DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
[Docket No. OCC-2007-0005]

FEDERAL RESERVE SYSTEM
[Docket No. OP-1278]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
[No. 2007-09]

NATIONAL CREDIT UNION ADMINISTRATION

Statement on Subprime Mortgage Lending

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA) (collectively, the Agencies).

ACTION: Final guidance – Statement on Subprime Mortgage Lending.

SUMMARY: The Agencies are issuing a final interagency Statement on Subprime Mortgage Lending. This guidance has been developed to clarify how institutions can offer certain adjustable rate mortgage (ARM) products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume.

EFFECTIVE DATE: [Insert date of publication in Federal Register].

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SUPPLEMENTARY INFORMATION:

I. Background

The Agencies developed this Statement on Subprime Mortgage Lending to address emerging risks associated with certain subprime mortgage products and lending practices. In particular, the Agencies are concerned about the growing use of ARM products[1] that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. The Agencies are concerned that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period. In addition, borrowers may not be adequately informed of product features and risks, including their responsibility to pay taxes and insurance, which might be separate from their mortgage payments.

These products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have more recently been offered to subprime borrowers as “credit repair” or “affordability” products. The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Agencies are also concerned that subprime borrowers may not fully understand the risks and consequences of obtaining this type of ARM loan. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

[1] For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

In response to these concerns, the Agencies published for comment the *Proposed Statement on Subprime Mortgage Lending* (proposed statement), 72 FR 10533 (March 8, 2007). The proposed statement provided guidance on the criteria and factors, including payment shock, that an institution should assess in determining a borrower's ability to repay the loan. The proposed statement also provided guidance intended to protect consumers from unfair, deceptive, and other predatory practices, and to ensure that consumers are provided with clear and balanced information about the risks and features of these loans. Finally, the proposed statement addressed the need for strong controls to adequately manage the risks associated with these products.

The Agencies requested comment on all aspects of the proposed statement, and specifically requested comment about whether: 1) these products always present inappropriate risks to institutions and consumers, or the extent to which they may be appropriate under some circumstances; 2) the proposed statement would unduly restrict the ability of existing subprime borrowers to refinance their loans, and whether other forms of credit are available that would not present the risk of payment shock; 3) the principles of the proposed statement should be applied beyond the subprime ARM market; and 4) limitations on the use of prepayment penalties would help meet borrower needs.

The Agencies collectively received 137 unique comments on the proposed statement. Comments were received from financial institutions, industry-related trade associations (industry groups), consumer and community groups, government officials, and members of the public.

II. Overview of Public Comments

The commenters were generally supportive of the Agencies' efforts to provide guidance in this area. However, many financial institution commenters expressed concern that certain aspects of the proposed statement were too prescriptive or could unduly restrict subprime borrowers' access to credit. Many consumer and community group commenters stated that the proposed statement did not go far enough in addressing their concerns about these products.

Financial institutions and industry groups stated that they supported prudent underwriting, but opposed a strict requirement that ARM loans subject to the proposed statement be underwritten at a fully indexed rate with a fully amortizing repayment schedule. They also stated that these loan products are not always inappropriate, particularly because they can be a useful credit repair vehicle or a means to establish a favorable credit history. Many of these commenters expressed concern that the proposed statement would unduly restrict credit to subprime borrowers. They also requested that the proposed statement be modified to allow lenders flexibility in helping existing subprime borrowers refinance out of ARM loans that will reset to a monthly payment that they cannot afford.

The majority of financial institutions and industry group commenters opposed the application of the proposed statement outside the subprime market. A number of these commenters requested clarification of the scope of the proposed statement and the definition of "subprime."

Some industry group commenters also expressed concern that consumer disclosure requirements would put federally-regulated institutions at a disadvantage and cause consumer information overload. They also requested that any changes to consumer disclosure requirements be part of a comprehensive reform of existing disclosure regulations.

Consumer and community group commenters generally supported the proposed statement. Many of these commenters expressed their concern that the products covered by the proposed statement present inappropriate risks for subprime borrowers. Many of these commenters supported extending the scope of the proposed statement to other mortgage products. These commenters supported the proposed underwriting criteria, though a number of them suggested stricter underwriting criteria. They also supported further limiting or prohibiting the use of reduced documentation and stated income loans, suggesting that such a reduction would be in the best interests of consumers.

