

RESCINDED

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Department of the Treasury

Regulatory Bulletin

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Handbook: **Thrift Activities**

Subject: **Asset Quality**

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



Section: 217

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides an update to Thrift Activities Regulatory Handbook Section 217, Consumer Lending. Please replace the existing handbook section with the enclosed revised section.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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SUMMARY OF CHANGES

OTS is issuing an update to the following Thrift Activities Handbook Section. Change bars in the margins indicate revisions. We provide a summary of all substantive changes below. This handbook section is in plain language to comply with the President's June 1, 1998, memorandum "Plain Language in Government Writing."

217 Consumer Lending

Introduction: Expands discussion of consumer credit.

Regulatory Considerations: Adds discussion of HOLA provisions. Adds language stressing the importance of the board ensuring that the institution adequately controls the risks associated with consumer lending.

Portfolio Characteristics: Adds subheadings for Secured versus Unsecured; Open-end versus Closed-end Loans; and Direct versus Indirect.

Organizational Structure: Stresses the importance of staff expertise in the consumer lending area.

Classification: Adds new section regarding the Interagency Uniform Retail Credit Classification and Account Management Policy.

Debt Cancellation Contracts: This new section discusses the December 18, 1995 OTS-OGC Debt Cancellation Contracts opinion.

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Housing-Related Consumer Loans: Adds discussion of HOLA authority regarding housing-related loans that may or may not be secured by real estate, such as mobile home loans or unsecured home improvement loans. Adds discussion on the application of the real estate lending standards on high loan-to-value loans.

Direct Auto Loans: Includes discussion of file documentation.

Other Secured Loans: Adds guidance that relates to other secured consumer loans, including loans secured by aircraft, boats, and recreational vehicles.

Unsecured Consumer Lending: Revises previous discussion of Unsecured Loans.

Education Loans: Adds subheading and discusses HOLA authority.

Time Share Loans: Adds subheading and explains “ownership” of time shares, including an example.

Subprime Lending: Adds new section.

Business Loans: Adds a new section that addresses underwriting and review aspects examiners should consider in the assessment of a institution’s consumer lending program.

Credit Scoring: Adds new section and a cross reference to a future section on credit scoring.

Laws and Regulations Affecting Consumer Loans: Streamlines and moves to end of handbook section.

References: Updates CFR references with respect to final Lending and Investment regulation.

Procedures: Number 2 refers to Handbook Section 201, Lending Overview, a new section we will issue in the near future. Adds new procedures Nos. 5, 6, 11 through 14, 21 and 23. Splits former No. 16 into new procedures Nos. 22 and 24. Omits former No. 18.

Questionnaire: Adds new questions 12 and 20 through 22.

Appendix A: Adds interagency policy statement on Subprime Lending.

Appendix B: Adds additional procedures for examining institutions engaged in subprime lending.



—Scott M. Albinson

Managing Director, Supervision

INTRODUCTION

OTS defines consumer credit as credit extended to individuals for personal, family, or household purposes. Consumer credit includes the financing or refinancing of:

- automobiles
- mobile homes
- boats
- personal use aircraft
- other recreational vehicles
- furniture and appliances
- other consumer durable goods.

Consumer credit also includes loans for other personal financial needs, including the granting of overdraft lines of credit and the purchase of consumer loan accounts from retailers or other lenders.

Savings associations also grant home improvement and home equity loans for consumer purposes. Because these are typically large-dollar, long-term loans secured by real estate, OTS classifies them as real estate loans.

Some institutions may also originate small-dollar, business-purpose installment loans based on the credit capacity of the borrower rather than an in-depth analysis of the business. These loans are sometimes underwritten and processed in the same department with the consumer loans, so therefore, may be part of the consumer loan review during examinations. However, for purposes of determining a thrift's investment limits under the Home Owners' Loan Act (HOLA) Section 1464, Part 5(c), the thrift must categorize these small-dollar, business purpose installment loans as business loans. To assess the borrower's total liability to the thrift, aggregate these small-dollar, business purpose installment loans with any other commercial loans to the same borrower.

REGULATORY CONSIDERATIONS

HOLA limits a federal savings association's investment in consumer loans to 35 percent of assets when aggregated with the institution's commercial paper and corporate debt securities. The institution may only invest amounts in excess of 30 percent of assets in loans made directly by the institution.

For the purpose of determining compliance with the lending and investment limitations under HOLA, a federal association does not have to aggregate its consumer loans with education loans, home improvement loans (even when made without real estate security), deposit account loans, and credit card loans or extensions of credit made in conjunction with credit cards.¹ HOLA provides a separate authority and investment limit for each of those loan types.

OTS's lending and investment rule (12 CFR Part 560) requires each savings association to conduct its lending activities prudently and use lending standards that meet the following objectives:

- Are safe and sound.
- Ensure adequate portfolio diversification.
- Are appropriate for the size and condition of the institution, the nature and scope of its operations, and conditions in its lending market.

The regulation also requires that each association monitor the condition of its portfolio and the adequacy of any collateral securing the loans.

A consumer lending portfolio comprises many small amortizing loans with relatively short maturities. Since consumer loans are generally small, your review should focus on the following areas:

¹ While people often use credit card accounts for consumer purposes, a federal savings association's ability to invest in them is authorized under a separate section of the HOLA. See Handbook Section 218 for a discussion of credit card accounts.

- Overall policies, procedures, and internal controls
- System support
- Management and staff capabilities
- Product pricing
- Portfolio performance.

You should structure your examination review to determine whether the institution has identified and is monitoring and controlling the risks associated with its consumer lending programs.

You will generally review a sample of loans to test compliance with internal guidelines and requirements. The depth of such sampling will depend on the adequacy of the internal loan review process and the scope of the internal audit program. (Refer to Thrift Activities Regulatory Handbook Section 209, Sampling.) It is often unproductive to analyze a large number of individual credit files to determine portfolio asset quality. Your review of overall portfolio performance, including delinquency and charge-off reports, is more effective for this purpose. Such reports can also be used as a basis for classifying assets.

In addition to evaluating the current portfolio condition, you should also identify potential problems that could result from any of the following practices:

- Overly permissive lending policies.
- Lack of adherence to established policies.
- Poor internal controls.
- Potentially dangerous concentrations.
- Poor collection procedures.
- Failure to act promptly when changes in economic or market conditions call for changes in lending standards or procedures.

PORTFOLIO CHARACTERISTICS

Consumer loans may be secured or unsecured, open-end or closed-end, direct or indirect. These characteristics affect the level of risk and type of underwriting procedures required.

Secured versus Unsecured

With secured loans, the institution requires the borrowers to pledge assets as collateral for the loan. Institutions usually base the collateral required on the level of risk, the borrower's credit history, and the lender's policy. Typically, when a consumer loan finances the purchase or refinance of an asset, the collateral will consist of the item being purchased. However, institutions cannot use "household goods" [defined at § 535.1(g)] to secure a loan, other than when credit is used to purchase the items secured.

