OCC 99-15
OCC BULLETIN

Comptroller of the Currency

Administrator of National Banks

Subject: Subprime Lending Description: Risks and Rewards

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

PURPOSE AND SUMMARY

This bulletin discusses the risks and rewards associated with subprime lending and provides supplemental guidance for national banks that engage in this activity. Because subprime lending may affect a bank's allowance for loan and lease losses and its funding strategies, a basic discussion of those topics is included, as well. Interim examiner guidance may be found in the appendix; such guidance will eventually appear in a booklet of the *Comptroller's Handbook*. This material augments the "Interagency Guidance on Subprime Lending" that was jointly issued by the federal financial institutions regulatory agencies on March 1, 1999.

While subprime lending can offer attractive returns and expand consumer credit choices, it involves elevated levels of credit and other risks. Banks must engage in such lending cautiously. The board of directors must have done comprehensive due diligence; management must have a well-developed business plan that acknowledges the increased risk levels, allocates the necessary resources, and establishes the controls necessary to prudently manage the risks.

The following safeguards should also be in place and effectively maintained:

- Detailed policy guidance that sets limits on the amount of risk that will be assumed, and addresses how the bank will control portfolio quality and avoid excessive exposure.

- Increased capital, if appropriate, for the volume and nature of risk 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 adverse quality/performance trends.

- Reporting systems capable of providing the detailed information necessary to assess adherence to established underwriting, operating, pricing, accounting, and appraisal guidelines, as well as the effects of those guidelines.

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

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BACKGROUND

The terms "subprime" or "nonprime" lending describe credit that is extended to borrowers exhibiting higher delinquency or default risk characteristics than those of traditional borrowers. Risk of default may be assessed by conventional credit risk measures (such as credit/repayment history and debt-to-income levels) or by alternative measures (such as credit scores). Subprime lending generally covers two broad categories of borrowers: those attempting to repair their credit history because of previous credit problems (usually one or more major derogatory items such as 90 days or more past due, charge-offs, or bankruptcies); and those attempting to establish or expand their credit history (because, for example, of "thin" files or little or no traditionally reported credit activity). Borrowers within these categories represent a broad range of risk, but typically include those with unproven credit performance, repayment problems because of an adverse event such as job loss or medical emergency, or a history of mismanaging their finances and debt obligations.[1]

Subprime lending is emerging as a target market for many national banks. Market evolution has been influenced by factors such as increased competition by nonbanks in the prime lending markets, added funding availability through the securitization market, and a growing recognition of business opportunities available in previously underserved or unserved markets. This increased competition has the tendency to result in declining margins and relaxed underwriting standards, trends that are beginning to show in the OCC's annual underwriting surveys. This erosion, coupled with increasing consumer debt burden levels, has the potential to adversely affect the long-term profitability and asset quality of subprime lenders, especially if economic conditions deteriorate.

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 participate in this market. These examinations uncovered a number of serious weaknesses in the business and control processes used to manage the risks associated with subprime lending activities. The deficiencies were more pronounced in two types of banks: those that knowingly engaged in subprime lending activities without an adequate understanding of the risks involved and those that unwittingly entered the market by relaxing underwriting standards or loosening credit-grading criteria in response to competition.

The reviews also indicated that few lenders have the ability to measure profitability at the product, portfolio, and customer level, increasing the likelihood of inappropriate

[1] The existence of any one default factor need not result in credit to the borrower being considered subprime. Mechanisms to mitigate risk characteristics or the lack of a credit history, such as a government guarantee supporting the credit, may allow lenders to extend the credit to the borrower on more favorable terms. Banks may also consider using government subsidies and other credit enhancements, setting up a reserve account for a borrower's unanticipated expenses, and working with community partners to provide the borrower with education and technical assistance.

strategic decisions or competitive responses. This deficiency is significant because banks are often attracted to the subprime market by the potential to earn yields that far exceed those available in the prime markets. The key consideration for lenders entering the subprime market should be the ability to earn ***risk-adjusted*** yields that appropriately compensate the bank for the increased credit and operational risks and costs assumed.

