



OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Guidelines for National Banks to Guard Against
Predatory and Abusive Lending Practices

TO: Chief Executive Officers of All National Banks and National Bank Operating
Subsidiaries, Department and Division Heads, and All Examining Personnel

INTRODUCTORY STATEMENT

The Office of the Comptroller of the Currency (OCC) has received inquiries as to whether state laws and local initiatives addressing certain types of abusive lending practices can apply to national banks under the principles of federal preemption that have been articulated by the federal courts. Inquiries have also been made about the standards of conduct that the OCC expects national banks to observe in this area.

Because these inquiries raise issues of broad public interest, the OCC believes it appropriate to set forth in this advisory letter supervisory guidance concerning lending practices that have been criticized as “predatory” or “abusive.” Such practices are inconsistent with important national objectives, including the goals of fair access to credit, community development, and stable homeownership by the broadest spectrum of America. Any lending practices that take unfair advantage of borrowers, or that have a detrimental impact on communities, also conflict with the high standards expected of national banks.

Many abusive lending practices are already unlawful under existing federal laws and regulations.¹ But even where the particular attributes of a loan are not subject to a specific prohibition, loans reflecting abusive practices nevertheless can involve unfair and deceptive conduct and present significant safety and soundness, reputation, and other risks to national banks.²

Although the OCC does not have reason to believe that national banks or their operating subsidiaries (collectively referred to herein as “national banks”) generally are engaged in

¹ See, e.g., Home Ownership and Equity Protection Act, 15 USC 1639.

² See, e.g., OCC Advisory Letter 2002-3, “Guidance on Unfair or Deceptive Acts or Practices” (March 22, 2002); OCC Bulletin 2001-47, “Third Party Relationships,” (November 1, 2001); OCC Bulletin 2001-6, “Expanded Guidance for Subprime Lending Programs” (January 31, 2001); OCC Advisory Letter 2000-11, “Title Loan Programs” (November 27, 2000); and OCC Advisory Letter 2000-10, “Payday Lending” (November 27, 2000).

predatory lending practices, it expects that national banks will take appropriate steps to ensure that they do not become involved in predatory lending.³

This guidance provides examples of practices that may be abusive, and provides advice on how national banks should avoid engaging in such practices.

The advisory also describes how certain abusive lending can involve unfair or deceptive practices and thus violate section 5 of the Federal Trade Commission Act (FTC Act).⁴ The OCC will review credible evidence that a national bank has engaged in abusive lending practices and, where such practices are found to violate an applicable law or safety and soundness standards, will take appropriate supervisory action.

BACKGROUND

The terms “abusive lending” or “predatory lending” are most frequently defined by reference to a variety of lending practices.⁵ Although it is generally necessary to consider the totality of the circumstances to assess whether a loan is predatory, a fundamental characteristic of predatory lending is the aggressive marketing of credit to prospective borrowers who simply cannot afford the credit on the terms being offered. Typically, such credit is underwritten predominantly on the basis of the liquidation value of the collateral, without regard to the borrower’s ability to service and repay the loan according to its terms absent resorting to that collateral. This abusive practice leads to “equity stripping.” When a loan has been made based on the foreclosure value of the collateral, rather than on a determination that the borrower has the capacity to make the scheduled payments under the terms of the loan, based on the borrower’s current and expected income, current obligations, employment status, and other relevant financial resources, the lender is effectively counting on its ability to seize the borrower’s equity in the collateral to satisfy the obligation and to recover the typically high fees associated with such credit. Not surprisingly, such credits experience foreclosure rates higher than the norm.