If the institution obtains collateral, it should perfect its security interest in the collateral. The institution should recognize that the market value of personal property such as automobiles and recreational vehicles will likely decline over time, and lenders typically receive only a wholesale price for repossessed property. Therefore, it is prudent to match the loan amortization period to the estimated depreciation or useful life of the security property.

With regard to unsecured loans, the institution is depending on borrowers' promise and ability to repay their loans. Therefore, institutions usually limit unsecured loans to borrowers with sound credit backgrounds. Moreover, because an individual's financial condition may change over time, institutions generally grant unsecured loans for shorter time frames than secured loans.

For both unsecured and secured consumer loans, the borrower's cash flow is the primary repayment source. This may come from the borrower's employment, business, investments, or other reliable sources, including social security, other government benefits, child support, and alimony.

Open-end versus Closed-end Loans

OTS defines open-end credit as a credit in which the creditor takes the following steps:

- Extends credit under a plan that contemplates repeated transactions.
- Imposes a periodic finance charge on any outstanding unpaid balance.
- Provides a reusable credit line. (In other words, the customer can re-borrow any repaid portion of the outstanding balance.)

Credit cards, home equity lines of credit, and checking overdraft lines of credit are the most common forms of open-end credit. We refer to most other consumer credit with fixed payment terms as closed-end or installment credit.

Direct versus Indirect

Consumer loans may also be direct or indirect. When an institution originates the loan, it is a direct loan. If a seller of retail goods (dealer) originates the loan and then sells it to the institution, it is an indirect loan. Satisfactory performance of indirect lending often stems from the structure of the agreement with the dealers and the institution's oversight of the performance of loans from each dealer. Thrift Activities Regulatory Handbook Section 216, Floor Plan and Indirect Lending, discusses the basic characteristics of indirect lending.

ORGANIZATIONAL STRUCTURE

Institutions generally divide their consumer loan departments into four functional areas: acquisition, servicing, payment processing, and collection.

- The acquisition area originates loans. The personnel handle applications from individuals or through dealers (sellers of retail goods). They also gather and review credit information and decide to approve or reject the loans.
- The servicing area disburses loan proceeds; processes loan forms; prepares payment books; controls notes, collateral, and documentation; and prepares various reports (such as reports on delinquencies, extensions, renewals, and irregular payments).

- The payment area receives, processes, and posts all payments the institution receives.
- The collection area provides the follow-up, adjustment, and other activities involved with delinquent loans.

Consumer lending requires a trained and experienced staff. The level of required expertise depends on the degree of risk and complexity of the lending activity. Manufactured-home and time-share lending, for example, are areas that require substantial expertise.

CONSUMER LENDING POLICIES AND PROCEDURES

The success of a consumer lending operation depends on the institution's policies, procedures, systems, and controls. When reviewing an institution's consumer lending activities, you should determine that management has implemented policies and procedures to identify, measure, monitor, and control the credit and other risks associated with its consumer lending program.

The board of directors plays a critical role in the development of the institution's lending policies and procedures. The board should adopt policies that require comprehensive written procedures for the following areas:

- Reviewing and approving loan applications.
- Determining credit lines.
- Providing acceptable documentation standards.

The board should regularly review these policies to determine whether they are adequate and compatible with changing strategies and market conditions.

An institution should also align its consumer lending policy with the goals of its business plan. Management should perform a cost-benefit analysis that evaluates the required and probable return, amount of capital the institution will invest in start-up costs, and expected operating expenses and credit losses under various economic conditions.

The loan underwriting policy should clearly identify the following elements:

- The types of loans the institution will and will not accept.
- Any unique risks or characteristics of particular types of loans.
- Specific lending authority for each officer and group of officers.

The board of directors should set loan approval criteria based on the borrower's credit history, ability to pay, stability of income, and debt-to-income ratios. Other items that the board should address include loan-to-value ratios, collateral values, and loan terms. The primary consideration is always the creditworthiness of the borrower.

The institution's underwriting policies for consumer credit should also consider the borrower's overall debt load, generally measured by the borrower's total monthly payment obligations divided by gross monthly income. While some lenders establish a relatively low maximum allowable debt-to-income ratio (such as 40 percent, for example), others may establish a higher acceptable limit (such as 50 percent). The board of directors should establish effective underwriting standards, including debt-to-income ratios that are prudent and appropriate for the products offered in the institution's lending area. You should review these policies for adequacy and effectiveness in producing a quality loan portfolio that does not expose the institution to inordinate levels of credit risk.

Adequate loan pricing is also an essential element of a consumer loan policy. In defining its loan pricing, the institution should reflect market conditions, credit and interest rate risks, funding costs, direct and indirect operating expenses, expected credit losses, and desired profit margin. An institution should reevaluate its loan pricing formula when market conditions change or any time its loans fail to provide a reasonable profit relative to the risks undertaken.

Sound underwriting policies are not sufficient without other portfolio management guidelines. The board should require management to monitor the application of policies and procedures, including internal loan review. Senior management and the board should receive adequate reports to

monitor portfolio composition, delinquencies, and losses.

In addition, institutions should develop sound policies for the collection and timely charge-off of delinquent consumer loans. Effective collection procedures can minimize losses. The timely reporting of delinquency and credit losses allow management and the board to monitor the effectiveness of the institution's underwriting standards and controls. Effective collection procedures also assist them in evaluating the success of consumer products and the overall lending operation.

Delinquency and loss trend analysis allows for early correction of developing problems and provides a basis for determining the adequacy of the Allowance for Loan and Lease Losses (ALLL).

Classification

Because most consumer loans are small, homogeneous, and uniformly underwritten, they are generally classified based on their payment status rather than an individual review of each loan. This relieves you and institution staff from the burden of having to individually review each retail credit.

OTS adopted the Interagency Uniform Retail Credit Classification and Account Management Policy, issued by the Federal Financial Institutions Examinations Council (FFIEC).

The policy statement provides guidance on:

- Standards for re-aging delinquent accounts.
- The classification of accounts when the borrower is deceased or filed for bankruptcy protection, or the account involves fraud.
- The classification of loans secured by one- to four-family residential mortgages.

The guidance states that institutions should classify closed-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 119 cumulative days.

- Loss when they become contractually delinquent 120 days or more.

Institutions should classify their open-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 179 days.
- Loss when they are 180 days or more contractually delinquent.

These classification standards are not absolute, however. If management can clearly demonstrate that a delinquent loan is *well-secured and in the process of collection*, they do not have to classify the loan. See CEO Memo No. 103 for the Uniform Retail Credit Classification Policy.