The OCC supports banks' efforts to responsibly serve their customers and enhance credit access for borrowers with special credit needs. However, the OCC is concerned by the extent to which some banks have focused on competitors' product design, terms, and pricing; without sufficient consideration of their own strategic plans, management expertise, risk management, and operational capacity/capability. While many of the principles and operational requirements are similar to traditional prime consumer lending, the need for increased attention to detail is heightened with the increased level of risk assumed in subprime lending. Consequently, banks should not engage in this activity without a clear understanding of the business and its inherent risks and a well-conceived business plan. Anything less exposes the bank to unacceptable and unnecessary risk of loss.

Banks must also recognize the fair lending and other compliance risks presented by subprime lending activities, and take steps to control those risks. In particular, banks must ensure that credit criteria – including those that distinguish prime from subprime borrowers – are applied in a nondiscriminatory manner, based on factors that reasonably predict risk and advance legitimate business purposes. Similarly, banks working with affiliated or unaffiliated subprime lenders must take steps to ensure that referrals of credit applicants to and from the subprime lender are made in a nondiscriminatory manner and otherwise comply with fair lending and other applicable laws.

The remainder of this bulletin discusses business planning and risk management practices that should be observed by banks that choose to engage in subprime lending in any material way.

STRATEGIC AND BUSINESS PLANNING

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Comprehensive due diligence is a prerequisite for informed decision-making on any material new line of business, and especially for subprime lending because of the additional and sometimes nontraditional risk being assumed. Management and the board must fully understand the business and the inherent risks if they expect to mitigate them effectively. At a minimum, due diligence should focus on understanding the higher levels of credit, compliance, reputation, and other risks involved, plus the likelihood that origination, servicing, collections, operating, and capital costs will increase. Moreover, the bank must realistically assess whether it has the commitment and resources to meet these costs; if it does not, the business should not be entered or expanded.

The following specific considerations should be included in the decision-making process:

- **Competition**. Before deciding to engage in subprime lending, the board and management should conduct a realistic analysis of the competitive environment. Long-term success and profitability usually require products that are designed to leverage an individual institution's unique strengths and capabilities, rather than simply reacting to competitive pressures. Pursuing a market or product line that is already saturated with competitors will be less likely to yield acceptable risk-based returns over time.

- **Management, Staffing, and Training Needs**. Specialized expertise is required to manage subprime lending operations effectively. The board and management should pay particular attention to ensuring that a strong and experienced subprime management team and adequate staff are in place before engaging in the activity. In addition, compensation programs should be weighted towards factors such as portfolio quality and risk-adjusted profitability and should never depend primarily on volume or growth targets.
- **Information Systems.** As with any retail credit product, detailed analyses are critical to the risk management function. This is particularly true for subprime lending because of the specialized nature of the activity and the increased risk presented by the customer base. The ability to perform the level of analysis warranted depends on the accuracy, completeness, and timeliness of information generated by the bank's MIS and operating systems. Therefore, management should ensure that systems employed possess the capacity and level of detail necessary to accommodate subprime activity, and that data integrity is regularly tested.

- **Profitability and Pricing**. Comprehensive profitability projections should be prepared for each subprime product and incorporated into the business plan. Profitability projections should reflect *all* relevant costs, including corporate overhead; acquisition, servicing, and collection expenses; allowance allocations;

and funding and capital costs. Management should track actual performance against projections regularly and have a process for addressing variances.

Most banks recognize the importance of risk-based pricing, yet the approaches employed are often unsupported. Reasonable and prudent pricing methods should differentiate the price charged based on factors that result in higher cost structures, such as a higher risk of default, higher risk of loss in the event of default, and higher prepayment speeds. Banks should support the basis for risk-based pricing differentials through clearly documented analyses which show that returns are adequate to compensate them for the various levels of risk assumed. Once the pricing structure has been established, management should also ensure that the bank's underwriting process accurately assesses applicants' ability to perform given the prescribed interest rates and fee structures.

Properly analyzed and documented risk-based pricing decisions also help minimize the potential for discriminatory pricing differences. Banks that cannot fully justify and support pricing differences based on risk will face heightened compliance and reputation risk exposures if pricing results in disparate treatment, if pricing decisions are made on bases prohibited by the Equal Credit Opportunity Act or other consumer protection statutes, or if practices appear to be abusive or arbitrary to particular customers or groups. Permitting loan officers the discretion to set prices on a loan-by-loan basis without documenting a risk or cost basis for the price will significantly increase the compliance and reputation risk for an institution.