While such disregard of basic principles of loan underwriting lies at the heart of predatory lending, a variety of other practices may also accompany the marketing of such credit:

- Loan “flipping” – frequent refinancings that result in little or no economic benefit to the borrower and are undertaken with the primary or sole objective of generating additional loan fees, prepayment penalties, and fees from the financing of credit-related products;
- Refinancings of special subsidized mortgages that result in the loss of beneficial loan terms;
- “Packing” of excessive and sometimes “hidden” fees in the amount financed;
- Using loan terms or structures – such as negative amortization – to make it more difficult or impossible for borrowers to reduce or repay their indebtedness;
- Using balloon payments to conceal the true burden of the financing and to force borrowers into costly refinancing transactions or foreclosures;

³ National banks and their subsidiaries face significant risks of indirectly and inadvertently facilitating predatory lending practices through the use of third-party loan brokers and in connection with loan purchases. Therefore, the OCC has also issued guidance stating its expectation that national banks will establish appropriate due diligence and monitoring procedures adequate to address such risks. See OCC Advisory Letter 2003-3, “Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans” (February 21, 2003).

⁴ 15 USC 45(a)(1).

⁵ See, e.g., OCC Advisory Letter 2000-7, “Abusive Lending Practices” (July 25, 2000).

- Targeting inappropriate or excessively expensive credit products to older borrowers,⁶ to persons who are not financially sophisticated or who may be otherwise vulnerable to abusive practices, and to persons who could qualify for mainstream credit products and terms;
- Inadequate disclosure of the true costs, risks and, where necessary, appropriateness to the borrower of loan transactions;
- The offering of single premium credit life insurance; and
- The use of mandatory arbitration clauses.

LEGAL AND SUPERVISORY RISKS ASSOCIATED WITH ABUSIVE LENDING PRACTICES

Safety and Soundness Concerns

As noted above, a departure from fundamental principles of loan underwriting generally forms the basis of abusive lending: lending without a determination that a borrower can reasonably be expected to repay the loan from resources other than the collateral securing the loan, and relying instead on the foreclosure value of the borrower's collateral to recover principal, interest, and fees. A national bank that makes a loan to a consumer based predominantly on the liquidation value of the borrower's collateral, rather than on a determination of the borrower's repayment ability, including current and expected income, current obligations, employment status, and other relevant financial resources, is engaging in a fundamentally unsafe and unsound banking practice that is inconsistent with established lending standards.⁷ This practice not only increases the risk to the bank that the loan will default but may also increase the bank's potential loss exposure upon default.

Safety and soundness concerns can also arise when a bank's lending practices effectively foreclose access to a secondary market. Major government-sponsored enterprises (GSEs) active in the secondary market for mortgage loans have taken a number of affirmative steps to reduce the possibility that they will purchase abusive loans.⁸ These steps include a refusal to purchase mortgage loans:

- In which the lender has not adequately determined the borrower's ability to repay the debt;
- Subject to the Home Ownership and Equity Protection Act (HOEPA);⁹
- With points and fees in excess of 5 percent of the loan amount, except in cases where a higher amount of fees was justified to prevent the loan from being unprofitable; and
- In which a prepaid single premium credit insurance policy was included in the amount financed.

These GSEs also restrict the use of prepayment penalties. In addition, these entities require monthly borrower payments on loans they have purchased to be reported to the major credit-

⁶ See AARP "Subprime Mortgage Lending and Older Americans," (March 2001) (predatory lending practices often are targeted at older homeowners), available at [http://www.research.aarp.org/consume/dd57_lending.html].

⁷ See 12 CFR 30, Appendix A. See also 12 CFR 34, D, Appendix A.

⁸ See, e.g., Freddie Mac "Protecting Borrowers from Predatory Lending Practices," (1997; revised 2003), available at [http://www.freddiemac.com/corporate/affordhouse/predlend/apl_fact.html]; Fannie Mae, "Fannie Mae Chairman Announces New Loan Guidelines to Combat Predatory Lending Practices," News Release (April 11, 2000), available at [<http://www.fanniemae.com/newsreleases/2000/0710.jhtml>]. These secondary market guidelines can serve as a useful guide for national banks in developing their own lending policies.

