

# Ohio Division of Financial Institutions

## Mortgage Brokers & Lenders Letter 2008-2

March 7, 2008

TO: Ohio Mortgage Lenders Registered Under the Ohio Mortgage Loan Act.

SUBJECT: Statement on Subprime Mortgage Lending Regarding Compliance with Ohio R.C. §§ 1321.53(A)(4) and 1349.41(B)

SUMMARY: This letter is intended to alert mortgage lenders registered under the Ohio Mortgage Loan Act of the position of the Ohio Division of Financial Institutions that compliance with the requirement that they demonstrate financial responsibility, character, and general fitness to warrant the belief that the business will be operated honestly and fairly in compliance with and within the purposes of sections 1321.51 to 1321.60 of the Revised Code per Ohio R.C. §1321.53(A)(4), as well as act in good faith and with fair dealing per Ohio R.C. §1349.41(B), requires due consideration of the proper procedures set forth herein on the placement of subprime loan products.

### **Ohio Revised Code § 1321.53(A)(4)**

This provision of the Ohio Mortgage Loan Act (“OMLA”) is intended to prevent dishonest businesses or those that act in violation of the OMLA or its purposes from obtaining or retaining a certificate of registration under the OMLA.

### **Ohio Revised Code § 1349.41(B)**

This provision of the Ohio Revised Code is intended to require that mortgage lenders act in good faith and fair dealing when, inter alia, presenting loan products and financing options to consumer borrowers.

## **OHIO DIVISION OF FINANCIAL INSTITUTIONS STATEMENT ON SUBPRIME MORTGAGE LENDING**

### **I. INTRODUCTION**

On July 10, 2007, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) published a final interagency Statement on Subprime Mortgage Lending in the *Federal Register* (Volume 72, Number 131, Page 37569-37575) (“Subprime Statement” or “Statement”). The interagency Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency Statement does not cover a majority of loan originations, on March 2, 2007 the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) announced their intent to develop a parallel statement for use by the mortgage industry and state regulatory agencies.

The following statement adopted by the Ohio Division of Financial Institutions will assist in the regulation of mortgage lenders, brokers, and loan officers not affiliated with a bank holding company or an insured financial institution. The statement will promote consistent regulation in the mortgage market and clarify how one can offer subprime mortgage products, and in particular adjustable rate mortgage (ARM) products, in a way that clearly discloses the risks that borrowers may assume.

In order to maintain regulatory consistency, this guidance and statement substantially mirrors the interagency Statement, except for the deletion of sections not applicable to non-depository institutions.

## **II. BACKGROUND**

The Agencies developed their Statement on Subprime Mortgage Lending to address emerging risks associated with certain subprime mortgage products and lending practices. In particular, the Agencies were concerned about the growing use of ARM products<sup>1</sup> that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. There is concern by both the Agencies and the Ohio Division of Financial Institutions ("Division") that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers.

Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period. In addition, borrowers may not be adequately informed of product features and risks, including their responsibility to pay taxes and insurance, which might be separate from their mortgage payments.

These products originally were extended to customers primarily as a temporary credit accommodation in anticipation of the early sale of the property or in expectation of future earnings growth. However, these loans have more recently been offered to subprime borrowers as "credit repair" or "affordability" products. The Division is concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Division is also concerned that subprime borrowers may not fully understand the risks and consequences of obtaining this type of ARM loan. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that is not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

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<sup>1</sup> For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

### III. TEXT OF GUIDANCE

The text of the Division's Statement on Subprime Mortgage Lending follows:

#### STATEMENT ON SUBPRIME MORTGAGE LENDING

The Division seeks to substantially adopt the federal Statement on Subprime Mortgage Lending issued by the Office of the Comptroller of the Currency and other Agencies to federally insured depository institutions on July 10, 2007, to address emerging issues and questions relating to certain subprime mortgage lending practices.<sup>2</sup> The term "subprime" primarily refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income (DTI) ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans have a higher risk of default than loans to prime borrowers. Generally subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or at least one 60-day delinquency in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.
- Bankruptcy in the last 5 years.
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood.
- Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime loans. Additionally, this list may not match all market or institution specific subprime definitions, but should be used as a starting point from which the Division will undertake expanded examination efforts.

The Division is concerned borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.<sup>3</sup> In particular, the Division is concerned with certain adjustable-rate mortgage (ARM) products typically<sup>4</sup> offered to subprime borrowers that have one or more of the following characteristics:

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<sup>2</sup> The term "subprime" is described in the 2001 *Interagency Expanded Guidance for Subprime Lending Programs*. (Reprinted online at [www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf](http://www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf)) See OCC Bulletin 2001-6, Jan. 31, 2001

<sup>3</sup> Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

<sup>4</sup> As noted by the OCC and other federal agencies in the final statement, although the Interagency Subprime Statement focuses on subprime borrowers, it also applies to ARM products that have one or more characteristics that can cause payment shock. Registrants should look to the principles of this statement when such ARM products are offered to non-subprime borrowers.

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan.<sup>5</sup>
- Very high or no limits on how much the payment amount or the interest rate may increase (“payment or rate caps”) on reset dates.
- Limited or no documentation of borrowers’ income.
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment.
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks. The consequences to borrowers could include:

- Being unable to afford the monthly payments after the initial rate adjustment because of payment shock.
- Experiencing difficulty in paying real estate taxes and insurance that were not escrowed.
- Incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the initial rate adjustment date.
- The rate adjustment date.
- Losing their homes.