- **Customer Relationship Planning**. Another major planning consideration is the long-term relationship that the bank wishes to establish with its customers. Many subprime borrowers should eventually migrate to a lower risk status as they demonstrate the ability to perform on their obligations. Banks should anticipate this event and design the products and processes necessary to recognize and reward borrowers' financial improvement. In addition, cross-selling opportunities and profitability objectives which realistically consider customers' needs and capacity to incur additional debt should be documented in action plans. Without such long-range planning and monitoring systems in place from inception, banks may fail to capitalize on the time and money expended in building the relationship and lose customers to more attractive or comprehensive offers from competitors.

- **Operating Capacity.** Because of customer maintenance requirements, subprime lending can quickly strain staff and operating systems. The planning process must consider the capacity constraints and the associated costs of efficiently servicing and collecting the anticipated volume of subprime lending.

- **Control Systems**. Because banks engaging in subprime lending assume a higher level of credit, compliance, transaction, reputation, and other associated risks, they cannot afford unnecessary exposure from failure to adhere to prescribed policies and procedures. A strong feedback process should be established whereby information obtained through control processes such as audit, loan review, and quality control is used to assess the appropriateness of policies and procedures.

The strategic decision to engage in subprime lending should also be supported by a sound business plan that establishes measurable financial objectives as well as limitations on growth, volume, and concentrations. These limitations should be established by product, collateral type, customer type or loan grade, and channel (source of origination). In addition, clear income and asset quality benchmarks should be established, with performance against targets regularly reviewed and discrepancies analyzed. Business plan performance analysis should be conducted frequently in the early stages of a new business or product initiative in order to detect adverse trends or circumstances in a timely manner.

POLICIES AND PROCEDURES

Management should develop and implement comprehensive policies and procedures specific to each subprime lending product before initiating the activity. The policies should provide well-defined guidance pertaining to risk limits, terms, operating procedures, collection activities, and compliance with applicable laws and regulations. Specific considerations are discussed in the following sections.

Loan Production

Banks generally originate subprime loans through a variety of channels, including direct sales, dealers, brokers, correspondents, and telemarketers. Regardless of source, it is critical that underwriting policies and procedures incorporate the risk tolerances established by the board and management and explicitly define underwriting criteria and exception processes. Underwriting policies and procedures should also address the following:

- **Clearly defined credit grades**. Credit grades should contain minimum and maximum criteria for each category (i.e., the lowest grade should not be a catchall that includes everything below the maximum criteria). The policy should also set guidelines for the following credit terms by risk grade:

- Maximum loan amount,
- Repayment terms,
- Advance rates/maximum loan-to-value, and
- Pricing.

- **Specific requirements for verification of application and collateral information**. At a minimum, address, income, and employment information should be verified. For sales financing, it is also advisable to verify product options or upgrades and cash down payment information with the applicant before disbursing funds.

- **Specific delegation authorities and monitoring and review procedures for third parties that are a source of accounts for the bank.** The bank should regularly track the quality of accounts sourced through each channel and make decisions regarding the continuation and form of the vendor relationship. Areas that warrant monitoring include performance (payments, delinquencies, and charge-offs); profitability; volume; approved versus declined accounts; credit grades of approved accounts; documentation and collateral exceptions; scorecard overrides or other underwriting exceptions; compliance with consumer protection laws and regulations; and consumer complaints.

- **Procedures for reviewing appraisal and other collateral valuations.** Since collateral frequently is a significant factor affecting the risk in subprime lending, it is essential to have an effective collateral review process. The process should include standards and procedures for performing initial and periodic collateral evaluations, a method for monitoring appraised or assigned values, and a process to select and manage a list of approved appraisers and other sources of collateral valuations.

- **Procedures for maintaining control of loan proceeds for debt consolidation loans to ensure that they are used to retire existing debt.** Management should consider adopting covenants that require borrowers to close consolidated accounts or otherwise limit subsequent debt assumption to better control the level of risk accepted.

- **Procedures for a post-closing document tracking process.** An effective review process should be in place to track critical post-closing documents such as mortgage notes, assignments, and title policies.

