

# CADWALADER

*Cadwalader, Wickersham & Taft*

100 Maiden Lane  
New York, NY 10038  
Tel: 212 504-6000  
Fax: 212 504-6666

New York  
Charlotte  
Washington  
London

## MEMORANDUM

**To:** Clients and Friends  
**From:** Cadwalader, Wickersham & Taft  
**Date:** February 8, 2001  
**Re:** Recent Interagency Expanded Guidance on Subprime Lending

---

---

On January 31, 2001 the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the “Agencies”) expanded previously issued examiner guidelines<sup>1</sup> for supervising subprime lending activities by certain insured depository institutions and their subsidiaries (the “Guidelines”). In a departure from the more generalized approach taken by the Agencies in the March 1999 Guidelines, the current Guidelines provide a definition of “subprime” and specify a range of capital over and above the minimum capital requirements as a starting point in determining the amount of capital needed to support the risks associated with subprime lending, including the retention of subordinated interests in securitized pools of subprime loans.

As a starting point, examiners will expect institutions whose level of subprime activity subjects them to the Guidelines to hold capital against their subprime portfolio in “an amount that is *one and one half to three times greater* than what is appropriate for non-subprime assets of a similar

---

<sup>1</sup> Interagency Guidance on Subprime Lending, March 1, 1999 (the “March 1999 Guidelines”).

type.” For institutions that underwrite higher-risk subprime asset pools, such as unsecured loans or high loan-to-value second mortgages, the Guidelines suggest that capital levels of as high as 100% of the loans outstanding may be necessary. The exact amount of capital required will be at the discretion of the examiners and the banking agencies.

In addition, the Guidelines hold each subprime lender responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities “and for *fully documenting* the methodology and analysis supporting the amount specified,” including portfolio stress test results. A finding that capital is inadequate to support the risk in an institution’s subprime lending activities can lead to supervisory action up to and including submission of a capital plan.

□ Applicability of Guidelines: The Guidelines apply specifically to those institutions that have subprime lending programs<sup>2</sup> with an aggregate credit exposure to subprime loans and residual subordinated interests in subprime pools greater than or equal to 25% of tier 1 capital.<sup>3</sup> Examiners have discretion to apply the Guidelines to smaller portfolios that are experiencing rapid growth or adverse performance trends, are administered by inexperienced management, or have inadequate or weak controls. The Guidelines expressly exclude (i) individual subprime loans originated and managed, in the ordinary course of business, as exceptions to prime risk selection standards, (ii) prime loans that develop credit problems after acquisition, (iii) loans initially extended in subprime programs that are later upgraded to prime as a result of performance, (iv) community development loans as defined in regulations under the Community Reinvestment

---

<sup>2</sup> For Guideline purposes the term “program” refers to the process of acquiring on a regular or targeted basis, either through origination or purchase, subprime loans to be held in the institution’s own portfolio *or accumulated and packaged for sale*.

<sup>3</sup> Tier 1 capital is defined in the Agencies’ risk-based capital standards: 12 CFR Part 3, Appendix A (OCC); 12 CFR Part 208, Appendix A (Federal Reserve); Part 325, Appendix A (FDIC); 12 CFR 565.2(h) (OTS).

Act that may have some higher risk characteristics that are mitigated by government program guarantees, private credit enhancements or other appropriate risk mitigation techniques.

□ Definition of “Subprime”: The Guidelines provide the following illustrative list of credit risk characteristics of subprime borrowers:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies 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) (Fair, Isaac & Co.) of 660 or below (depending on the product/collateral), or other credit bureau proprietary risk score with an equivalent default probability.
- 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.

□ Other Topics Covered: The Guidelines also provide guidance on: “Risk Management Expectations” with reference to the extensive Risk Management discussion in the March 1999 Guidelines; evaluation of the adequacy of an institution’s loan loss reserves (the “Allowance for Loan and Lease Losses”); criticism and referral for enforcement proceedings of “Predatory or Abusive Lending Practices”; “Examination Review and Analysis”; and individual loan and portfolio “Classification Guidelines”.

\* \* \*

The Guidelines are likely to have several, perhaps unintended, consequences. First, subprime lending and the acquisition of subprime loans sufficient in volume or nature to trigger the

Guidelines will incur significant capital costs that may reduce the number of available lenders and purchasers, result in higher rates or fees and increase the cost of credit to subprime borrowers.

Second, the Guidelines currently apply only to insured depository institutions and their subsidiaries and not to nonbank lending subsidiaries of bank holding companies.<sup>4</sup> As a consequence, bank holding companies will be encouraged to isolate subprime lending in a nonbank subsidiary of the holding company, further increasing the cost to the consumer owing to such companies' higher funding costs.

Third, it can be expected that participants in the subprime market who become subject to these higher capital requirements will seek to remove subprime loans from their balance sheets as promptly and fully as possible. Such participants may also seek to use short term, off-balance sheet, programs for interim financing prior to securitization or ultimate sale of subprime assets.

The increased capital requirements for subprime lenders send a clear message that the Agencies question whether risk management techniques alone are sufficient to mitigate the risk associated with subprime lending. It remains to be seen the extent to which significantly higher capital costs will discourage banks from engaging in subprime lending activities.

\* \* \*

If you have any questions concerning this memorandum, please call Derrick D. Cephas at (212) 504-6588, Lawrence D. Fruchtmann at (212) 504-6859, Barbara T. Barrantes at (212) 504-6702 or your principal contact at Cadwalader.

---

<sup>4</sup> The Agencies have proposed to amend the risk based capital rules to apply a dollar-for-dollar capital charge for all retained interests in securitizations, which would also apply to bank holding companies, but this proposal has not been finalized. See, 65 Federal Register 57993 (9/27/00).