Both industry group and consumer and community group commenters expressed concern that the proposed statement will not apply to all lenders. Industry group commenters indicated this would put federally-regulated financial institutions at a competitive disadvantage. Consumer and community group commenters encouraged the Agencies to continue to work with state regulators to extend the principles of the proposed statement to non-federally supervised institutions. Since the time that the Agencies announced the proposed statement, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued a press release confirming their intent to "develop a parallel statement for state supervisors to use with state-supervised entities."[2]

III. Agencies' Action on Final Joint Guidance

The Agencies are issuing the *Statement on Subprime Mortgage Lending* (Statement) with some changes to respond to the comments received and to provide additional clarity. The Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Significant comments on specific provisions of the proposed statement, the Agencies' responses, and changes to the proposed statement are discussed below.

Scope of Guidance

A number of financial institution and industry group commenters and two credit reporting companies requested that the definition of "subprime" be clarified. A financial institution and an industry group commenter requested a bright-line test to determine if a borrower falls into the subprime category.

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[2] Media Release, CSBS & AARMR, "CSBS and AARMR Support Interagency Statement on Subprime Lending" (March 2, 2007), available at http://www.csbs.org/AM/Template.cfm?Section=Search&template=/CM/HTMLDisplay.cfm&ContentID=10295.

The Agencies considered commenters' requests that a definition of "subprime" be included in the Statement. The Agencies determined, however, that the reference to the subprime borrower characteristics from the *2001 Expanded Guidance for Subprime Lending Programs* (Expanded Guidance) provides appropriate information for purposes of this Statement. The Expanded Guidance provides a range of credit risk characteristics that are associated with subprime borrowers, noting that the characteristics are illustrative and are not meant to define specific parameters for all subprime borrowers.[3] Because the term "subprime" is not consistently defined in the marketplace or among individual institutions, the Agencies believe that incorporating the subprime borrower credit risk characteristics from the Expanded Guidance provides sufficient clarity.

A number of commenters also requested clarification as to whether the proposed statement applies to all products with the features described. In addition, the Agencies specifically requested comment regarding whether the proposed statement's principles should be applied beyond the subprime ARM market. All consumer and community groups and some of the financial institutions who addressed this question supported application of the proposed statement beyond the subprime market. However, most financial institution and industry group commenters opposed application of the proposed statement beyond the subprime market. These commenters stated that the issues the proposed statement was designed to address are confined to the subprime market and expansion of the proposed statement to other markets would unnecessarily limit the options available to other borrowers.

As with the proposed statement, the Statement retains a focus on subprime borrowers, due to concern that these consumers may not fully understand the risks and consequences of these loans and may not have the financial capacity to deal with increased obligations. The Agencies did revise the language to indicate that the proposed statement applies to certain ARM products that have one or more characteristics that can cause payment shock, as defined in the proposed statement. While the Statement has retained its focus on subprime borrowers, the Agencies note that institutions generally should look to the principles of this Statement when such ARM products are offered to non-subprime borrowers.

Risk Management Practices

Predatory Lending Considerations

Some financial institution and industry group commenters raised concerns that the proposed statement implied that subprime lending is "per se" predatory. The Statement clarifies that subprime lending is not synonymous with predatory lending, and that there is no presumption that the loans to which the Statement applies are predatory.

Qualifying Standards

The proposed statement provided that subprime ARMs should be underwritten at the fully indexed rate with a fully amortizing repayment schedule. Many consumer and community groups supported the proposed statement's underwriting standards. Other consumer and community groups thought that the proposed qualifying standards did not go far enough, and

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[3] Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*.

suggested that these loans should be underwritten on the basis of the maximum possible monthly payment. The majority of industry group commenters who addressed this issue opposed the proposed underwriting standard as overly prescriptive. Some commenters also requested that the Statement define "fully indexed rate with a fully amortizing repayment schedule." All of the commenters that addressed the issue favored including a reasonable estimate of property taxes and insurance in an assessment of borrowers' debt-to-income ratios.