Servicing and Collections

A well-developed servicing function is essential for effective management of subprime lending. Management should establish procedures and operational controls that are efficient and able to facilitate the early intervention necessary to properly manage higher risk borrowers. Strong procedures and controls are necessary throughout the servicing process; however, particular attention is warranted in the areas of new loan setup and collections.

New loan setup consists of inputting borrower information into the servicing system to ensure accurate payment processing and loan management. Appropriate servicing of the loan requires the loan setup unit to input data accurately and in a timely manner. (For mortgage loans, new loan setup normally occurs within 15 days of closing, although it may be moderately longer for acquired loans.) Upon setup on the servicing system, the borrower is normally sent a letter that introduces the company's services and includes the first payment coupon. Timely new loan setup improves the bank's ability to monitor borrower performance, establishes positive customer relations, and helps to reduce the volume of loans with first payment defaults.

Collection processes in a subprime lending operation are generally more intensive than in prime lending operations. Subprime lenders should have well-defined written collection policies and procedures that include issues such as default management (e.g., cure programs, foreclosures, and repossessions), re-marketing efforts, and strategies to minimize delinquencies.

Cure programs include practices such as re-aging, extensions, renewals, rewrites, or other types of account restructuring. Cure programs should be used only when the bank has substantiated the customer's renewed willingness and ability to pay, and evaluated the probability of future payments sufficient to satisfy the debt. (See also "Uniform Retail Credit Classification and Account Management Policy" issued by the Federal Financial Institutions Examination Council.) The terms of the revision should be in writing and acknowledged by the borrower with a signature, with any associated fees collected up front. Management should perform periodic analyses to ensure that its cure programs are neither masking poor initial credit risk selection nor deferring losses.

Policies and procedures for foreclosure and repossession activities should specifically address the types of cost/benefit analyses to be performed before pursuing collateral, including valuation methods employed; timing of foreclosure or repossession; and accounting and legal requirements. Management should also ensure that staffing levels are appropriate to resolve foreclosures and repossessions quickly.

Collateral re-marketing is often a component of the loss mitigation process in subprime lending. Re-marketing policies and procedures should ensure that collateral is acquired and liquidated effectively and in compliance with applicable laws. In addition, policies should clearly outline whether the bank will finance the sale of the repossessed collateral, and if so, the limitations which apply. Banks should track the performance of such loans to assess the adequacy of these policies and procedures.

An important aspect of an effective subprime servicing and collection program is frequent bank-initiated communication with customers. As indicated earlier, subprime lending is by nature riskier-than-normal lending in that it involves extending credit to borrowers exhibiting higher default risk characteristics and delinquency rates. In order to provide this service to borrowers who need assistance to develop or reestablish the necessary payment discipline to improve their credit standings, banks should consider employing some or all of the following communication techniques:

- **Welcome calls.** The customer service department usually initiates communication with the borrower within a day or two of loan origination to review loan terms and answer any questions. Lenders that use these calls find they can often clear up misunderstandings that may occur during the origination process early, thereby averting ill-will or payment problems in the future.

- **Monthly statements.** Subprime lenders generally believe that monthly statements are more effective than payment coupon books. Regular statements keep the debt highlighted in the borrower's mind, whereas a coupon book may languish forgotten in a drawer. In addition, statements provide lenders with an additional opportunity to communicate with their borrowers (through statement messages, inserts, or newsletters), and to update customers on their balances and account status.

- **Reminder calls.** These calls are placed several days before the payment due date to remind borrowers of the upcoming payment. Lenders have found that this practice helps keep the upcoming payment a priority in the borrower's mind, and it has been particularly effective for new or higher risk borrowers.

- **Late payment calls.** Soon after a missed payment date, a late payment call lets the borrower know that late payments do not go unnoticed. Since subprime borrowers often have higher leverage ratios, timely initiation of the collection process may help lenders direct available cash to the required loan payment. Subprime lenders have found telephone calls to be more effective than letters for notifying debtors of their delinquency status and eliciting payments.

- **Default Letters.** In the event that a loan becomes delinquent and the lender is not able to contact the borrower, or the loan becomes two payments delinquent, collectors often send a default letter to the borrower to convey the seriousness of the situation in writing.

