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Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

Questions and Answers for Examiners Regarding the Interagency Expanded Guidance for
Subprime Lending Programs Issued January 31, 2001

Applicability of the Guidance

1. Question: Does the guidance apply to all institutions?

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that *systematically* target the subprime market through *programs* that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community lending process, or making loans to subprime borrowers as an occasional exception to a prime lending program, even if the aggregate of these loans totals more than the 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime lending programs generally have knowingly and purposefully focused on the subprime lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

2. Question: How many institutions will the guidance affect, and what will the impact on those institutions be?

Most institutions do not have subprime programs as defined by the guidance. We estimate that the guidance will currently apply to less than 2 percent of insured institutions (about 150 to 170) based on the Agencies' examination conclusions and monitoring activities. However, this number may change as institutions enter and exit the subprime lending business or as other institutions are identified as having subprime lending programs.

Most of the institutions affected have already experienced some degree of expanded review during recent examinations. Furthermore, most of these institutions already have sufficient reserves and capital to support their higher risk portfolios as outlined in the guidance.

3. Question: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25% of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk management and internal control systems in place to properly identify, measure, monitor, and control the inherent risks in its subprime portfolio. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk management and control systems in place to safely engage in the activity.

Subprime Characteristics

4. Question: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help examiners identify lenders that are engaged in subprime lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that "this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers."

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists *several* characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different

characteristics listed as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

- Fitch defines a subprime borrower as, "...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a [FICO] credit score in the range above 680." Fitch's mortgage credit grade matrix lists the following credit history elements for "A-," the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; charge-off or judgements exceeding \$500 in the past 24 months; and/or a debt-to-income ratio of 45%.¹
- Standard & Poor's subprime mortgage underwriting guidelines define subprime "A-" characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45%, and no bankruptcy in the past five years. Standard and Poor's also, "...considers subprime borrowers to have a FICO credit score of 659 or below."²
- Standard & Poor's has classified nonprime "B" auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1% to 7.5%, and FICO credit scores ranging from 620-679.³
- Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620-660 range as an indication that the "borrower's willingness to repay debt as agreed is uncertain." FICO scores below 620 are placed in the Cautious Review Category, and Freddie Mac considers scores below 620 "as a strong indication that the borrower's credit reputation is not acceptable...."⁴

¹ Fitch IBCA, Duff & Phelps, "Rating U.S. Residential Subprime Mortgage Securities," March 16, 2001: 2.

² Standard & Poor's, "U.S. Residential Subprime Mortgage Criteria," Structured Finance, 1999: 12, 169.

³ Standard & Poor's, "Auto Loan Criteria and Market Overview 1998," Structure Finance Ratings Asset-Backed Securities, 6.

⁴ Freddie Mac, *Single-Family Seller/Service Guide*, Chapter 37, Section 37.6: Using FICO Scores in Underwriting (03/07/01).

Capital Guidance

5. Question: If an institution is engaged in subprime lending as described by the guidance, does the 1.5 to 3 times capital described in the guidance automatically apply?

No. The Expanded Interagency Guidance on Subprime Lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan loss reserves and capital to offset the additional risks that may exist in subprime activities. The Agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution's overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution's reserves or capital are deficient will be discussed with the institution's management and with each Agency's appropriate supervisory office before a final decision is made.

6. Question: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk-based, e.g., the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime finance companies (that are not currently suffering from adverse ratings) maintain equity capital to managed asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.

Guidance's Effect on Lending Activities, Access to Credit, and the Secondary Market

- 7. Question: Are the Agencies concerned that the subprime guidance will affect availability of credit to consumers as a result of institutions not wanting to be labeled as “subprime lenders” or having to increase reserves and capital because of the subprime guidance?**

The Agencies do not expect institutions to curtail or discontinue a safely managed and successful lending program based on the guidance, nor should institutions be deterred by a loan portfolio segment being identified as subprime during an examination. The Agencies support lending designed to responsibly serve customers and enhance credit access for borrowers. Moreover, the Agencies believe that the industry as a whole is adept at making informed, rational credit decisions. Well-managed subprime lending, supported with the capital and reserve levels suggested in the guidance, can be a profitable business and at the same time serve community credit needs. Most institutions identified as subprime lenders already carry sufficient levels of reserves and capital to support the risks; therefore, additional costs should be minimal.

- 8. Question: Are the Agencies concerned that the subprime guidance will disrupt transactions in the secondary mortgage market?**

The subprime guidance, and any resulting increased supervisory analysis, is not expected to affect the purchase and sale of loans in the secondary market. The secondary market for loans with potentially higher-risk borrower profiles is well-established. For example, Freddie Mac and Fannie Mae have consistently purchased loans to higher risk borrowers based on their respective underwriting criteria. The GSEs define subprime to carry out their own objectives. Agency guidance to examiners does not dictate GSE policy.

- 9. Question: The Agencies' guidance indicates that it is “meant to intensify examination scrutiny of institutions” that systematically target the subprime market as a substantial line of business. Are the Agencies trying to discourage institutions from conducting this business by increasing the examination burden?**

No. The Agencies' objective is to ensure that subprime lending is conducted in a safe and sound manner so that its benefits can be realized without undue risk to the institution, its depositors, or the deposit insurance funds. While subprime lending can be profitable, some insured institutions have entered this business line without the appropriate risk management practices, reserves, or capital support, and a disproportionate number of problem situations and failures has resulted.

The guidance is consistent with the risk-focused examination process used by all of the Agencies. Under this process, the Agencies routinely concentrate examination resources on banking activities that pose higher risk to institutions, depositors, and the deposit insurance funds.