⁹ HOEPA loans are closed-end loans secured by a consumer's principal dwelling, other than a reverse mortgage or a loan to finance the acquisition or initial construction of the home, that are high-cost because they exceed specified statutory and regulatory interest-rate or fee thresholds. Such loans are subject to specific disclosure requirements and substantive restrictions in federal law. See 15 USC 1602(aa)(1) and 12 CFR 226.32.

reporting bureaus. National banks and their operating subsidiaries whose business practices are inconsistent with these guidelines, therefore, run the risk of losing an important source of funding for their operations, and of thereby exposing themselves to greater default risk and risk of loss.

Violations of the FTC Act

National banks are subject to section 5 of the FTC Act, which makes unlawful “unfair or deceptive acts or practices” in commerce.¹⁰ The OCC has the authority to enforce section 5 with respect to national banks and to impose sanctions for violations in individual cases.¹¹ Such practices as loan flipping, equity stripping, and the refinancing of special subsidized mortgage loans may be indicative of unfair or deceptive practices that violate section 5 of the FTC Act. The OCC believes that application of the standards of section 5 and use of the OCC’s authority to enforce compliance with those standards in individual cases is a particularly appropriate approach to ensure that abusive lending practices are not occurring in the national banking system.

While such determinations are inherently fact-specific, the OCC has issued detailed guidance on the standards it will generally employ in determining whether an act or practice is unfair or deceptive under the FTC Act.¹² Practices may be found to be *deceptive* and, therefore, unlawful under section 5 of the FTC Act if each of the following factors are present:

- First, there is a representation, omission, act, or practice that is likely to mislead;
- Second, the act or practice would be likely to mislead a reasonable consumer (*a reasonable member of the group targeted by the acts or practices in question*); and
- Third, the representation, omission, act, or practice is likely to mislead in a material way.

A practice may be found to be *unfair* and, therefore, unlawful under section 5 of the FTC Act if each of the following factors are present:

- First, the practice causes substantial consumer injury, such as monetary harm;
- Second, the injury is not outweighed by benefits to the consumer or to competition; and
- Third, the injury caused by the practice is one that consumers could not reasonably have avoided.

Loan “Flipping” and the Refinancing of Special Subsidized Mortgages as Unfair or Deceptive Practices Under the FTC Act

Loan “flipping” is generally understood to mean the repeated refinancing of a loan under circumstances that result in little or no economic benefit to the borrower, with the objective of generating additional loan points, loan fees, prepayment penalties, and fees from financing the

¹⁰ 15 USC 45(a)(1).

¹¹ Congress gave the OCC broad powers to compel national banks to comply with any “law, rule, or regulation.” 12 USC 1818(b)(1). This includes the ability to issue cease and desist orders when the OCC determines that a national bank is violating or has violated section 5 of the FTC Act. The other federal banking agencies have comparable authority to enforce section 5 of the FTC Act with respect to the banks they regulate. See, e.g., FDIC Financial Institution Letter, FIL 57-2002 (May 30, 2002), available at [<http://www.fdic.gov/news/news/financial/2002/fil0257.html>]. See also Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System to Rep. John J. LaFalce (May 30, 2002), available at [<http://www.federalreserve.gov/boarddocs/press/bcreg/2002/2002530/attachment.pdf>].

¹² See OCC Advisory Letter 2002-3, “Guidance on Unfair or Deceptive Acts or Practices” (March 22, 2002).

sale of credit-related products. In addition, the practice is frequently targeted to consumers with limited financial options. Ascertaining whether a lender has engaged in loan “flipping” is a highly fact-specific determination, but the practice generally involves sequential refinancing transactions where, among other things, there is *little or no economic benefit to the borrower*. Therefore, “flipping” should be thought of as a limited, discrete subset of refinancing transactions. Depending upon the totality of the circumstances, loan flipping may be an unfair or deceptive practice in violation of the FTC Act. The OCC will take supervisory action as appropriate to address such violations.

