on Financial Institutions and Consumer Credit on March 27, 2007.

Description

A detailed description of each of these recent guidance releases and statements follows.

Final Interagency Guidance on Nontraditional Mortgage Product Risks (9/29/2006):

The Interagency Guidance addresses the potential increased risks associated with nontraditional mortgage products such as "interest-only" mortgages, where the borrower pays no principal for the first few years of the loan, and "payment option" adjustable-rate mortgages ("ARMs"), which allow the borrower flexible payment options and have the potential for the accumulation of negative amortization. It also outlines how institutions can offer nontraditional mortgage products in a responsible, safe, and sound manner, and in a way that clearly identifies the risks that borrowers assume when accepting loans of this nature, with a focus on three primary areas: "Loan Terms and Underwriting Standards,"

"Portfolio and Risk Management Practices," and "Consumer Protection Issues."

FDIC's Supervisory Policy on Predatory Lending (1/22/2007): The FDIC recently published a *Supervisory Policy Statement on Predatory Lending* that describes the upward trend of "abuses" in the subprime lending market over the past decade. The Statement calls for more responsible lending to ensure the legitimacy of the subprime market and concludes with steps the agency is committed to take to combat abusive lending practices.

These actions are seen "through the examination process and supervisory actions; encouraging banks to serve all members and areas of their communities fairly; and providing information and financial education to help consumers make informed choices from the wide array of available financial services."

Freddie Mac Subprime Lending Standards (2/27/2007): In response to the guidance being offered by regulators to encourage responsible lending, Freddie Mac has announced that it will cease to buy 2/28 and 3/27 mortgage products that are not underwritten at the fully indexed and amortizing rate and/or lack sufficient documentation beginning September 1, 2007. Freddie Mac indicates that it is taking this position in an effort to encourage more responsible lending and lessen the likelihood of excessive payment shock and possible foreclosure. Freddie Mac will now offer

fixed-rate and hybrid ARM products with reduced adjustable rate margins; longer fixed-rate terms; and longer reset periods to give lenders more responsible choices to offer subprime borrowers.

Freddie Mac will also limit the use of low-documentation underwriting for these types of mortgages and will limit "Stated Income and Asset" products to borrowers whose incomes are not readily verifiable as part of its "reasonableness standard" for stated incomes. As part of its shift in underwriting standards, Freddie Mac has also made strong recommendations that loans be underwritten in a manner consistent with the prime market and include escrow for taxes and insurance, but has presently stopped short of a mandate to maintain escrow accounts as a purchase requirement.

Freddie Mac will also continue to promote its consumer education programs on subprime lending, including CreditSmart®, Don't Borrow Trouble, and other foreclosure prevention initiatives.

Proposed Statement on Subprime Mortgage Lending (3/8/2007): To further the discussion on responsible lending, the Agencies have released separate guidance with requests for comment on subprime mortgage products.

Unlike the Interagency Nontraditional Mortgage Guidance, the statement requests comment on certain product characteristics like the "2/28" and

"3/27" ARMs and expounds on the related risks. Additionally, the Agencies seek comment on more detailed specific lines of questioning.

Congressional Hearings on Nontraditional and Subprime Mortgage Lending (3/22/2007 and 3/27/2007):

The US Senate Committee on Banking, Housing and Urban Affairs conducted a hearing on March 22, 2007 entitled "*Mortgage Market Turmoil: Causes and Consequences*", which included congressional testimony relating to subprime mortgage lending and predatory lending. The Committee Chairman, Chris Dodd, stated that he was very interested in the Agencies' finalizing their Proposed *Statement on Subprime Mortgage Lending*. He also said that he was looking into some Congressional actions that might help the Agencies address concerns about predatory lending, as well as provide relief to borrowers. Witness testimonies generally noted that there was a difference between subprime and predatory lending and that there was a real need to accommodate the subprime market. In addition, it was noted that less than half of the subprime lending activity or the current market problems is occurring in Federally-regulated institutions.

A similar hearing was held in the House of Representatives on March 27, 2007. This hearing, conducted by the House Subcommittee on Financial Institutions and Consumer Credit was entitled, "*Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulatory*

Institutions." Testimonies provided in this session included suggestions for some type of national standards that would be applicable to all mortgage lenders, including non-banks, at the Federal and state levels.

KPMG Commentary

The practice of "responsible lending" continues to permeate across the financial services regulatory industry to include notions of consumer protection and awareness, fairness, transparency in disclosures and messaging, and safe and sound underwriting and service practices. *The Interagency Guidance on Nontraditional Mortgage Risk* serves as a baseline for risk management practices, and will likely continue to be expanded upon through Federal, State and industry banking announcements and actions.

Institutions should make every effort to ensure responsible lending practices throughout the course of a client experience - through marketing, underwriting and pricing, and servicing/collections. This includes a review of, and strengthening where appropriate, current lending policies and controls, including:

- Provision of consumer education;
- Marketing collateral and brochures;
- Product descriptions;
- Underwriting standards;
- Consumer disclosures (upfront and servicing);
- Servicing and collection practices;
- Complaint tracking;
- Fair lending monitoring;

- Third party controls; and
- Servicing/collection monitoring and stress-test modeling.

For additional information regarding responsible lending practices, or information related to the Agencies' releases, please contact Linda Gallagher: lgallagher@kpmg.com or Amy Matsuo: amatsuo.com.

FINANCIAL INDUSTRY REGULATORY PRACTICE LETTERS ISSUED IN 2007	
<p>RPL NUMBER 07-01 Subject: US Basel II and Basel IA Developments As Issued By: Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; Office of Thrift Supervision</p>	<p>RPL NUMBER 07-02 Subject: Joint Proposed Rules Implementing “Broker” Exceptions for Banks under the <i>Securities Exchange Act of 1934</i> As Issued By: Board of Governors of the Federal Reserve System; Securities and Exchange Commission</p>
<p>RPL NUMBER 07-03 Subject: New Interagency Policy Statement on the Allowance for Loan and Lease Losses As Issued By: Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; Office of Thrift Supervision; National Credit Union Administration</p>	<p>RPL NUMBER 07-04 Subject: Regulatory Assistance for the Hedge Fund Industry As Issued By: Securities and Exchange Commission</p>
<p>RPL NUMBER 07-05 Subject: Responsible Lending Guidance As Issued By: Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; Office of Thrift Supervision; National Credit Union Administration, Securities and Exchange Commission</p>	

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