CHARACTERISTICS OF SPECIFIC TYPES OF CONSUMER LOANS

There are many types of consumer loans, each having unique characteristics and risks. We provide a brief overview of the major categories below.

Debt Cancellation Contracts

Institutions may directly provide debt cancellation contracts on originated loans, subject to certain safeguards. Debt cancellation typically provides for the repayment of a loan in the event of the borrower's death or disability, with exceptions for late payments, late charges, loans in default and deaths due to suicide.

The association should not retain any recourse related to debt cancellation if it sells such loans. In addition, an association offering debt cancellation must either obtain insurance to cover its loss exposure or establish reasonable actuarial reserves (or some combination of reserves and insurance) for the loss risk.

Housing-Related Consumer Loans

Housing-related consumer loans may include equity term loans and lines of credit, home improvement loans, and manufactured-home loans. Interest on consumer loans secured by qualified residences (such as second mortgage and home

equity loans) is generally deductible in calculating federal income taxes if the loan does not exceed the borrower's basis in the home. Because of their favorable tax treatment, home equity loans have become very popular.

Home improvement loans differ from home equity loans. Home improvement loans may only be used to repair, equip, alter, or improve residential real property. In addition, home improvement loans may be conventional or Federal Housing Administration (FHA)-insured. Most importantly, thrifts may invest in home improvement loans without limitation under a separate authority under the HOLA. The thrift does not aggregate home improvement loans with other consumer credit to determine compliance with the HOLA's investment limitations.

Under the HOLA, a thrift may also invest in manufactured home loans without limitation. For reporting purposes, the thrift classifies manufactured-home loans on the Thrift Financial Report as either real estate loans or mobile home loans, depending on the documentation of the collateral value. If the home is fixed to a permanent site on which the lender holds a mortgage, the institution can classify it as a real estate loan.

The value of the manufactured home can fluctuate more than traditional housing, and they often depreciate more rapidly. This type of lending poses greater risks than conventional home lending due to the collateral value uncertainties and the mobility of the housing unit. Thrift Activities Regulatory Handbook Section 216, Floor Plan and Indirect Lending, provides general guidelines for manufactured-home lending.

Although institutions grant home improvement and home equity loans for consumer purposes, they typically secure the loans with real estate and classify them as real estate loans. The Real Estate Lending Standards rule, 12 CFR §§ 560.100-101, requires an institution to establish prudent written real estate lending standards that consider the supervisory loan-to-value ratio (LTV) limits in the Interagency Real Estate Lending Guidelines appended to that rule. Any loan secured by a one- to four-family residence with an LTV of 90 percent or higher should have private mortgage insurance or readily marketable collateral and other credit

strengths that offset the higher risks associated with loans with low borrower equity. Such loans, when aggregated with other loans in excess of the supervisory LTV limit, will receive increasing regulatory scrutiny and should not exceed 100 percent of total capital.

A loan secured by real estate is normally a real estate loan for purposes of 12 CFR §§ 560.100-101 and is subject to the Real Estate Lending Standards rule, whether it is fully or partially secured by real estate. The real estate lending standards rule lists nine exceptions, for example, when such loans are sold promptly without recourse and when the real estate collateral is taken as an abundance of caution.

A real estate secured loan may qualify for the abundance of caution exception and be considered a consumer loan if it is well-supported by other collateral and the value of the real estate is small in relation to the other assets securing the loan.

Abundance of caution does not include cases where the borrower's credit is sufficiently strong that the institution does not deem it necessary to take collateral, but does so anyway. See Handbook Section 212, Real Estate Lending.

Direct Auto Loans

Direct auto loans represent one of the largest categories of consumer loans. Some of the primary considerations you should consider for auto loans are:

- Borrower credit debt-load requirements.
- Acceptable loan-to-value ratios.
- Verification of the condition and market value of the vehicle.
- Acceptable age of autos taken as collateral.
- Acceptable maturities.
- Pricing to reflect all costs relating to the lending program.
- Insurance requirements.

- Lien perfection.

The auto loan files should contain the application, a copy of the sales agreement, a current credit report on the borrower, income verification, evidence of current property insurance coverage, and proof of lien perfection. Depending on state law, this likely includes the original certificate of title with the institution's lien recorded on the document. Institutions engaging in auto lending should have policies and procedures for the recovery of collateral from delinquent accounts and the sale of repossessed vehicles.

You should confer with the examiner assigned to the Lending Overview section. Evidence of significant auto loan charge-offs, delinquencies, or increases in delinquencies should alert the reviewer to weaknesses in the lending program. This includes inappropriate underwriting policies, collection efforts, or repossession activities.

Other Secured Loans

Other categories of secured consumer loans include boat and recreational vehicles, aircraft, savings accounts, and loans secured by other collateral, including furniture, appliances, and jewelry. Savings account loans typically exhibit the least credit risk because the borrower's savings account fully secures the loan. The other types of secured loans can pose significant risk because the collateral may have a low resale value and can be difficult to repossess. Two key factors when originating these types of loans are the borrower's ability and willingness to repay the debt.

Boats, recreational vehicles, and farm equipment (particularly small tractors and related implements) can exhibit collateral values highly dependent on local market conditions. For these types of secured credits, the institution should base collateral valuation techniques on regional valuation reference guides and local, rather than national, conditions.

Unsecured Consumer Lending

Unsecured consumer loans include open-end credit (including overdraft protection and credit cards) and personal loans. While people often think of credit cards to individuals for household purposes as consumer loans, HOLA authorizes them under a separate lending authority. Thus, the institution does not aggregate credit cards with other consumer loans to determine compliance with HOLA's percentage of assets limitations. Refer to Thrift Activities Regulatory Handbook Section 218, Credit Card Lending, for further detail.

If improperly underwritten, unsecured loans are among the riskiest types of loans due to the absence of security. Moreover, the institution has limited control over the consumer's overall debt level given the abundance of available consumer credit. Institutions must carefully evaluate the creditworthiness of the borrower because there is no collateral to fall back on should the borrower default. Some institutions often require a credit-worthy cosigner or guarantor when making loans to borrowers with limited or marginal credit histories. If there is a cosigner, § 535.3 of the regulations imposes specific disclosure requirements on member institutions. (Refer to the Compliance Activities Regulatory Handbook Section 355, Unfair or Deceptive Acts, for further detail.)

Education Loans

Federal savings institutions may invest in education loans under a separate HOLA authority. Therefore, institutions do not have to aggregate education loans with other consumer loans to determine compliance with HOLA's lending limits. Education loans can be either relatively safe high-yield investments or risky specialized consumer loans. The risk depends on whether a government agency guarantees the debt and whether the institution is in compliance with the insuring agency's rules regarding the program.

Government insurance is available because students typically have low incomes and unproven credit histories, making them unattractive credit risks. The Student Loan Marketing Association (Sallie Mae) came into being in 1972 to further this purpose, and serves as a secondary market and

warehouse facility for student loans. The Commissioner of Education, or a state or a nonprofit private institution with which the Commissioner has an agreement, insures the loans.