Inappropriate Practices

The following practices are usually limited or prohibited by successful subprime lenders:

- Payment holidays, skip-a-pays, or similar programs where a customer is given the option to forgo one or more payments due.
- Pay-aheads, where a payment that exceeds the contractual amount due is applied in such a way that it eliminates the need to make monthly payments until the over-payment is exhausted.
- Recurring re-agings, extensions, or renewals, for accounts with no supportable or demonstrated improvement in ongoing repayment ability.
- Over-limit authorizations on open-end subprime accounts for other than emergency purposes.

These practices increase risk in that they may mask actual portfolio performance and inhibit the ability of management to understand and monitor the true credit quality of the portfolio. In addition, rehabilitating damaged credit or establishing new credit requires the discipline of maintaining a regular payment schedule in order to demonstrate credit performance.

RISK MANAGEMENT

Involvement of the bank’s risk management function should begin with new product design and continue through to the collections process. Because risk management is such a critical function, the board and management should ensure that these positions are adequately staffed with competent, experienced individuals who have sufficient resources, tools, and management support to discharge their responsibilities effectively.

Today’s frequently automated, volume-oriented consumer lending environment also requires clear, accurate, and timely management information to effectively manage risk. Too often, banks choose to modify existing information systems to manage their subprime portfolios without first determining what specific or new information is required to realistically assess performance. This lack of appropriate information leads to an incomplete understanding of the quality and performance of the portfolio, and limits the opportunity to make timely adjustments to plans, products, policies, or training when necessary. Noted deficiencies include the inability to monitor profitability by product or customer, inadequate exception reporting, inadequate document tracking systems, and inadequate information to properly analyze the sources and causes of quality shifts and other performance issues. Areas which warrant particular attention in a subprime lending environment include exception tracking and reporting, portfolio and customer analysis, and credit scoring and reporting.

Exception Tracking and Reporting

Tracking exceptions to lending and operating policies is critical to understanding portfolio quality, analyzing trends, and monitoring compliance with fair lending and other consumer protection laws. At a minimum, management should track and report exceptions in the areas of underwriting policy, collateral and documentation, credit grading, pricing, credit score overrides, and over-limit accounts. Reports should show exceptions by individual account and capture aggregate trends over time. In addition, management should regularly track exceptions by bank employee, specific dealer or broker, or other origination channel. This information should be used to measure additional risk overall and by channel, to make adjustments to policies and procedures, identify training needs, and to provide input for personnel evaluations and compensation programs.

Portfolio Analyses

Analyses of portfolio quality should capture trends in volume, delinquencies (including early payment defaults[2] and roll rates[3]), charge-offs, cash collections, collateral valuations, bankruptcies and prepayments, cure or workout programs, and exceptions. At a minimum, analyses should be segmented by product, vintage, credit grade, and origination source; they should identify shifts in portfolio mix and risk profiles. Because

[2] Early payment defaults include first payment defaults as well as accounts with two or more payments past due within the first six months.

[3] Roll rates refer to the movement of accounts from one payment status to another; e.g., the percentage of 60-days-past-due accounts that “roll” to 90 days past due or, conversely, from 60 days past due to current. Calculations should capture both forward (worsening) and backward (improving) performance.

of the potential for rapid growth to mask performance, analyses should incorporate adjustments to assess performance under more normalized growth patterns. This is typically done through the use of reports that track delinquency and charge-off performance on a lagged basis. A lagged report compares today's delinquencies or charge-offs to outstanding balances from a prior period. Common lag times usually range from six months to one year for most consumer products, although the timing should reflect normal seasoning periods (or delinquency patterns) for specific products. Management should understand the causes of identified shifts and trends in portfolio quality and document actions taken to mitigate increasing risk levels (e.g., underwriting policy changes, redirected marketing efforts, or changes to collection strategies).

Ongoing portfolio quality analyses should also include reviews of changes in customer creditworthiness over time, particularly for open-end lines of credit. This information promotes appropriate and timely account management activities (e.g., account graduation and/or cross-selling, line increase/decrease, early intervention, or counseling). Active review of customer behavior at the account level will also enhance management's understanding of the subprime market.

As previously noted, the industry recognizes two distinct groups within the subprime population: borrowers attempting to repair their credit and those attempting to establish traditional credit payment histories. These two populations tend to behave differently. However, with the possible exception of initial account-decision scorecards, the groups are rarely segmented for purposes of analysis or account management. Effective risk management requires further segmentation to understand and respond appropriately to this customer base. Market segmentation should also extend beyond the two major groups to possible behavioral subgroups. For example, a bank might segment borrowers repairing credit because of a major medical event from those in an over-leveraged position.