The Agencies continue to believe that institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the loan according to its terms. This analysis 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. Qualifying consumers based on a low introductory payment does not provide a realistic assessment of a borrower's ability to repay the loan according to its terms. Therefore, the proposed general guideline of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, remains unchanged in the final Statement. The Agencies did, however, provide additional information regarding the terms "fully indexed rate" and "fully amortizing payment schedule" to clarify expectations regarding how institutions should assess borrowers' repayment capacity.

Reduced Documentation or Stated Income Loans

Several commenters raised concerns about reduced documentation or stated income loans. The majority of commenters who addressed this issue supported the proposed statement's position that institutions should be able to readily document income for many borrowers and that reduced documentation should be accepted only if mitigating factors are present. A few financial institution and industry group commenters urged the Agencies to allow lenders some flexibility in deciding when these loans are appropriate for borrowers whose income is derived from sources that are difficult to verify. On the other hand, some consumer and community group commenters stated that borrowers are not always given the option to document income and thereby pay a lower interest rate. They also indicated that stated income loans may be a vehicle for fraud in that borrower income may be inflated to qualify for a loan.

The Agencies believe that verifying income is critical to conducting a credible analysis of borrowers' repayment capacity, particularly in connection with loans to subprime borrowers. Therefore, the final Statement provides that stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity. The Statement provides some examples of mitigating factors, and sets forth an expectation that reliance on mitigating factors should be documented. The Agencies note that for many borrowers, institutions should be able to readily document income using recent W-2 statements, pay stubs, and/or tax returns.

<u>Workout Arrangements</u>

The Agencies specifically requested comment on whether the proposed statement would unduly restrict the ability of existing subprime borrowers to refinance out of certain ARMs to avoid payment shock. The Agencies also asked about the availability to these borrowers of other mortgage products that do not present the risk of payment shock. The majority of financial institution and industry group commenters who responded to this specific question believed that the proposed statement would unduly restrict existing subprime borrowers' ability to refinance. However, most consumer and community groups who addressed the issue expressed the view that allowing existing borrowers to refinance into another unaffordable ARM was not an acceptable solution to the problem and, therefore, that eliminating this option would not be an undue restriction on credit. Some commenters mentioned that certain government sponsored entities and lenders have already committed to revise their lending program criteria and/or create new programs that potentially may provide alternative mortgage products for refinancing existing subprime loans.

To address these issues, the Agencies incorporated a section on workout arrangements in the final text that references the principles of the April 2007 interagency *Statement on Working with Borrowers*. The Agencies believe prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Consumer Protection Principles

Prepayment Penalties

The Agencies specifically requested comment regarding whether prepayment penalties should be limited to the initial fixed-rate period; how this practice, if adopted, would assist consumers and affect institutions; and whether an institution's providing a window of 90 days prior to the reset date to refinance without a prepayment penalty would help meet borrower needs. The overwhelming majority of commenters who addressed this question agreed that prepayment penalties should be limited to the initial fixed-rate period, and several commenters proposed a complete prohibition of prepayment penalties. Commenters suggested different time frames for expiration of the prepayment penalty period, ranging from 30 to 90 days prior to the reset date. Several industry group commenters, however, opposed such a limitation. They stated that prepayment fees are a legitimate means for lenders and investors to be compensated for origination costs when borrowers prepay prior to the interest rate reset. Further, these commenters noted that most lenders do not offer mortgage products that have prepayment penalty periods that extend beyond the fixed interest rate period and that borrowers should be allowed time to exit the loan prior to the reset date.

In light of the comments received, the Agencies revised the Statement to state that the period during which prepayment penalties apply should not exceed the initial reset period, and that institutions generally should provide borrowers with a reasonable period of time (typically, at least 60 days prior to the reset date) to refinance their loans without penalty. There is no supervisory expectation for institutions to waive contractual terms with regard to prepayment penalties on existing loans.[4]

Consumer Disclosure Issues

Many financial institution and industry group commenters suggested that the Agencies' consumer protection goals would be better accomplished through amendments to generally

[4] Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

applicable regulations, such as Regulation Z (Truth in Lending)[5] or Regulation X (Real Estate Settlement Procedures).[6] Some financial institution and consumer and community group commenters questioned the value of additional disclosures and expressed concern that the proposed statement would contribute to consumer information overload. A few commenters stated that the proposed statement would add burdensome new disclosure requirements and would result in the provision of confusing information to consumers.