Institutions should verify that the borrower is attending the school indicated and paying tuition bills.

Time Share Loans

Time share loans represent the financing of a consumer's purchase of a shared interest in vacation or resort property. Purchasers will then "own" a week in their favorite vacation resort and may return to the resort each year on the particular week. Once purchased, the owner only pays a fee for maintenance and membership in a national registry that allows owners to trade their week for visits to other resorts. Often, however, these fees are very high.

Developers frequently sell time shares to buyers for many times the aggregate value of the units. For example, a week in a typical resort will sell for \$8,000 to \$15,000, depending on the season. Thus, total sales may be \$500,000 or more for a unit the resort manager paid less than \$200,000 to build. As a result, time share resale prices are a fraction of what the buyer/borrower paid for them. If borrowers have to sell the property, they often do so at a substantial loss. Moreover, some resorts sell time shares with no clear or definable interest in the real estate.

Time share lending combines features of real estate investment, consumer lending, and hotel management. The hybrid nature of the time share and its untested legal status make the value of the collateral questionable. The negative publicity surrounding time share operations and misrepresentations of lien positions by developers or loan brokers further complicates this situation. Time share lending requires considerable expertise due to its complexity and risk. In addition, end loan lenders should evaluate both the overall viability of the time share project and the creditworthiness of the end loan borrower.

Subprime Lending

Subprime lending is the practice of extending credit to individuals with poor credit histories. In a joint interagency policy statement on subprime lending, dated March 1, 1999, OTS, together with the banking agencies stated, "If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound." (See the Interagency Policy Statement in Appendix A.)

The interagency policy statement defines subprime lending as the practice of extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. The institution typically measures risk of default by credit/repayment history, debt-to-income levels, or credit scores.

Subprime borrowers represent a broad spectrum of debtors. They range from those who exhibit repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include making loans to borrowers who have had minor, temporary credit difficulties but are now current; nor does it include loans to borrowers with normal credit histories that subsequently deteriorate.

In addition to direct extensions of credit, this guidance also applies to the purchase of the following:

- Subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount.
- Subprime automobile or other financing "paper" from lenders or dealers.
- Loan companies that originate subprime loans.

Many institutions entering the subprime lending business have discovered that they grossly underestimated the default rates and collection costs associated with these loans. Furthermore, several experienced non-bank subprime specialists have suffered material losses despite their considerable expertise in this field of lending. Because an economic downturn will tend to adversely affect

subprime borrowers earlier and more severely than standard risk borrowers, the institution should determine if it is prudent to begin or expand a subprime lending program at the current stage of the economic cycle.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the lender charges a price sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans.

The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. A number of financial institutions, however, have experienced significant losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size and level of capital support. Institutions that focus on subprime lending or enter the subprime lending business as anything more than an occasional, exception-based activity, should have board-approved policies, procedures and internal controls that identify, measure, monitor, and control these additional risks.

A separate, formal subprime policy is not necessary if institutions only occasionally grant subprime loans. However, a formal procedure should be in place for approving, documenting, and monitoring such exceptions to policy.

In light of the risks associated with this type of lending, OTS may impose higher minimum capital requirements or place investment limitations on institutions engaging in subprime lending. You should determine whether their subprime lending program is safe and sound, based on the following criteria:

- Magnitude of the risks assumed.
- Controls the institution has in place.
- Capital available to support this activity.

Business Loans

It may be more effective for you to review loans to small businesses when you review the consumer loan portfolio, particularly those with relatively small balances. Although institutions may underwrite these loans as consumer loans, they exhibit risk and underwriting elements distinct from most consumer loans.

Confirming a reliable source of repayment is critical to the small business loan underwriting process. A small business, along with a small business owner with no other income source, is dependent on the enterprise to generate adequate revenues to cover its cost of goods and operating expenses. Therefore, underwriting guidelines should consider the stability of the borrower's or business' cash flows, key operating trends, adequacy of capital to cover risks, and management's ability to react to its particular operating niche.

Financial data can be sketchy, as small enterprises may employ limited accounting systems and records. Even so, the institution should obtain a complete copy of the business' or owner's last three Federal income tax returns and recent credit report. The institution should also analyze any other available business-related financial statements.

Along with revenue, expense and net income trends, you should be alert to slow inventory turn-around or increasing accounts receivables. Depending on the size of the credit, the institution should have available a recent copy of the business' aging list for accounts receivable. Also, depending on the size of the loan and the institution's underwriting standards, you should inquire about insurance coverage, outstanding litigation, franchise requirements, lease terms and obligations, and management depth.

CREDIT SCORING

Credit scoring systems assess the credit-worthiness of potential borrowers and simplify/streamline the underwriting process for small-balance consumer loans. Thrifts often use credit scoring systems that assign numerical rankings to individuals based on available financial and demographic data. The credit scoring models then convert these rankings into scores, with higher scores indicating lower risk. The most widely used scoring systems are external systems available through credit bureaus. However, thrifts can purchase or develop a system to use internally and often use an internal and external system in conjunction.

Scoring systems can be an effective lending tool if the institution uses them properly. Before implementing a scoring system, a thrift must thoroughly study the characteristics of its loan product and customer base and what it expects the scoring system will achieve. The thrift then uses this information to adapt the system to their needs. This can be quite a complicated process and requires expertise to be effective. Following implementation, periodic review of the system, called validation, is necessary as the system ages and the customer base changes. Management should not implement scoring unless they are willing to devote the time and attention necessary to ensure that the system performs as expected and remains effective.

LAWS AND REGULATIONS AFFECTING CONSUMER LOANS

You should be familiar with all applicable consumer regulations. Section 300 of the Compliance Activities Regulatory Handbook discusses consumer regulations in detail. See the References at the end of this section for other OTS regulations, memoranda, and policy statements that apply to consumer loans. State usury laws establish maximum interest rates on loans. If an institution violates the state usury law, it may suffer some penalty such as forfeiture of interest. Consult state law to determine compliance. OTS has preempted most state usury laws for "federally related loans," which may include some consumer loans. Consult Part 590 of the regulations to review federal preemption of state usury statutes.

REFERENCES

United States Code (12 USC)

§1464(c)(2)(D) Consumer Lending Authority
§1464(c)(3)(A) Education Loans Authority

Code of Federal Regulations (12 CFR)

Part 535 Prohibited Consumer Credit Practices
§560.1 General Lending Standards
§560.2 Applicability of Law:
(Preemption of State Usury Laws)
§560.3 Definitions
§560.30 General Lending and Investment Powers of Federal Savings Associations
§560.31 Election Regarding Categorization of Loans or Investments
§560.93 Lending Limitations
§560.101-102 Real Estate Lending Standards

Consumer Lending Program

Examination Objectives

To determine if the established policies, procedures, and strategic plans regarding consumer lending adequately address safety and soundness, profitability, and compliance with laws and regulations.