Credit Scoring and Reporting

If the bank elects to employ credit scoring, models must be appropriate for the subprime population targeted and the products offered. It is not acceptable to rely on models developed for prime-type populations or differently structured products. Furthermore, any scoring models used should be actively monitored and periodically revalidated. (See OCC Bulletin 97-24, "Credit Scoring Models–Examination Guidance," dated May 20, 1997, for additional discussion of credit scoring models and expectations.)

In an apparent attempt to stem attrition, some institutions have chosen not to report performance on their subprime customers to the credit bureaus. The OCC believes it is appropriate for lenders to report to credit bureaus because failure to do so (1) makes credit bureaus' reports and scores less reliable; (2) undermines the lenders' ability to assert that they are helping customers repair their credit, currently a common subprime marketing point; and (3) prevents borrowers from demonstrating responsible credit payment behavior. The retail credit industry relies heavily on credit bureau information, and it is in the best long-term interests of users and borrowers that the information be as complete and accurate as possible.

CONTROL FUNCTIONS

In dealing with high-risk credit products, management should take steps to ensure that exposures from operational deficiencies, collateral imperfections, or third-party practices or financial instability are minimized. Effective and comprehensive control functions help avoid the assumption of unanticipated risk.

Quality Control and Audit

Quality control is a process for monitoring operational adherence to established risk tolerance levels and control processes, as contained in policies and procedures. A sound quality control program includes written objectives and procedures, established accountability and authority to resolve noted deficiencies, and independence from the operational areas. Quality control reports should be distributed to the board and senior management. These reports should present findings, track the resolution of identified issues, and assess the adequacy and timeliness of corrective action implemented. Coverage should include:

- Statistically valid monthly samples of all products by branch or office and by third-party originator. If statistical sampling methods are not used, it is recommended that a minimum of 10 percent of loan production activity be reviewed.

- Risk-based or discretionary samples of new products, underwriters, or third-party originators.

- Re-verification and documentation of residence, employment, income, deposits, and closing funds for all mortgage loan samples. Mortgage loan re-reviews should also include obtaining new credit bureau reports and substantiating property values for a portion of the sample. Well-managed subprime lenders typically "re-underwrite" 100 percent of loans originated through third-parties, or have effective control systems in place to monitor delegated underwriting activities.

- Re-verification and documentation of residence, employment, income, and transaction details such as product options and cash down payment for a reasonable sample of indirect installment sales credits.

Adequate staffing for control functions, in terms of numbers and expertise, is critical for subprime operations. Quality control should be sufficiently staffed to provide thorough and ongoing coverage of all operational areas. The board and management should also ensure audit staffing and coverage adequate to render an opinion on the quality of the subprime unit's operations, including internal and accounting controls, compliance with laws and regulations, and adherence to accounting standards.

Vendor Management

Banks use outside parties to perform a host of functions, from account origination and acquisition through collections. There are two major types of subprime vendors: those that source customers for the bank and those that provide a service to the lending operation (e.g., mail houses, data processors, equipment suppliers, outsourced operations). Because of the loss of direct operating control, banks must have a strong vendor management process that:

- Details the due diligence required in the vendor approval process;
- Ensures inclusion of key contract provisions, including those that require submission of information pertinent to managing the relationship;
- Assigns responsibility and accountability for managing the relationship;
- Clearly outlines oversight and monitoring procedures (e.g., monitoring of adherence to contract terms, tracking and analysis of specified performance measures, review of financial statements, performance of on-site reviews);
- Ensures that third-party originators meet the bank's underwriting standards on an ongoing basis; and
- Ensures compliance with fair lending and other consumer protection laws and regulations.

The OCC expects bank management to actively monitor subprime vendor performance and to take prompt corrective action when problems are noted. For example, banks engaged in indirect auto lending should closely monitor the quality of the accounts acquired from each dealer. Should the paper obtained from a given dealer perform below expectations, management should determine the cause and either institute effective remedial action or take steps to terminate the relationship.

