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# M E M O R A N D U M

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To Our Clients and Friends

Re: Agencies' Statement on Subprime Mortgage Lending

The Federal bank supervisory agencies (the "Agencies")[1] have issued guidance to clarify how depository institutions may offer subprime adjustable rate mortgages ("ARM") in a safe and sound manner, as well as how to disclose the risks that borrowers may encounter.

## BACKGROUND

The guidance is in response to the concern of the Agencies about the growing use of ARM products that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate for the remaining term of the loan. The Agencies indicate that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. The statement retains a focus on subprime borrowers, due to concern that such consumers may not fully understand the risks and consequences of these loans and may not have the financial capacity to deal with increased obligations. The statement also clarifies that subprime lending is not synonymous with predatory lending, and that there is no presumption that the loans to which the Statement applies are predatory.

## STANDARDS

The Agencies advise that prudent standards require institutions to recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.

[1] Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision and National Credit Union Administration.

The Agencies also state that institutions should verify and document a borrower's income (both source and amount), assets and liabilities. Stated income and reduced documentation loans should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. A higher interest rate is not an acceptable mitigating factor.

The Agencies state that advertisements, oral statements and promotional materials should provide clear and balanced information about the relative benefits and risks of the mortgage products. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify. Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial reset period. In general, borrowers should be provided a reasonable period of time (60 days prior to the reset date) to refinance without penalty.

Institutions are to develop systems to monitor whether actual practices are consistent with their policies and procedures and to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems.

The Agencies encourage institutions to work with borrowers who are in default or whose default is reasonably foreseeable and to follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.

The guidance states that the Agencies will take action against institutions that engage in predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices or otherwise engage in unsafe or unsound lending practices.

A copy of the Agencies' statement can be found on our web site at http://www.schwartzandballen.com/whats_new.html.

If you have any questions, please call Gilbert Schwartz, Robert Ballen, Tom Fox or Heidi Wicker at (202) 776-0700.