Consequences to brokers and lenders may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

While the Division’s Guidance on Nontraditional Mortgage Product Risks (see *DFI Mortgage Brokers & Lenders Letter 2006-3*) may not explicitly pertain to products with the characteristics addressed in this statement, it outlines prudent underwriting and consumer protection principles that registrants should consider with regard to subprime mortgage brokering and lending. This Statement reiterates many of the principles addressed in existing guidance relating to acting in good faith and fair dealing together with noting possible unfair and improper practices in contravention of state law.

### **Predatory Lending Considerations**

Subprime lending is not synonymous with predatory lending, and loans with ARMs are not per se prohibited by law. However, registrants should ensure that they do not engage in the types of predatory lending practices set forth in R.C. §1345.031. Typically, predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms.
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced (“loan flipping”).

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<sup>5</sup> For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Offering mortgage loans on such terms and in such manner as these can and will be used in the Division's determination of whether the Registrant meets the character and general fitness requirements set forth in the Ohio Mortgage Loan Act, R.C. §1321.53(A)(4). In addition, such conduct may result in violation of R.C. §1349.41(B), and possibly the Ohio Consumer Sales Practices Act (CSPA), R.C. §1345.02, which prohibits unfair or deceptive acts or practices.

**Underwriting Standards** - Registrants should refer to the section on "Loan Terms and Underwriting Standards" set forth in the *DFI Mortgage Brokers & Lenders Letter 2006-3* regarding the need for prudently underwritten real estate loans. Proper underwriting should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards also recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. A registrant'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,<sup>6</sup> assuming a fully amortizing repayment schedule.<sup>7</sup>

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. A registrant's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income. This assessment is particularly important if the registrant relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the lender and the borrower. Therefore, a registrant should have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, a registrant should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, registrants should verify and document the borrower's income (both source and amount), assets and liabilities. Reduced documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid

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<sup>6</sup> The "fully indexed rate" means the higher interest rate that will be imposed after the expiration of the introductory time period or by the occurrence of a specific triggering event for a mortgage loan agreement in which the current interest rate is a discounted or less than fully amortized interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

<sup>7</sup> The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

**Workout Arrangements** - The Division encourages its registrant note holders to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the lender and the borrower.

Registrants should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.<sup>8</sup> Such arrangements can vary widely based on the borrower's financial capacity. For example, a registrant might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The Division will not criticize registrants that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require registrants to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Registrants that place loans in their portfolio should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

### **Consumer Protection Principles**

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower's ability to repay the loan according to its terms.<sup>9</sup>
- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.<sup>10</sup>

Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products.<sup>11</sup> This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan. Registrants 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 (typically at least 60 days prior to the reset date) to refinance without penalty.

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses,

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<sup>8</sup> They may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

<sup>9</sup> See R.C. §1345.031(B)(2).

<sup>10</sup> See O.A.C. 1301:8-3-12(A) and (B).

<sup>11</sup> See R.C. §1321.60 and O.A.C. 1301:8-3-05.

they may be faced with the need for significant additional funds on short notice.<sup>12</sup> Therefore, mortgage product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of:

- Payment Shock. Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.<sup>13</sup>
- Prepayment Penalties. The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.
- Balloon Payments. The existence of any balloon payment.
- Cost of Reduced Documentation Loans. Whether there is a pricing premium attached to a reduced documentation or stated income loan program.
- Responsibility for Taxes and Insurance. The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

### **Control Systems**

Registrants should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, and encompass both one's own personnel and applicable third parties, which for lenders includes mortgage brokers and correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Registrants also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Registrants should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. A registrant'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, registrants should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

### **Supervisory Review**

The Division will continue to carefully review a registrant's management for consumer compliance processes, policies, and procedures. The Division will take action against

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<sup>12</sup> Note the requirements of R.C. §1322.063(A). Lenders generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

<sup>13</sup> To illustrate: a borrower earning \$42,000 per year obtains a \$200,000 "2/28" mortgage loan. The loan's two-year introductory fixed interest rate of 7% requires a principal and interest payment of \$1,331. Escrowing \$200 per month for taxes and insurance results in a total monthly payment of \$1,531 (\$1,331 + \$200), representing a 44% DTI ratio. A fully indexed interest rate of 11.5% (based on a six-month LIBOR index rate of 5.5% plus a 6% margin) would cause the borrower's principal and interest payment to increase to \$1,956. The adjusted total monthly payment of \$2,156 (\$1,956 + \$200 for taxes and insurance) represents a 41% increase in the payment amount and results in a 62% DTI ratio.

registrants and licensees that engage in predatory lending practices, violate consumer protection laws or fair lending laws, or otherwise engage in improper or dishonest activities.

**ACTION:** Registrants need to review their procedures to ensure compliance with current state law requiring they deal with buyers in good faith, demonstrate financial responsibility, character, and general fitness to warrant the belief that the business will be operated honestly and fairly in compliance with and within the purposes of the OMLA. Registrants also need to avoid unfair and deceptive acts or practices by adjusting their policies and practices accordingly to conform to this letter

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