OTHER CONSIDERATIONS

Other significant factors in the effective management of subprime activities include loan loss reserve protection and, for banks securitizing or servicing assets for third parties, accounting assumptions and reporting requirements.

Allowance for Loan and Lease Losses

Determining the adequacy of the allowance requires detailed analyses using proper portfolio segmentation and loss estimation techniques. Reserve practices should be sufficiently robust to protect against losses, taking into consideration actual loss experience, trends in borrower and collateral profiles, and any changes in the business or economic conditions.

Well-designed analyses recognize and adjust for the impact of portfolio growth, segment the portfolio to recognize major risk exposures, and use delinquency roll rates (by product, channel, vintage and grade) to evaluate exposures. Reserve analyses should also consider the impact of changes to underwriting, account management, and collections policies and procedures over time. Factors such as debt-to-income and loan-to-value standards will affect the ultimate amount of loss. Default-rate pricing or re-pricing initiatives that result in rate increases may also negatively affect loss rates. Other considerations include the success of cure programs, foreclosures and repossessions, and re-marketing practices.

More guidance can be found in the “Allowance for Loan and Lease Losses” section of the *Comptroller’s Handbook*. Lenders also must be aware that subprime loans, whether held by the bank or an affiliate, are subject to the FFIEC’s “Uniform Retail Credit Classification Account Management Policy.” The charge-off and other standards in the FFIEC policy are minimums and subprime lenders should consider adopting more conservative policies.

Securitization Activities

Because some banks rely on the securitization markets to fund their subprime lending, they must fully understand the accounting implications of such activity. The Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" (FAS 125), governs the accounting treatment for asset transfers in a securitization transaction. If a securitization transaction meets FAS 125 criteria, the seller must recognize any gain or loss on the sale on the date of the transaction (known as "gain-on-sale" accounting). Future expected cash flow streams from the securitized assets are recognized by establishing interest-only (IO) strip assets and servicing assets or liabilities. An IO strip asset represents the contractual right to receive excess interest cash flow from the securitized assets after credit losses, servicing fees and funding costs. A servicing asset is recorded when the benefits from servicing are expected to exceed adequate compensation demanded in the market for a third party to assume the servicing. A servicing liability is recorded when the benefits from servicing are expected to be less than adequate compensation demanded in the market for a third party to assume the servicing.

The valuation method and key assumptions used to value IO strip and servicing assets or liabilities must be reasonable and well-supported. In the initial valuation and the periodic impairment analyses, the projected cash flows to the bank must be realistic. Analyses should segment securitized assets by specific pool, and stratify the assets by predominant risk characteristics that may include: product, size, interest rate/coupon and type (fixed or variable), credit grade, origination date (vintage), term, geographic location, and origination channel. Key assumptions in all valuation analyses include:

- **Prepayment rates.** Prepayment speeds are a critical risk to securitized asset pools and should be analyzed thoroughly and monitored closely for initial valuation and ongoing impairment analyses. Prepayment speeds can vary greatly by product, credit grade, loan-to-value, geographic area, and other demographic or economic factors. For example, voluntary prepayments commonly accelerate with market interest rate reductions, driving down the estimated life of the pool of underlying assets and, therefore, the value of IO strips and servicing assets. In the subprime industry, improved borrower debt service ability is a significant factor in prepayment speeds, i.e., subprime borrowers may prepay faster than prime borrowers as they move up the credit spectrum, and may refinance at lower rates even without changes in market interest rates.

- **Credit loss rates.** Credit losses are a function of default rates and loss severity. Losses vary by loan characteristics such as loan-to-value, seasoning, credit grade, and lien position. Thus, effective loss forecasting and tracking of actual performance against projected loss rates is imperative. Management should track losses by product, channel, credit grade, vintage, and static pool.