For example, loan flipping may constitute an *unfair* practice under the FTC Act. The practice can result in substantial borrower injury resulting from the substantial fees imposed and from the fact that the transaction may increase debt burdens, decrease home equity, enhance the likelihood of foreclosure, and adversely affect the borrower’s credit history.¹³ In addition, loan flipping fails to generate benefits to the consumer that would outweigh this harm. The benefits to competition from this practice – such as lower consumer costs – also seem to be lacking. The harm from loan flipping also may not be “reasonably avoidable,” for example, if the costs, terms, and risks have not been described in a way that the consumer can reasonably be expected to understand and be able to act upon.¹⁴ As a general matter, many terms or practices associated with loan flipping carry risks that the borrower cannot reasonably be expected to appreciate in the absence of clear and understandable explanatory information.

Even a single refinancing transaction can be abusive and unfair or deceptive, such as in cases involving the refinancing of a special subsidized mortgage. These mortgages, often originated under programs sponsored by governmental or nonprofit organizations, generally contain below-market interest rates or other nonstandard terms beneficial to the borrower. The refinancing of such loans generally entails the loss of one or more of the beneficial loan terms, and thus, carries a particularly high risk of being detrimental to the borrower.

“Equity Stripping” as an Unfair or Deceptive Practice Under the FTC Act

“Equity stripping” is identified as a predatory lending practice because it is associated with significant harm to consumers, including an increase in debt burdens and the loss of home equity with little or no compensating benefit to the borrower. Home equity stripping typically involves making loans with excessively high, up-front fees that are financed and secured by the borrower’s home, often with an excessively high penalty upon prepayment of the loan, for the sole or primary objective of stripping the borrower’s home equity. It can also result from loan flipping, and from the practice of making a loan predominantly on the basis of the liquidation value of the collateral, without regard to the borrower’s ability to service and repay the loan according to its terms absent resort to that collateral. Whether a bank has engaged in “equity stripping” also is a highly fact-specific determination involving a finding of consumer abuse. It is to be distinguished from transactions in which home equity decreases may be an integral part of an informed consumer’s purpose for entering into the transaction.¹⁵ Depending upon the totality of the circumstances, equity stripping may be an unfair or deceptive practice in violation

¹³ In addition, there may be balloon payments in the new loan that may force another refinancing involving additional fees that will add to the ultimate cost of the credit, decrease home equity, and increase both the debt burden and the likelihood of foreclosure.

¹⁴ A review of such information also will be relevant to a determination of whether the transaction also involved *deception* under the FTC Act.

¹⁵ For example, some consumers may take out a home equity loan to finance improvements that will enhance the home’s value, or to finance other expenditures such as college tuition. Borrowers also may knowingly accept terms that risk the depletion of equity, such as prepayment penalties, in exchange for countervailing economic benefits such as a lower interest rate.

of the FTC Act. The OCC will take supervisory action as appropriate to address such violations involving equity stripping.

For example, equity stripping may constitute an *unfair* practice under the FTC Act. Equity-stripping practices will almost always involve substantial consumer injury. Such practices decrease the borrower's wealth, either immediately or over time, and can cause the borrower to lose his or her home. In addition, equity stripping will almost always fail to generate benefits to the consumer or to competition that would outweigh these substantial consumer harms. As with loan flipping, whether the practice was reasonably avoidable by a consumer would depend on the specific facts and circumstances of the transaction and entail a review of the adequacy of information provided to the consumer.¹⁶ This review would include an examination of whether and how the borrower was informed about particular terms or practices associated with equity stripping that carry risks the borrower cannot reasonably be expected to appreciate in the absence of clear and understandable explanatory information. Without adequate information about the effect of these terms and practices, a borrower may not be reasonably able to avoid the injury that may ensue from them.