Some industry group commenters asked the Agencies to provide uniform disclosures for these products, or to publish illustrations of the consumer information contemplated by the proposed statement similar to those previously proposed by the Agencies in connection with nontraditional mortgage products.[7] Several commenters also requested that any disclosures include the maximum possible monthly payment under the terms of the loan.

The Agencies have determined that, given the growth in the market for the products covered by the Statement and the heightened legal, compliance, and reputation risks associated with these products, guidelines are needed now to ensure that consumers will receive the information they need about the material features of these loans. In addition, while the Agencies are sensitive to commenters' concerns regarding disclosure burden, we do not anticipate that the information outlined in the Statement will result in additional lengthy disclosures. Rather, the Agencies contemplate that the information can be provided in a brief narrative format and through the use of examples based on hypothetical loan transactions. In response to requests by commenters, the Agencies are working on and expect to publish for comment proposed illustrations of the type of consumer information contemplated in the Statement.

The Agencies disagree with the commenters who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves. It is not the Agencies' intent to impose such a standard, nor is there any language in the Statement that does so.

Control Systems

While some commenters who addressed the control systems portion of the proposed statement supported the Agencies' proposal, some industry group commenters expressed concern that these provisions were neither realistic nor practical. A few industry group commenters requested clarification of the scope of a financial institution's responsibilities with regard to third parties. Some consumer and community group commenters requested uniform regulation of and increased enforcement against third parties.

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[5] 12 CFR Part 226 (2006).
[6] 24 CFR Part 3500 (2005).
[7] 71 FR 58673 (October 4, 2006).

The Agencies have carefully considered these comments, but have not revised this portion of the proposed statement. The Agencies do not expect institutions to assume an unwarranted level of responsibility for the actions of third parties. Moreover, the control systems discussed in the Statement are consistent with the Agencies' current supervisory authority and policies.

Supervisory Review

The Agencies received no comments on the supervisory review portion of the proposed statement. However, minor changes have been made to clarify the circumstances under which the Agencies will take action against institutions in connection with the products addressed in the Statement.

IV. Text of Final Joint Guidance

The final interagency Statement on Subprime Mortgage Lending appears below.

Statement on Subprime Mortgage Lending

The Agencies[1] developed this Statement on Subprime Mortgage Lending (Subprime Statement) to address emerging issues and questions relating to certain subprime[2] mortgage lending practices. The Agencies are concerned borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.[3] In particular, the Agencies are concerned with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;[4]

- Very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") on reset dates;

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[1] The Agencies consist of the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

[2] The term "subprime" is described in the 2001 *Expanded Guidance for Subprime Lending Programs*. Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*.

[3] Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

[4] For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

- Limited or no documentation of borrowers' income;

- Product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or

- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could include: being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to lenders may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

The Agencies note that many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 *Interagency Guidelines for Real Estate Lending* (*Real Estate Guidelines*), the 1999 *Interagency Guidance on Subprime Lending*, and the 2001 *Expanded Guidance for Subprime Lending Programs* (*Expanded Subprime Guidance*).[5]

While the 2006 *Interagency Guidance on Nontraditional Mortgage Product Risks* (*NTM Guidance*) may not explicitly pertain to products with the characteristics addressed in this Statement, it outlines prudent underwriting and consumer protection principles that institutions also should consider with regard to subprime mortgage lending. This Statement reiterates many of the principles addressed in existing guidance relating to prudent risk management practices and consumer protection laws.[6]

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[5] Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*. National banks also should refer to 12 CFR 34.3(b) and (c), as well as 12 CFR part 30, Appendix C.

[6] As with the *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006), this Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Risk Management Practices

Predatory Lending Considerations

Subprime lending is not synonymous with predatory lending, and loans with the features described above are not necessarily predatory in nature. However, institutions should ensure that they do not engage in the types of predatory lending practices discussed in the *Expanded Subprime Guidance*.[7] Typically, predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the 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 ("loan flipping"); 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 offering mortgage loans such as these face an elevated risk that their conduct will violate Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.[8]

Underwriting Standards

Institutions should refer to the *Real Estate Guidelines*, which provide underwriting standards for all real estate loans.[9] The *Real Estate Guidelines* state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to

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[7] Federal credit unions should refer to 12 CFR 740.2 and 12 CFR 706 for information on prohibited practices.