- **Discount rates.** Prepayment and default levels in the subprime markets are generally more volatile than in the prime market, which adds uncertainty to the timing and receipt of cash flows. Discount rates associated with subprime asset pools should reflect these underlying risk factors, with higher discount rates for more risky or uncertain cash flows. Two separate discount rates are often used to value retained interests held outside of trading accounts (trading account assets are marked to market daily). The discount rate used to estimate fair value in the initial and subsequent residual asset valuations should be based on current interest rate levels, adjusted for a spread that reflects the risks inherent in the transaction. If periodic valuations indicate that impairment exists, management should determine whether the impairment is temporary or other-than-temporary. One method of making this distinction is to perform a valuation analysis using a second discount rate, the risk-free rate of interest, in the present value calculation. If the present value of estimated future cash flows discounted at a risk-free rate is less than the amortized cost basis of the asset, the impairment is considered other-than-temporary and should be recognized in the income statement. For additional information on this method of distinguishing between temporary and other-than-temporary impairment, refer to the Financial Accounting Standards Board's Emerging Issues Task Force Consensus 93-18.

- **Servicing revenues.** Factors that influence the carrying values of servicing assets or liabilities include projections of late charges, other ancillary revenues, and current market rates for servicing. These factors may vary over time and with changes in borrower performance. Management should compare actual cash flows received with projected amounts to ensure that assumptions remain reasonable.

The relative importance of each assumption varies with the underlying characteristics of the product types. For example, credit loss assumptions have been far more critical for shorter-term products such as subprime auto and credit card pools, where defaults and credit losses occur earlier in the life of the underlying assets. Although credit considerations are always a concern in the subprime markets, the gains and IO valuations of longer term products such as home equity loans have tended to be more sensitive to changes in prepayments. The OCC expects banks to take a **conservative** approach when developing securitization assumptions and capitalizing future income flows from subprime lending pools.

Many issuers of asset-backed securities also provide credit enhancement to improve the marketability of the securities. Such enhancement is often cash collateral or over-collateralization using additional receivables. Aside from the regulatory capital requirements associated with various credit enhancement techniques, gain-on-sale calculations and subsequent valuation analyses should also recognize the deferred timing of cash receipts in transactions involving over-collateralization or cash collateral accounts. The accumulation or build-up required to fund over-collateralization enhancements can take an extended period (often 6-10 months), resulting in delayed cash flow to the issuer for much of the first year. However, in performing initial and subsequent valuation analyses, some issuers ignore the initial delayed cash flow as the over-collateralization account is funded, and give immediate time value to the excess spread. This approach is known as cash-in because it attributes cash flows to the bank even though the cash is still controlled by and held within the securitization trust. This valuation method can materially overstate the gain-on-sale recognition and is not consistent with generally accepted accounting principles (GAAP). The OCC requires that gain-on-sale calculations recognize that the cash flow stream is temporarily interrupted while over-collateralization accounts are funded. This valuation approach is known as cash-out because cash flow is only valued after it emerges unencumbered from the trust.

The recognized gain-on-sale amounts and the ongoing value of IO strip receivables depend on projected cash flow streams. Therefore, in addition to monitoring pool performance using accrual accounting methods, it is also prudent to monitor and compare actual net cash received from securitized asset pools with initial projections. The OCC recommends that banks use a static pool cash collections analysis that focuses on actual cash flows. This analysis entails reviewing monthly cash interest received relative to the principal balance of the pool to determine the cash yield on the portfolio; comparing the cash yield to the accrual yield; and tracking monthly changes. As part of this analysis, management should compare the timing and amount of cash flows received from the trust with those projected in the initial and subsequent valuation analyses. Monitoring and analyzing this data will help validate the appropriateness of the bank's assumptions, demonstrate prepayment speeds by pool, and provide an early indication of problems with collections or extensions.

Client and Investor Reporting

For banks that securitize or service loans for third parties, accurate and timely client and investor reporting is essential. Strong internal control systems must be in place to ensure that record-keeping is accurate, that accounting practices are appropriate, and that reports are prepared and distributed to appropriate parties in a timely manner. Procedures should be in place to reconcile each client or investor account monthly. Outstanding reconciling items generally should be resolved within 30 days. Aging reports for unreconciled items should be maintained and reviewed regularly.

SUMMARY

OCC 99-15
OCC BULLETIN

Comptroller of the Currency

Administrator of National Banks

Subject: Subprime Lending Description: Risks and Rewards

Subprime lending can be a viable means of enhancing bank income and meeting the credit needs of underserved and unserved markets. However, it requires specialized expertise, sound planning, and comprehensive analysis and systems to control the elevated risks associated with these activities. The absence of such safeguards in a bank that is materially engaged in subprime lending may constitute an unsafe and unsound banking practice.

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Appendix