Violations of Other Applicable Laws

Predatory lending practices also may violate other laws, such as HOEPA, which covers certain high-cost mortgage loans. Among other things, HOEPA prohibits negative amortization, increases in the interest rate upon default, and balloon payments for covered loans with a term of less than five years. It also restricts the use of prepayment penalties and due-on-demand clauses in covered loans.¹⁷ HOEPA also prohibits the refinancing of a covered loan to another covered loan in the first year of the loan, unless the refinancing is in the borrower's interest. In addition, HOEPA prohibits lenders from engaging in a pattern or practice of making covered loans based on the borrower's collateral without regard to the borrower's ability to repay, including the borrower's current and expected income, current obligations, and employment.¹⁸

Moreover, certain predatory lending practices involve unlawful discrimination. If a national bank engages in the practice of "steering" a borrower to a loan with higher costs rather than to a comparable loan offered by the bank with lower costs for which the borrower could qualify, and does this on the basis of the borrower's race, national origin, age, or gender, for example, the OCC will take appropriate enforcement action under the federal fair lending laws.¹⁹

Impact of Certain Abusive Lending Practices on CRA Evaluations and Ratings

Because Community Reinvestment Act (CRA) performance must be considered in connection with various applications for deposit facilities, including branch applications and bank merger transactions, predatory lending also may impede a bank's strategic plans to expand its operations or to combine with another organization. Under the CRA regulations, abusive lending practices that violate the federal fair lending laws, the FTC Act, or HOEPA, or that evidence other illegal

¹⁶ This review also will be relevant to a determination of whether the transaction involved *deception* under the FTC Act.

¹⁷ See 12 CFR 226.32.

¹⁸ See 12 CFR 226.34.

¹⁹ See 15 USC 1691; 42 USC 3601 *et seq.* Some government studies, for example, have concluded that certain abusive lending practices have been targeted to, and harm, low-income and predominantly minority neighborhoods and the elderly. See U.S. Department of Treasury and U.S. Department of Housing and Urban Development, "Curbing Predatory Home Mortgage Lending: A Joint Report" (June 2000), available at [<http://www.treas.gov/press/releases/reports/treasrpt.pdf>].

credit practices, adversely affect an institution's CRA performance.²⁰ When such conduct comes to the attention of the OCC, it will be taken into account in the OCC's evaluation of the bank's CRA performance.

Furthermore, a national bank that engages in a pattern or practice of extending credit based predominantly on the liquidation value of the collateral, or otherwise without regard to the borrower's ability to service and repay the loan — in addition to violating HOEPA in some circumstances — is not helping to meet the credit needs of the community consistent with safe and sound operations, and has acted contrary to the OCC's safety and soundness regulatory guidelines.²¹ Such an activity or practice also may adversely affect the OCC's evaluation of the bank's CRA performance.

RECOMMENDATIONS FOR AVOIDING PREDATORY AND ABUSIVE LENDING PRACTICES

In order to safeguard the interests of the bank and its customers, national banks are advised to have policies and procedures in place to prevent the bank and any of its subsidiaries from engaging in practices that might be considered predatory or abusive. Such policies and procedures should be fashioned to ensure that the bank's lending complies with applicable safety and soundness standards and consumer protection laws.

Establishment of Policies and Procedures

Underwriting policies

As noted above, when a loan has been made based on the foreclosure value of the collateral rather than on a determination that the borrower has the capacity to service and repay the loan without resort to the collateral, the lender is effectively counting on its ability to seize the borrower's collateral and use the borrower's equity in the collateral to satisfy the obligation, and is thus engaging in an unsafe and unsound banking practice.

National banks are advised to adopt policies and procedures to ensure that an appropriate determination has been made that the borrower has the capacity to make scheduled payments to service and repay the loan, including principal, interest, insurance, and taxes,²² based on a consideration of the borrower's:

- Current and expected income;
- Other relevant financial resources;
- Employment status; and
- Financial obligations, including other indebtedness.²³

²⁰ See 12 CFR 25.28(c). See also Interagency Questions and Answers Regarding Community Reinvestment, Q&A .28(c)-1, 66 Fed. Reg. 36620, 36640 (July 12, 2001).

²¹ See 12 CFR 30, Appendix A.

²² OCC safety and soundness regulatory guidelines require a national bank to "establish and maintain loan documentation practices that . . . [i]dentify the . . . source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner." 12 CFR 30, Appendix A.