To determine if institution officers and employees conform with the established guidelines.

To determine if officers and employees are able to perform their duties and responsibilities in a manner that ensures safety and soundness, profitability, and compliance with laws and regulations.

To determine if financial records and management reports provide accurate and necessary information to assist management and the directors in fulfilling their responsibilities.

To determine the adequacy of the audit function(s) in this area.

To determine the adequacy of the internal loan review function in this area.

To evaluate the credit quality of the consumer lending portfolio.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you identify violations of laws or regulations. (Examination and supervisory personnel may initiate corrective action depending on regional office policy.)

Examination Procedures

Wkp.Ref.

Level I

1. Review scoping materials related to this program.

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2. Coordinate with the examiner assigned Thrift Activities Handbook Section 201, Lending Overview, to determine the adequacy of the institution's policies and procedures through:

- Review of policy statements, underwriting guidelines, and manuals.
 - Review of compliance with the consumer lending projections set forth in the business plan.
 - Interviews with management.
 - Review of minutes related to this area.
-

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Consumer Lending Program

Wkp.Ref.

3. Determine whether management and the board periodically review objectives and related policies, and communicate any changes to the appropriate personnel.

4. Obtain the following reports and schedules applicable to the consumer loan area:

- Delinquent loans.
 - Classified loans.
 - Loans for which interest is not being collected in accordance with terms of the loan.
 - Loans where the institution has modified terms by reduction on interest rate or principal, or by other restructuring of repayment terms.
 - Extensions of credit to insiders.
 - The overdraft report and the list of individuals authorized for overdraft protection.
 - Miscellaneous loan debit and credit suspense accounts.
 - Loans considered problem loans by management.
 - The current interest-rate structure and schedule of fees.
 - Useful information resulting from review of minutes of the loan committee.
 - Reports furnished to the loan committee.
 - Reports furnished to the board of directors.
 - Loans classified during the previous examination.
 - The nature and extent of loans serviced.
-

5. Determine if the institution engages in high-risk consumer lending, such as subprime lending, the purchase of high-risk or subprime loans from other institutions, or the purchase of subsidiaries that engage in subprime lending. If so, complete the subprime lending procedures in Appendix B.

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6. Determine whether the classification and charge off of delinquent consumer credit are in compliance with the institution's policies and the Interagency Uniform Retail Credit and Account Management Policy. (See CEO Memo No. 103.)

7. Review the adequacy and accuracy of management reports.

8. Review the qualifications, capabilities, and expertise of consumer loan officers in relation to their responsibilities.

9. Ascertain compliance with laws, rulings, and regulations pertaining to consumer lending.

10. Document whether the institution corrected deficiencies mentioned in prior examination reports and audit reports.

11. Review the institution's use of modeling and credit scoring.

- Detail the types of models/scorecards used (for instance, generic/custom, vendor, etc.), by application.
 - Determine whether the development process is consistent with the institution's ability to undertake risk and its desired portfolio objectives.
 - Evaluate the ongoing monitoring and maintenance process in view of the portfolio's performance.
-

12. Determine that the institution uses all scorecards for purposes consistent with the development process/populations. If not (for instance, applied to an entirely different product, new/unproven geographic area, etc.), assess the possible results.

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13. Review the documentation supporting the institution's scoring models to:

- Ensure the scoring models are empirically derived and statistically sound.
 - Ensure the institution periodically monitors the factors and customer characteristics to determine whether they continue to effectively predict credit performance.
 - Determine whether the credit scores permit the institution to predict overall risk and the potential impact on collection activities.
 - Determine that the models stress test the population so they are able to predict delinquencies and losses over varying economic conditions.
-

14. Review management of the institution's scoring systems to ensure that:

- Systems continue to reflect current underwriting standards and risk parameters.
 - Management maintains a portfolio chronology log to record significant events related to the credit acquisition process for each consumer portfolio. Review the log.
 - The institution revalidates the scorecards as necessary. Review the report of the last validation.
 - The institution supervises and maintains the scoring systems in accordance with vendor-provided specifications and recommendations (as specified in the scoring manual).
-

15. Complete the General Questionnaire.

16. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Level II

17. Test a sample of loans for compliance with established policies and procedures. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Hand-book.) The extent of testing will depend on preliminary findings, and the review of work performed by the auditors and internal loan review personnel.

18. Review the reconciliation of the subsidiary ledgers for consumer loans with the general ledger. Investigate any large unreconciled items.

19. If policies, procedures, and reports are inadequate, it may be necessary to review loans for asset quality. If so, select borrowers for examination review using an appropriate sampling technique. If the outstanding balance or credit line of a large-dollar, high-risk loan is material, consider including some of these loans for individual classification review. (Discuss such large dollar loans with the examiner assigned to Thrift Activities Regulatory Handbook Section 211.)

20. Analyze credit files for all borrowers for whom you prepared line sheets for the following concerns:

- Credit quality (earnings, indebtedness, credit history, loan modifications).
 - Adequacy of loan and collateral documentation (loan-to-value ratios, age of collateral, perfection of security interests, evidence of hazard insurance).
 - Compliance with the loan policy.
-

21. Analyze the institution's pricing of its consumer loans to determine if it considers all costs, including expected losses, operating expenses, and cost of funds in the pricing model. (The institution should do this for each loan product.)

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22. Review the institution's loan modification/extension/rewrite/deferral policy. Determine if the policy is reasonable and complies with the Interagency Uniform Retail Credit Classification and Account Management policy.

23. Review delinquency and repossession reports. Determine if the institution tracks delinquencies and loan losses by product type and by production facility, such as loan officer, branch office, or outside broker.

24. Determine if the institution has taken steps to curtail or modify problem lending, whether it be due to poor underwriting policies and procedures, the risks inherent in a particular loan type, or deficiencies in the loan production facility.

