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OCC Addresses Subprime Lending Risk Issues

WASHINGTON-- The Office of the Comptroller of the Currency today issued guidance on subprime lending to assist banks that engage in this new activity and to ensure that they understand the risks involved and have appropriate controls in place.

"While subprime lending can offer attractive returns, it is a new business for our banks and it carries with it a new set of risks," said Comptroller John D. Hawke, Jr. "Banks that engage in subprime lending must be sure that they understand this unique business and that they have systems in place to monitor, control and price the risk they are taking on."

"The guidance we are issuing today will assist senior bank management in understanding not only the risks involved in subprime lending, but the resources necessary to prudently manage those risks."

The issuance, which supplements interagency guidance issued by the four federal bank and thrift regulatory agencies on March 1, calls for banks that engage in subprime lending to establish and maintain the following safeguards:

- Detailed policy guidance that sets limits on the amount of risk that will be assumed;

- Controls to ensure effective portfolio servicing activities, including collections, default management, and collateral document management;

- Risk management processes and analyses that promote understanding of the portfolio and early identification of negative trends;

- Reporting systems capable of providing the information necessary to assess adherence to established underwriting, operating, pricing, accounting, and appraisal guidelines;

- Controls to ensure compliance with fair lending and other consumer protection laws.

Subprime lending describes credit that is extended to borrowers exhibiting higher delinquency or default risk characteristics than those of traditional borrowers. Subprime borrowers represent a broad range of risk, but include those who persistently mismanage their debt obligations, those who have exhibited repayment problems because of an adverse event such as job loss, and those with unproven credit performance.

"If properly managed, subprime lending provides a means to bring

into the banking system a new group of borrowers who would not qualify for credit under traditional criteria," said Mr. Hawke. "As they build a solid credit history, they have an opportunity to move into more traditional loan programs. That benefits both the borrower and the bank."

During 1998, the OCC responded to the rapid growth in subprime lending with a series of examinations designed to evaluate the planning, loan production, loan servicing, securitization, and risk management practices employed by national banks that participated in this market.

"These examinations demonstrated that a key consideration for lenders entering the subprime market should be the ability to earn risk-adjusted yields, as opposed to nominal yields" said David D. Gibbons, Deputy Comptroller for Credit Risk. "The yields must be sufficient to fully compensate the bank for the increased credit and operational risks and costs assumed."

The new guidance addresses the serious weaknesses disclosed by these examinations in the business and control processes used to manage the risks associated with subprime lending activities.

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