²³ In addition, as appropriate, policies should address the use of multiple borrowers to satisfy debt-service coverage ratios to protect against reliance on the income of third-party guarantors or other obligors whose relationship to the borrower or to the collateral suggests that they may not, in fact, be relied upon to repay the loan as structured, if necessary, to prevent default or foreclosure.

Such policies also should address debt-to-income and loan-to-value ratios, as necessary to mitigate the risk of lending without regard to ability to repay.

Policies addressing risk of abusive practices

National banks should also consider articulating clear policies and procedures to specify, if applicable, whether and under what circumstances the bank will make loans involving features or circumstances that have been associated with abusive lending practices, including the following:

- Frequent, sequential refinancings;
- Refinancings of special subsidized mortgages that contain terms favorable to the borrower;
- Single-premium credit life insurance or similar products;
- Negative amortization;
- Balloon payments in short-term transactions;
- Prepayment penalties that are not limited to the early years of a loan;
- Financing points, fees, penalties, and other charges;
- Interest rate increases upon default;
- Mandatory arbitration clauses; and
- Making loans subject to HOEPA.²⁴

As noted above, transactions involving these features may be appropriate in many circumstances and may contribute to legitimate business objectives. However, to avoid the risk that a transaction could be deemed to involve unfair or deceptive practices, a primary objective of such policies and procedures should be to prevent customer misunderstanding of the terms and relative costs, risks, and benefits of their loan transaction. Borrowers should be provided with the information that is sufficient to draw the borrower's attention to these key terms, and to enable them to determine whether the loan meets their particular financial circumstances and needs. National banks also should have policies to help ensure that interest rates and other pricing terms for their loans reasonably reflect the costs and risks of making such loans and are consistent with OCC regulations.²⁵ Furthermore, to promote credit access where borrowers demonstrate a good record of performance in handling credit, national banks are encouraged to adopt policies and procedures that provide for reporting of good credit histories to the major credit reporting bureaus.

Policies concerning appropriateness of certain transactions

In addition, as noted above, some practices may be unfair or deceptive, and abusive, depending upon the consumers that are affected or that are the target audience. Therefore, bank policies may need to specifically address such circumstances. The bank may face significant risks when it offers to borrowers who are elderly, vulnerable, or not financially sophisticated, loan products that contain features that have been associated with abusive lending. Thus, banks are advised to adopt policies and procedures that ensure that lending practices reflect the degree of care that is appropriate to the risk, considering such factors as:

- The sophistication or expertise of the borrower in credit transactions, if known or apparent;
- The need for, and proposed use of, the loan proceeds, if known or stated;
- The borrower's understanding of how the loan meets the borrower's particular financial circumstances and needs; and

²⁴ See footnote 8.

²⁵ See 12 CFR 7.4002.

- The bank's assessment of the terms and conditions of the loan relative to those needs.

Loan Quality Control Reviews and Corrective Action

As a general matter, banks should periodically perform a documentation review on a random sampling of transactions to ensure that transactions comply with bank policies and legal requirements. In addition, in appropriate circumstances, such as when a particular risk has been identified, banks should conduct a more comprehensive review. For example, documentation reviews may indicate problems involving potential fraud or abuse such as significant and unexplained variations between the preliminary disclosures required to be provided to customers under the Truth in Lending Act or the Real Estate Settlement Procedures Act and the final charges appearing on closing documents; fees that appear to be duplicative or unearned; or evidence of materially misleading statements or omissions with respect to the costs, benefits, risks, and burdens of the transaction. In such circumstances, the bank should take all steps appropriate, including corrective action, to address the deficiencies and to address any borrower injury.

CONCLUSION

The OCC encourages national banks to adopt policies and procedures to address, and in practice to avoid, engaging in loan practices that may be abusive, unfair, or deceptive – practices that raise legal risks and serious supervisory concerns and that, if not remedied, could result in supervisory action, injury to the bank's reputation, and financial loss.

For further information concerning the matters discussed in this advisory letter, please contact the Community and Consumer Law Division at (202) 874-5750, the Compliance Division at (202) 874-4428, or the appropriate supervisory office.

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