25. Determine the adequacy of collection procedures and whether practices conform to policy. Consider whether the institution takes the following steps:

- Actively use and maintain up-to-date collection cards (contact records).
 - Accord special handling for first payments defaults.
 - Make timely telephone contacts and follow up broken promises of payment within a reasonable period.
 - Ensure outside repossession agents are licensed and bonded.
 - Account for repossession separately by customer name, loan balance, date of repossession, and dealer origin.
 - The institution has written procedures for the disposal of repossessed property that require the institution to dispose of vehicles in a timely manner (standard 15 days after the expiration of the customer redemption period). Determine whether the institution documented the method of sale and received competitive bids.
-

26. Determine projected loan growth.

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27. Ensure that the examination meets the *Objectives* of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

28. Select a sample of accounts and perform direct verification with the borrower.

29. Reconcile or perform verifications of any accounts as necessary.

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Consumer Lending Questionnaire

	Yes	No		Yes	No
General Questionnaire					
<i>Consumer Loan Policies</i>					
1. Has the board of directors adopted written consumer loan policies that:			6. Are persons who subsequently review or test documents supporting recorded credit adjustments prohibited from also handling cash and checks?		
<ul style="list-style-type: none"> • Establish procedures detailing loan underwriting guidelines such as: debt/income ratios, loan-to-value ratios, job stability requirements, credit history requirements, acceptable collateral, and loan terms for each type of loan? 			If not, who reviews and tests? _____		
<ul style="list-style-type: none"> • Establish standards for determining credit lines? 			7. Are persons who investigate reconciling items prohibited from also handling cash? ...		
<ul style="list-style-type: none"> • Establish minimum standards for documentation? 			<i>Loan Approval</i>		
2. Does the board review consumer loan policies at least annually to determine if they are compatible with the current business plan and the marketplace?			8. Do authorized officers conduct loan approvals?		
<i>Segregation of Duties</i>			9. When amounts are significant, does the institution require two authorized signatures to effect approval or a status change in an individual customer account?		
3. Are persons who perform or review the preparation and posting of subsidiary consumer loan records prohibited from:			<i>Physical Security of Documents</i>		
<ul style="list-style-type: none"> • Issuing official checks or drafts singly? 			10. If secured property is marketable security or small personal property, does the association have physical control of the security? If so, is it:		
<ul style="list-style-type: none"> • Handling cash or checks? 			<ul style="list-style-type: none"> • Under the supervision of an officer? 		
4. Are persons who perform or review the preparation and posting of interest records prohibited from:			<ul style="list-style-type: none"> • Kept under dual control? 		
<ul style="list-style-type: none"> • Issuing official checks or drafts singly? 			<ul style="list-style-type: none"> • Kept in a fireproof container? 		
<ul style="list-style-type: none"> • Handling cash or checks? 			<ul style="list-style-type: none"> • Inventoried periodically and maintained in a log? 		
5. Are persons who receive and investigate inquiries about loan balances prohibited from also handling cash and checks?			<ul style="list-style-type: none"> • Released under controlled procedures and in a timely manner once proof of loan pay-off has been received? 		
If not, who receives and investigates inquiries? _____			<i>Collateral</i>		
			11. Does the association maintain records that:		
			<ul style="list-style-type: none"> • Detail the complete description of collateral pledged? 		
			<ul style="list-style-type: none"> • Are signed by the customer? 		

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Consumer Lending Questionnaire

	Yes	No		Yes	No
12. When collateral value is high, does the association require that two officers review and approve the release?			<ul style="list-style-type: none"> • Test check postings to general ledger at least weekly? 		
<i>Balancing of Subsidiary Ledgers to the General Ledger</i>			<i>Other</i>		
13. Does the association reconcile at least monthly the subsidiary consumer loan records to the appropriate general ledger accounts?			17. Does the association maintain a daily record summarizing loan transaction details, e.g., loans made, payments received, and interest collected, to support applicable general ledger entries?		
<i>Disbursements of Loan Proceeds</i>			18. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that will result in a change in customer account status?		
14. Does the association segregate disbursement and loan approval responsibilities?			19. Does management establish collection policies so that:		
<i>Operating Review System</i>			<ul style="list-style-type: none"> • A delinquent notice is sent prior to a loan becoming 30 days past due? • Collection effort is intensified when a loan becomes two payments past due? • Records of collection efforts are maintained in the customer's file? 		
15. Has the association developed procedures for monitoring compliance with established controls?			20. Does the institution engage in subprime consumer lending activities?		
16. Has the association assigned employee(s) to:			21. Does the institution purchase consumer loans from others?		
<ul style="list-style-type: none"> • Review new loan documentation? • Determine proper segregation of duties and prohibit loan officers from processing loan payments? • Recompute the amount of discount on new loans? • Review entries to unearned discount or income accounts? • Determine accurate and prompt posting of payments? 			22. Does the institution engage in indirect consumer lending?		

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Interagency Guidance on Subprime Lending

March 1, 1999

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Background and Scope

Insured depository institutions have traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, in recent years a number of lenders¹ have extended their risk selection standards to attract lower credit quality accounts, often referred to as subprime loans. Moreover, recent turmoil in the equity and asset-backed securities market has caused some non-bank subprime specialists to exit the market, thus creating increased opportunities for financial institutions to enter, or expand their participation in, the subprime lending business. The federal banking agencies have been monitoring this development and are providing guidance on this activity.

For the purposes of this guidance, “subprime lending” is defined as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.² Risk of default may be measured by traditional credit risk measures (credit/repayment history, debt to income levels, etc.) or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. This guidance applies to direct extensions of credit; the purchase of subprime loans from other

¹ The terms “lenders,” “financial institutions,” and “institutions,” in this document refer to insured depository institutions and their subsidiaries.

² For purposes of this paper, loans to customers who are not subprime borrowers are referred to as “prime.”

lenders, including delinquent or credit impaired loans purchased at a discount; the purchase of subprime automobile or other financing “paper” from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Moreover, the ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Recently, however, a number of financial institutions have experienced losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution’s staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk. Institutions that began a subprime lending program prior to the issuance of this guidance should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards. If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.

Capitalization

The federal banking agencies believe that subprime lending activities can present a greater than normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. The amount of additional capital necessary will vary according to the volume and type of subprime activities pursued and the adequacy of the institution’s risk management program. Institutions should determine how much additional capital they need to offset the additional risk taken in their subprime lending activities and document the methodology used to determine this amount. The agencies will evaluate an institution’s overall capital adequacy on a case-by-case basis through on-site examinations and off-site monitoring procedures considering, among other factors, the institution’s own analysis of the capital needed to support subprime lending. Institutions determined to have insufficient capital must correct the deficiency within a reasonable timeframe or be subject to supervisory action. In light of the higher risks associated with this type of lending, the agencies may impose higher minimum capital requirements on institutions engaging in subprime lending.

Risk Management

The following items are essential components of a well-structured risk management program for subprime lenders:

Planning and Strategy. Prior to engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution’s overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for

after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets and/or customers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Staff Expertise. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possesses sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

Lending Policy. A subprime lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime lending program. While not exhaustive, the following lending standards should be addressed in any subprime lending policy:

- Types of products offered as well as those that are not authorized;
- Portfolio targets and limits for each credit grade or class;
- Lending and investment authority clearly stated for individual officers, supervisors, and loan committees;
- A framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital;
- Collateral evaluation and appraisal standards;
- Well defined and specific underwriting parameters (i.e., acceptable loan term, debt to income ratios, loan to collateral value ratios for each credit grade, and minimum acceptable credit score) that are consistent with any applicable supervisory guidelines;³
- Procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines;
- Credit file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision; and

³ Extensions of credit secured by real estate, whether subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory Loan-to-Value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. See 12 CFR Part 34, subpart D (OCC); 12 CFR Part 208, appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS) for further information.

- Correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards.

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

Purchase Evaluation. Institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and the loan losses that may be experienced as they evaluate expected profits. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (i.e., the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due diligence review prior to committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.

Loan Administration Procedures. After the loan is made or purchased, loan administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts such as calling delinquent borrowers frequently, investing in technology (e.g., using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business.

Subprime loan administration procedures should be in writing and at a minimum should detail:

- Billing and statement procedures;
- Collection procedures;
- Content, format, and frequency of management reports;
- Asset classification criteria;
- Methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- Criteria for allowing loan extensions, deferrals, and re-agings;
- Foreclosure and repossession policies and procedures; and

- Loss recognition policies and procedures.

Loan Review and Monitoring. Once loans are booked, institutions must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for sub-portfolios. Institutions should have information systems in place to segment and stratify their portfolio (e.g., by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

Consumer Protection. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory “steering” of borrowers to subprime products for reasons other than the borrower’s underlying creditworthiness. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of “The Home Ownership and Equity Protection Act of 1994,” Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This Act amended the Truth-in-Lending Act to provide certain consumer protections in transactions involving a class of non-purchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z, 12 C.F.R. §226.32, and Regulation X, the Real Estate Settlement Procedures Act (RESPA), 12 USC §2601, and adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate-related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited basis characteristic (e.g., race, sex, age, etc.). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

Securitization and Sale. Some subprime lenders have increased their loan production and servicing income by securitizing and selling the loans they originate in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution’s assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit quality problems.

Recent turmoil in the financial markets illustrates the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as predominant risk and cash flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

Reevaluation. Institutions should periodically evaluate whether the subprime lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?
- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored and controlled?
- Has the program met the credit needs of the community that it was designed to address?

Examination Objectives

Due to the high-risk nature of subprime lending, examiners will carefully evaluate this activity during regular and special examinations. Examiners will:

- Evaluate the extent of subprime lending activities and whether management has adequately planned for this activity.

- Assess whether the institution has the financial capacity to conduct this high-risk activity safely without an undue concentration of credit and without overextending capital resources.
- Ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage the program.
- Evaluate whether management has established adequate lending standards and is maintaining proper controls over the program.
- Determine whether the institution's contingency plans are adequate to address the issues of alternative funding sources, back-up purchasers of the securities or the attendant servicing functions, and methods of raising additional capital during a period of an economic downturn or when financial markets become volatile.
- Review securitization transactions for compliance with FAS 125 and this guidance, including whether the institution has provided any support to maintain the credit quality of loans pools it has securitized.
- Analyze the performance of the program, including profitability, delinquency, and loss experience.
- Consider management's response to adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
- Determine if the institution's compliance program effectively manages the fair lending and consumer protection compliance risks associated with subprime lending operations.



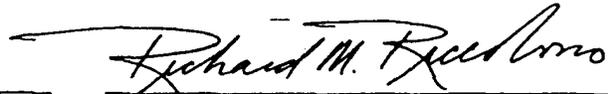
Richard C. Spillenkothen
Director, Division of Banking
Supervision and Regulation
Board of Governors of the Federal Reserve System



James L. Sexton
Director, Division of Supervision
Federal Deposit Insurance Corporation



Emory W. Rushton
Senior Deputy Comptroller for
Bank Supervision Policy



Richard M. Riccobono
Deputy Director
Office of Thrift Supervision

Subprime Lending – Examination Procedures

Use the following examination procedures to assess an institution’s subprime lending activities. Choose only those procedures needed, based on the level of risk and size of the institution’s subprime lending activities. Seldom will you need to perform all procedures. You should also coordinate the use of these procedures with procedures performed by other examiners to avoid duplication. **Furthermore, you should test and verify enough underlying transactions to confirm that the institution’s actual practices are consistent with stated policies, practices, and management reports. Significant variances normally indicate a need for closer examination scrutiny.**

These procedures are generic so you may apply them to all types of lending. You will, however, need to add any specific procedures for the type of subprime lending you review. Finally, these procedures deal primarily with safety and soundness issues. Consumer compliance issues can also pose significant risk for institutions that engage in subprime lending. For additional guidance, examiners should refer to the *OTS Compliance Activities Handbook*.

Level I

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The following Level I procedures will provide you with an overview of an institution’s subprime lending activities and the risks involved. You should perform these procedures in institutions that have material amounts of subprime lending. You should perform only those procedures necessary to meet examination objectives. **Note: examinations seldom require all steps.**

1. Review the following information to understand the examination scope and history and the institution’s level of subprime lending:
 - The scope memorandum issued by the examiner in charge.
 - The previous examination findings.
 - Comments of the external and internal auditors (including any quality control staff) and their reports to management.
 - Management’s responses to examiner and auditor recommendations and comments.
 - Institution reports on subprime portfolios.

2. Evaluate the content of the most recent management reports and reports prepared for the board of directors relating to subprime lending. Determine if the reports are adequate.

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3. Review the monthly financial information provided to senior management, and evaluate its usefulness and accuracy. Review the most recent fiscal year-end and current year-to-date financial information for subprime products, and compare to budgets and forecasts. Discuss any significant variances with management.

4. Review management’s budget and capital plan for subprime products. Assess reasonableness, trends, and actual versus projected performance for the respective products.

5. Assess the adequacy and reasonableness of the institution’s lending policies and procedures used to manage subprime portfolios. Pay particular attention to any changes since the last examination. Review policies to ensure that they address:

- Lines of authority and segregation of duties
- Underwriting limits
- Concentrations of credit (for instance, geographic, product type, broker, source of recourse)
- Permissible types of loans
- Underwriting criteria (maximum acceptable debt-to-income, scorecard cutoffs, etc.)
- Required/eligible collateral
- Collateral valuation guidelines/methods
- Exception processes
- Credit grading (“A,” “B,” “C,” etc. paper)
- Cure programs (for example, re-agings, extensions, renewals, rewrites)

6. Determine whether all appropriate staff use and adhere to the lending policies and procedures. Determine the adequacy of exception reporting.

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7. Determine whether management and the board of directors review the policies at least annually in light of the portfolio’s performance and the institution’s strategic goals.

8. Evaluate the institution’s staffing, training, and compensation plans for its subprime operations. Assess staff adequacy in light of portfolio volume and performance.

9. Review the institution’s underwriting process to determine the level of automation, use of credit scoring models, and the override/exception process.

10. Review delinquency and loss reports on a product-by-product basis and by acquisition channel. Determine if delinquency levels are in line with projections.