[8] The OCC, the Board, the OTS, and the FDIC enforce this provision under section 8 of the Federal Deposit Insurance Act. The OCC, Board, and FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002–3—*Guidance on Unfair or Deceptive Acts or Practices*, March 22, 2002, and 12 CFR part 30, Appendix C; Joint Board and FDIC *Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks*, March 11, 2004. The OTS also has issued a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered (12 CFR 563.27). The NCUA prohibits federally insured credit unions from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition (12 CFR 740.2).

[9] Refer to 12 CFR part 34, subpart D (OCC); 12 CFR Part 208, subpart C (Board); 12 CFR part 365 (FDIC); 12 CFR §§ 560.100 and 560.101 (OTS); and 12 CFR 701.21 (NCUA).

adequately service the debt.[10] The 2006 *NTM Guidance* details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate,[11] assuming a fully amortizing repayment schedule.[12]

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (*e.g.*, principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, institutions should verify and document the borrower's income (both source and amount), assets and liabilities. Stated income and reduced documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can

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[10] OTS Examination Handbook Section 212, *1-4 Family Residential Mortgage Lending*, also discusses borrower qualification standards. Federally insured credit unions should refer to LCU 04-CU-13- *Specialized Lending Activities.*

[11] The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

[12] The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

Workout Arrangements

As discussed in the April 2007 interagency *Statement on Working with Borrowers*, the Agencies encourage financial institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Financial institutions should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.[13] Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The Agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower's ability to repay the loan according to its terms; and

- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

[13] Institutions may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial reset period. In general, borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without penalty.[14]

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.[15] Therefore, mortgage product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of:

- *Payment Shock*. Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.[16]

- *Prepayment Penalties*. The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.[17]

- *Balloon Payments*. The existence of any balloon payment.

- *Cost of Reduced Documentation Loans*. Whether there is a pricing premium attached to a reduced documentation or stated income loan program.

- *Responsibility for Taxes and Insurance*. The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

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[14] Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

[15] Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

[16] To illustrate: a borrower earning $42,000 per year obtains a $200,000 "2/28" mortgage loan. The loan's two-year introductory fixed interest rate of 7% requires a principal and interest payment of $1,331. Escrowing $200 per month for taxes and insurance results in a total monthly payment of $1,531 ($1,331 + $200), representing a 44% DTI ratio. A fully indexed interest rate of 11.5% (based on a six-month LIBOR index rate of 5.5% plus a 6% margin) would cause the borrower's principal and interest payment to increase to $1,956. The adjusted total monthly payment of $2,156 ($1,956 + $200 for taxes and insurance) represents a 41% increase in the payment amount and results in a 62% DTI ratio.

[17] See footnote 14.

Control Systems

Institutions should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

Supervisory Review

The Agencies will continue to carefully review risk management and consumer compliance processes, policies, and procedures. The Agencies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED "STATEMENT ON SUBPRIME MORTGAGE LENDING"]

Dated: June 28, 2007

John C. Dugan (signed)
John C. Dugan,
Comptroller of the Currency

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED "STATEMENT ON SUBPRIME MORTGAGE LENDING"]

By order of the Board of Governors of the Federal Reserve System, June 28, 2007.

Jennifer J. Johnson (signed)
Jennifer J. Johnson
Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT ON SUBPRIME MORTGAGE LENDING”]

Dated at Washington, D.C., the 27th day of June, 2007

By order of the Federal Deposit Insurance Corporation

Robert E. Feldman (signed)
Robert E. Feldman,
Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED "STATEMENT ON SUBPRIME MORTGAGE LENDING"]

Dated: June 28, 2007
By the Office of Thrift Supervision

John Reich (signed)
John Reich,
Director

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED "STATEMENT ON SUBPRIME MORTGAGE LENDING"]

Dated: June 28, 2007
By the National Credit Union Administration

JoAnn M. Johnson (signed)
JoAnn M. Johnson,
Chairman