11. Review the institution’s process for pricing subprime products, including:

- The use of risk-based pricing
- How competitor pricing affects the institution’s pricing
- How pricing models are maintained.

12. Assess the process used by risk management to measure and monitor risk by product, vintage, solicitation, and account source. Ensure that a process exists to report problems to senior management and, if there are problems noted, that the institution promptly takes corrective action.

13. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Level II

The following Level II procedures require a more detailed examination of institution practices. You should perform only those procedures necessary to make an informed assessment of the institution’s subprime lending activities. Not all procedures will be applicable for a given institution. Moreover, the examiner in charge may omit applicable procedures if the volume of subprime lending is small in relation to the institution’s size or when the overall exposure to loss is low.

14. Review a sample of loans made during the review period (including some new accounts originated in the past quarter). Evaluate whether loans are consistent with current underwriting guidelines, and whether the institution notes and monitors exceptions and overrides in accordance with policy.

15. Assess the adequacy of exception reporting, and determine if the institution’s response to significant variations is appropriate. Determine whether the level of exceptions results in higher levels of delinquencies and losses, indicative of weaknesses in the underwriting process.

16. Determine the adequacy of the institution’s verification procedures, and ensure that, at a minimum, they routinely confirm residence, employment, and income for subprime borrowers.

17. Evaluate the adequacy of management information systems (MIS), and reporting for subprime lending activities, and determine whether management monitors appropriate key measurements (for example, approval/override rates, etc.).

18. Review the institution’s marketing process. Determine whether the institution:

- Tests new products before launching a large-scale lending program.
- Has controls and reporting in place to monitor marketing plans and activity.
- Uses application scoring models or other targeting techniques.

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19. Determine whether the institution has guidelines that govern purchasing subprime loans originated elsewhere. Assess the reasonableness of those guidelines. Consider whether processes are in place to ensure that purchased loans are consistent with the institution’s underwriting criteria, and the institution is able to reject loans that do not meet its criteria.

20. Assess the adequacy of the process used to “approve” brokers and other origination sources. Be alert for any concentration risks and insider or affiliate relationships. Ensure that:

- Management maintains a current and complete list of all vendors.
 - The institution actively manages vendor relationships including:
 - Maintenance of current and complete contracts (inclusion of appropriate clauses, receipt of audit reports, financial statement requirements, etc., monitoring for adherence to terms/performance guidelines; information for renegotiation).
 - Annual review of vendor audit reports and financial condition.
 - Development of necessary controls (for example, restricting access to institution information).
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21. Assess the adequacy of the documentation supporting pricing decisions and models. Determine that assumptions used are reasonable and complete, and that it appropriately captures all relevant income and expense categories.

22. Determine the adequacy of the institution’s quality control and internal audit processes (for example, frequency, scope, accuracy, and meaningfulness of conclusions).

23. Determine the adequacy (substance and timing) of management response and follow-up on audit and quality assurance findings. Evaluate the training and qualifications of quality control staffing, and evaluate the reasonableness of reporting lines.

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24. Determine if the institution uses and properly applies credit scoring in the subprime lending functions.

25. Assess the structure, management, and staffing of the collections department. Assess the appropriateness of the institution’s collection strategies.

26. Evaluate various cure programs used, such as re-aging, fixed payment, Consumer Credit Counseling Services, and forgiveness. Specifically:

- Determine what programs are in place or planned and review written policies.
- Verify that management monitors and analyzes the performance of each program.
- Assess the current and potential impact of such programs on reported performance and profitability, including allowance implications.

27. Evaluate the adequacy of the institution’s classification and charge-off policy by:

- Determining that it adheres to the guidance of the FFIEC Uniform Retail Credit Classification Policy.
- Reviewing automated data processing parameters used for classification and charge-offs. These parameters should correspond to those described in the charge-off policy. (If not, discuss the differences with management and request appropriate corrective action.)
- Determining how the institution loads accounts scheduled for charge-off into a charge-off queue or other system for loss. Specifically:
 - Determine the circumstances, if any, that would delay a charge-off.
 - Determine when the institution recognizes losses (daily, weekly, or monthly).

28. Evaluate whether the allowance for loan and lease loss policy specifically identifies subprime lending portfolios. Determine if:

- The institution has a written description of the process used to determine the adequacy of the allowance.

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- The analysis documents the factors considered in evaluating subprime portfolios.
- Charge-off policies are consistent with the FFIEC’s Uniform Retail Credit Classification and Account Management Policy.

29. Review the institution’s most recent quarterly evaluation of the allowance. Determine whether the institution’s allowances for subprime portfolios are reasonable and supported.

30. Determine whether the institution funds subprime lending portfolios by securitizing the receivables.

31. Evaluate the performance of institution-issued securities supported by subprime loans. Determine whether:

- Performance trends are stable, improving, or deteriorating.
 - Early amortization or other credit enhancement triggers are nearing their set-off points. If so, discuss with management the potential cash flow and reputation risk issues.
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32. Discuss with management how the institution determines accounting treatment for securitized assets. Review the institution’s process for valuing residual assets associated with securitized subprime portfolios. Determine whether:

- Assumptions (prepayment speeds, loss forecasts, and discount rates) are reasonable and conservative.
 - The institution uses the cash-out method for valuing cash flows.
 - The institution uses static pool cash collection analysis to support cash flow assumptions.
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33. Determine whether any recourse provisions (such as over-collateralization) are in the securitization agreement or if the institution has provided recourse through non-contractually required credit support. For example, does the institution routinely repurchase past-due loans from securitized asset pools. If so, the examiner should investigate the risk-based capital and recourse implications with examiners performing the review of capital adequacy.

34. Review a sample of investor account reconciliations. Determine whether monthly investor reports are accurate and promptly submitted.

35. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, including:

- The level of risk in the institution’s subprime lending activities, including:
 - Credit quality of the subprime portfolios, taking into account trends in portfolio performance, delinquencies, and losses.
 - Compliance with established guidelines.
 - Compliance with applicable laws, rulings, and regulations.
- Quality of risk management, including:
 - Adequacy of policies and underwriting standards.
 - Adequacy of processes, including planning.
 - Management’s ability to conduct its retail lending in a safe and sound manner.
 - Adequacy of control systems, including loan review, audit, and management information systems.
- Deficiencies noted during the examination.

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36. In consultation with the examiner in charge, determine whether the risks identified are significant enough to merit bringing them to the board's attention in the Report of Examination (ROE). If so, prepare examination comments, including any necessary corrective measures, discuss these with management, and record management's comments in the ROE. If you determine deficiencies are not significant enough to include them in the ROE, discuss them and any recommendations you may have with management and record them along with management's response in the work papers.

37. Prepare a memorandum or update the work program with any information that will facilitate future examinations. Organize and reference work papers in accordance with OTS guidance.

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